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Revenue Recognition
SEC Comment Letter Considerations, Including Industry Insights
Segment Reporting
Share-Based Payment Awards
Statement of Cash Flows
Matt Himmelman and Steve Barta supervised the preparation of the April 2020 edition of this Roadmap and extend their deepest appreciation to all professionals who helped in its development, but in particular Patrice Mano and Paul Vitola, the other core members of the working group. This edition would not have been possible without the numerous contributions of the following professionals on the Accounting and Reporting Services team of Deloitte & Touche LLP’s National Office and the Washington National Tax team of Deloitte Tax LLP who were instrumental in developing the updated guidance contained herein:

Chris Ahl  
Chris Barton  
Justin Bettencourt  
David Brown  
Ryan Caldwell  
Chris Chiriatti  
Peggy Cullen  
Jeff Fitzgerald  
McKenna Hennelly  
Patrick Johnson  
Krystle Kort  
Peggy Cullen  
Jeff Fitzgerald  
McKenna Hennelly  
Patrick Johnson  
Krystle Kort  
Alice Loo  
Nikki Nikizad  
Peter O’Grady  
Tejal Shah  
Michael Watson  

Special thanks to those in our Production group who worked tirelessly to make this Roadmap a reality:

Teri Asarito  
Geri Driscoll  
David Eisenberg  
David Frangione  
Michael Lorenzo  
Peter McLaughlin  
Jeanine Pagliaro
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Preface

April 2020

To our friends and clients:

We are pleased to present the April 2020 edition of *A Roadmap to Accounting for Income Taxes*. This Roadmap provides Deloitte’s insights into and interpretations of the income tax accounting guidance in ASC 740\(^1\) and the differences between that standard and IFRS\(^\circledR\) Standards (in Appendix F). The income tax accounting framework has been in place for many years; however, views on the application of that framework to current transactions continue to evolve because structures and tax laws are continually changing. Therefore, use of this Roadmap, though it is intended as a helpful resource, is not a substitute for consultation with Deloitte professionals on complex income tax accounting questions or transactions.

The body of this Roadmap combines the income tax accounting rules from ASC 740 with Deloitte’s interpretations and examples in a comprehensive, reader-friendly format. The Roadmap reflects Accounting Standards Updates (ASUs) issued by the FASB through December 31, 2019. Each chapter of this publication typically starts with a brief introduction and includes excerpts from ASC 740 or related guidance, Deloitte’s interpretations of those excerpts, and examples to illustrate the relevant guidance. (Some of the calculations in the examples use rounded numbers for simplicity.) The Roadmap includes pending content from recently issued ASUs, some of which may already apply to some entities and others of which may allow for early adoption. Readers should refer to the transition guidance in the *FASB Accounting Standards Codification* or in the relevant ASU to determine the effective date(s) of the pending guidance.

Throughout the Roadmap, new guidance has been added and minor edits have been made to existing guidance to improve its clarity. The organization of this Roadmap has been changed significantly from that of previous versions so that the information is presented in a more logical and user-friendly manner. In addition, guidance on accounting for the tax effects of the Tax Cuts and Jobs Act, which was contained in Appendix B in the 2018 edition of this Roadmap, has been incorporated into the appropriate chapters in this edition.

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

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

Sincerely,

Deloitte & Touche LLP

\(^1\) For the full titles of standards, topics, and regulations, see Appendix G. For the full forms of abbreviations, see Appendix H.
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Chapter 1 — Overview

The accounting for income taxes under ASC 740 can be extremely complex. This chapter summarizes the core concepts under ASC 740 and gives an overview of the objectives of the accounting for income taxes.

<table>
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<th>ASC 740-10</th>
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| **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. 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.

| **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.

| **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.
1.1 Background of ASC 740

A basic principle of the taxation of income in many jurisdictions, including the U.S. federal jurisdiction, is that an entity is taxed only on its net earnings (i.e., it is taxed on total revenue after expenses incurred to generate the revenue have been deducted to arrive at a net amount of taxable income). Generally, an entity applies a rate or series of rates to taxable income to determine a preliminary amount of income tax owed for the period. In many jurisdictions, the entity then reduces that preliminary amount by available income tax credits, if any, to determine the ultimate amount of tax owed in a particular period.

If there were no differences between the way an entity determined its income before tax under U.S. GAAP and its taxable income, and there were no tax credits available, a profitable entity could simply multiply its U.S. GAAP income before tax by the statutory tax rate(s) applicable to the jurisdiction(s) in which the income was earned and record an income tax payable and corresponding expense each period. But there are many differences between income before tax determined under U.S. GAAP and taxable income. Accordingly, ASC 740 provides a framework for the accounting for income taxes that takes into account these differences. Under this framework, the amount of income tax expense an entity is required to record each period does not simply equal the amount of income tax payable each period. Rather, ASC 740 requires an entity to record income tax expense each period as if there were no differences between the timing of recognition of events for income before tax for U.S. GAAP purposes and that for taxable income. ASC 740 also requires an entity to reduce income tax expense otherwise determined each period (or record an overall income tax benefit) for the expected benefit of net operating losses (NOLs) and tax credits that, in many taxing jurisdictions, may be carried forward or back to reduce taxable income in a future period or get a refund of taxes paid in a prior period.

1.2 Objectives of ASC 740

There are two primary objectives related to accounting for income taxes:

a. To recognize the amount of taxes payable or refundable for the current year

b. 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.
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:

a. The tax payment or refund that results from a particular tax return is a joint result of all the items included in that return.

b. 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.

c. 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.

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

a. The amount of taxes that will be payable or refundable in future years inclusive of reversing temporary differences and carryforwards

b. The amount of taxes that would be payable or refundable in future years exclusive of reversing temporary differences and carryforwards.

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.

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

1.2.1 Understanding “Events That Have Been Recognized in an Entity's Financial Statements or Tax Returns”

Although the form of financial statements for financial reporting purposes is significantly different from the form of an income tax return, an entity could prepare a set of tax basis financial statements that would look very similar to a set of financial statements prepared for financial reporting purposes by using the information in the entity's income tax return. The accounting for income taxes is most easily understood if one first assumes that the income tax return is used to create a set of tax basis financial statements similar in form to a set of financial statements prepared for financial reporting purposes. ASC 740-10-20 defines an event as a “happening of consequence to an entity.” An event has an ASC 740 accounting consequence if it results in recognition in (1) the entity's U.S. GAAP financial statements for a period, (2) the entity's tax basis financial statements for a period, or (3) both.
1.2.2 Understanding “the Amount of Taxes Payable or Refundable for the Current Year”

An entity calculates the amount of income taxes payable or refundable for the current year by completing its income tax return(s) for the year. That process will result in the determination of an amount of income tax owed to a taxing authority or, in some circumstances, an amount of a refund due to the entity from the taxing authority. A current income tax payable or refundable is recorded for such amounts with an offset to current income tax expense in the income statement.

1.2.2.1 Permanent Differences

When an event is permanently recognized in a different manner or amount in U.S. GAAP financial statements than it is in tax basis financial statements, a permanent difference between pretax net income and taxable income arises. A common example of such an event in the United States is the recognition of certain portions of meals and entertainment expenses that are not deductible for tax purposes. Tax credits (whether used in the current period or carried forward to reduce income taxes otherwise owed in a future period), which reduce the amount of tax owed but do not affect the amount of income before tax for U.S. GAAP purposes, also create permanent differences.

Under ASC 740, entities inherently take into account the income tax effects of permanent differences other than those created by tax credit carryforwards by recognizing current income tax expense corresponding with “the amount of taxes payable or refundable for the current year.” In other words, such permanent differences will affect the amount of the income tax payable and corresponding current tax expense for the period. These permanent differences will also affect the income tax rate the entity appears to be paying on its U.S. GAAP pretax income (i.e., the entity's effective tax rate (ETR)). For example, if a cash expenditure results in an expense for financial reporting purposes but does not represent an expense for income tax purposes (i.e., because it is permanently disallowed), the entity's overall ETR for financial reporting purposes will be higher than its statutory rate. For this reason, permanent differences are often described as having a “rate impact” under ASC 740. Permanent differences do not give rise to deferred tax assets (DTAs) and deferred tax liabilities (DTLs).

The income tax effects of permanent differences created by tax credit carryforwards result in DTAs and do not affect the amount of income taxes payable in the current period. See the discussion of attributes in Section 1.2.3.2.

1.2.3 Understanding “Deferred Tax Assets and Liabilities” and “Future Tax Consequences”

DTAs and DTLs (1) represent the future tax consequences of certain events that have been recognized differently for U.S. GAAP or tax purposes and (2) result from two primary sources: temporary differences and attributes.

1.2.3.1 Temporary Differences

Temporary differences arise when an event is ultimately accounted for in the same manner and amount for U.S. GAAP and tax purposes but in different periods. When such an event is recognized in either the U.S. GAAP or tax basis financial statements, a temporary difference may arise between pretax net income reported for financial reporting purposes and taxable income reported for income tax purposes.
Chapter 1 — Overview

As a simple example, assume that an entity acquires a fixed asset with cash of $100 and capitalizes the expenditure for both financial reporting and income tax purposes. Assume further that for income tax purposes, the fixed asset is depreciated entirely in one year, but it is depreciated over five years for financial reporting purposes. After one year, the asset will have a carrying amount or “basis” of $0 for income tax purposes but will have a carrying amount of $80 for financial reporting purposes. This $80 basis difference is temporary because ultimately the entire $100 will be recognized as an expense for both financial reporting and income tax purposes. Since the expense will be recognized in different periods, a temporary difference arises in the treatment of the expenditure.

ASC 740-10-25-20 identifies a number of additional types of events that could create a temporary difference. Such events and temporary differences are discussed in more detail in Chapter 3.

1.2.3.1.1 Future Tax Consequences of Temporary Differences

To recognize the “future tax consequences of [the] events that have [temporarily] been recognized [differently] in an entity’s financial statements [than in its] tax returns,” an entity must use a balance sheet model in accordance with ASC 740. A critical assumption under this model is that all of the entity’s assets and liabilities will be recovered or settled, respectively, at their financial statement carrying amount as determined under U.S. GAAP at the end of the reporting period. To understand the importance of this assumption, management and practitioners must understand the concepts of “financial statement carrying amount” and “tax basis.”

The initial “carrying amount” or “basis” for both financial reporting purposes and income tax purposes can generally be thought of as the amount of consideration paid to acquire an asset or the amount of consideration received upon incurring a liability. For example, the initial carrying amount or basis in a fixed asset for both financial reporting and income tax purposes is typically the amount of cash paid to acquire it. Similarly, the carrying amount or basis of a note payable is usually the amount of cash received upon the note’s issuance. The initial carrying amount is subsequently adjusted for appreciation, accretion, depreciation, amortization, or impairment (as permitted or required under financial reporting and income tax reporting rules). That is, the carrying amount for financial reporting purposes and for income tax purposes is the amount at which the asset or liability is reported in the U.S. GAAP and (hypothetical) tax basis balance sheet at the end of the reporting period.

When an asset is recovered, an entity generally either pays income tax (at the statutory tax rate) on the amount of proceeds in excess of the tax basis or takes a deduction for the amount by which the tax basis exceeds the proceeds received. Similarly, the entity takes a deduction for the amount by which the consideration paid to settle a liability exceeds the tax basis (a loss) or pays tax on the amount by which the tax basis of the liability exceeds the consideration paid to settle it (a gain).

Under the balance sheet model, the entity compares the financial statement carrying amount of each of its assets and liabilities with the carrying amount or “basis” of each of those assets and liabilities for income tax purposes in the relevant taxing jurisdiction. Any difference between the carrying amount of an asset or liability for financial reporting purposes and that for income tax purposes must be analyzed to determine whether it is a temporary difference that gives rise to a DTA or DTL. The “future tax consequences of events that have been recognized [differently] in an entity’s financial statements [than in its] tax returns” are the tax effects, as described in the previous paragraph, that would arise if the asset were recovered or the liability were settled at its financial statement carrying amount. If a tax liability would result, the entity has a taxable temporary difference and records a DTL with a corresponding deferred tax expense in the income statement. If a deduction would result, the entity has a deductible temporary difference and records a DTA with a corresponding deferred tax benefit in the income statement. If no tax consequence would arise, the basis difference is not a temporary difference that gives rise to a DTA or DTL.
To revisit the example in Section 1.2.3.1, at the end of the first year, the “future tax consequences of [the] events that have [temporarily] been recognized [differently] in an entity's financial statements [than in its] tax returns” assuming the entity were to recover the asset for its financial statement carrying amount would be a taxable gain of $80 (i.e., the amount by which the $80 that hypothetically would be received upon the assumed recovery exceeds the current tax basis of $0). Therefore, the entity would record a DTL at the end of the first year representing the future tax consequence (a future tax payable on an $80 gain) of recovering the fixed asset for its financial statement carrying amount. Assuming a 20 percent tax rate, the entity would record a DTL for $16.

1.2.3.2 Attributes

In some jurisdictions, entities are permitted to carry forward or back losses (as determined under income tax rules of the relevant jurisdiction) to offset earnings of a future or prior period (and potentially get a refund of taxes paid on income of a previous period). These losses are commonly referred to as NOL carryforwards or carrybacks. Similarly, an entity may be permitted to carry forward or back income tax credits that it could not use in the current year. NOLs and tax credits that may be carried forward are commonly referred to as attributes.

1.2.3.2.1 Future Tax Consequences of Attributes

The future tax consequence of an attribute is generally either a deferred deduction (i.e., an NOL carryforward that can be used to reduce taxable income of a future period) or a deferred income tax credit (to reduce the amount of income tax otherwise owed in a future period), each of which is represented by a DTA. DTAs and corresponding deferred tax benefits are recorded for attributes, subject to an assessment of realizability, to reflect the “future tax consequences” of the event (generation of the NOL or tax credit carryforward) that has occurred in the entity's tax basis financial statements. The future tax consequence is the reduction in taxes owed as a result of applying a credit carryforward to reduce taxes payable or applying an NOL carryforward to reduce taxable income of a future period.

1.2.4 Complexities in Applying ASC 740

While the objectives of ASC 740 may seem straightforward in simple scenarios, there can be a tremendous amount of complexity in the accounting for income taxes under ASC 740. The above overview may serve as a foundation for an understanding of the concepts and complexities discussed in the remaining chapters.
Chapter 2 — Scope

2.1 Introduction
ASC 740 applies to the accounting for all taxes imposed on an entity by a taxing authority that are based on the entity’s income. This may include taxes imposed by U.S. and foreign federal, state, and local jurisdictions and is true regardless of how a tax is labeled by a particular jurisdiction. Although this principle may appear simple, entities must often use significant judgment in determining whether a tax is an income tax within the scope of ASC 740. Taxes that are not income taxes within the scope of ASC 740 are accounted for in accordance with other U.S. GAAP generally applicable to the recognition, measurement, and disclosure of assets and liabilities, income, and expenses throughout the Codification. This can result in significant differences between the accounting for taxes under ASC 740 and the accounting for taxes under other Codification guidance. For example, deferred taxes are not recognized for non-income-based taxes, and neither expense nor income associated with non-income-based taxes is recorded in the income tax expense line in the statement of operations. In addition, uncertainties about the recognition and measurement of a non-income-based tax in a particular jurisdiction would not be accounted for in accordance with the guidance applicable to uncertain tax positions in ASC 740-10.

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.

15-2A Paragraph not used.

15-2AA The guidance in this Subtopic relating to accounting for uncertainty in income taxes applies 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.

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.
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.

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.

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.

The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax (or similar tax) to the extent it is based on capital or a non-income-based amount and there is no portion of the tax based on income. If a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred tax assets and liabilities shall be recognized and accounted for in accordance with this Topic. Deferred tax assets and liabilities shall be measured using the applicable statutory income tax rate. An entity shall not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets. The amount of current tax expense equal to the amount that is based on income shall be accounted for in accordance with this Topic, with any incremental amount incurred accounted for as a non-income-based tax. See Example 17 (paragraph 740-10-55-139) for an example of how to apply this guidance.

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.

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

Related Implementation Guidance and Illustrations

- Treatment of Certain Payments to Taxing Authorities [ASC 740-10-55-67].
- Example 17: Determining Whether a Tax Is an Income Tax [ASC 740-10-55-139].
2.2 Taxes Based on Income

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.

For a tax to be an income tax within the scope of ASC 740, revenues and gains must be 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 authoritative literature (e.g., ASC 450).

2.3 Taxes Assessed in Lieu of Income Tax

In certain jurisdictions and for certain entities, an entity may be subject to certain taxes in lieu of an income tax, such as an excise or other type of tax. For example, not-for-profit foundations that make certain minimum distributions are generally exempt from U.S. 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. Entities should carefully consider how each type of tax is assessed to determine whether the tax should be included within the scope of ASC 740.

Further, the questions of whether an entity is subject to a tax based on income or a non-income-based tax in a particular jurisdiction are not always mutually exclusive. See Section 2.5 for information on hybrid tax regimes, in which an entity may be subject to both income and non-income-based taxes or be subject to tax based on the higher of an income tax or a non-income-based tax.

2.4 Certain Entities Exempt From Income Taxes on the Basis of Legal Form

The legal form established for an entity may determine whether the entity is taxable or tax exempt. 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, and certain LLCs), or they function similarly to a pass-through entity (e.g., real estate investment trust (REIT), regulated investment company (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. That is, an
entity that was previously tax exempt may be subject to income taxes if it no longer meets certain legal conditions required by its taxing authority to qualify for tax-exempt status. See Section 4.1.2.1 for an example of how an entity should consider a taxing authority’s administrative practices and precedents in regard to its tax-exempt status.

In addition, an entity may change its tax status, which may affect its designation as either a taxable or nontaxable entity. Changes in tax status can be voluntary or involuntary, and the accounting treatment for each may be different. Further, complexities can arise regarding the measurement of the tax implications and timing of recognition depending on the structure of the transaction. See Section 3.5.2 for further discussion of an entity's change in tax status.

2.5 Hybrid Taxes

An entity's tax obligation may not always solely be determined by applying either an income-based measure or a non-income-based measure. In a hybrid tax regime, the 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 increment (in addition to the income tax). 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 an entity is 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, the 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, the 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book pretax income</td>
<td>$80,000</td>
</tr>
<tr>
<td>Originating taxable temporary difference</td>
<td>3,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$77,000</td>
</tr>
<tr>
<td>Current tax payable (based on income)</td>
<td>$19,250</td>
</tr>
<tr>
<td>Capital tax (“floor” amount) that is considered to be outside the scope of ASC 740</td>
<td>8,000</td>
</tr>
<tr>
<td>Current tax within the scope of ASC 740</td>
<td>$11,250</td>
</tr>
</tbody>
</table>

Changing Lanes

Stakeholders indicated to the FASB that the guidance on hybrid tax regimes increased the cost and complexity of applying ASC 740, particularly when the tax amount deemed to be a non-income tax was insignificant. Further, the guidance introduced complexity in the determination of the appropriate tax rate an entity should use when recording deferred taxes. As part of the Board’s Simplification Initiative, in December 2019, the FASB issued ASU 2019-12, which modifies the requirements related to the accounting for hybrid tax regimes. Although ASC 740 does not apply to taxes that are based on items other than income, ASC 740-10-15-4 specifies that in the context of a franchise tax that is based on capital, if there is a tax based on income that is greater than the tax that is based on capital, only that excess is subject to the guidance in ASC 740.

To reduce the cost and complexity of applying ASC 740, the FASB amended ASC 740-10-15-4(a) to state that if there is an amount that is based on taxable profit, it should be included in the tax provision, with any incremental amount recorded as a non-income-based tax. This amendment effectively reverses the order in which an entity determines the type of tax under current U.S. GAAP. In addition, the ASU provides related amendments to the illustrative examples in ASC 740-10-55-26 and ASC 740-10-55-139 through 55-144. The FASB notes that the amendments are consistent with the accounting for other incremental taxes, such as the base erosion anti-abuse tax (BEAT).

The FASB originally proposed that these amendments be applied on a retrospective basis. However, upon redeliberation in September 2019, the Board reversed its decision and decided to allow application of the amendment by using either a retrospective or a modified retrospective approach. For further information about ASU 2019-12, see Appendix B.
2.6 Accounting for Withholdings on Certain Payments (e.g., Dividends, Interest, Royalties, or License Fees)

In some tax jurisdictions, dividends to owners and other payments (e.g., interest, royalty, or license payments) may trigger a tax obligation to the tax authority in the payor’s jurisdiction (sometimes referred to as a “withholding tax”). Such a tax may be required to be withheld from the payment by the payor and remitted to the taxing authority. It is not always clear whether the payor or the recipient should account for the tax as an income tax, and careful consideration is often required.

2.6.1 Accounting for a Withholding Tax by the Payor

Treatment of the withholding tax by the payor of the dividend will depend on whether the tax is assessed on the payor or on the payee. This is a legal determination in the jurisdiction of the payor.

In some jurisdictions, a tax based on dividends distributed is assessed directly on the dividend payor. In these cases, remittance of the withholding tax should be accounted for in equity as a part of the dividend (rather than as an expense of the payor) only if both of the conditions outlined in ASC 740-10-15-4(b) are met. 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 is not met, a tax assessed directly on the dividend payor should not be considered a withholding for the benefit of the recipient. Instead, it should be accounted for by the payor as either 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 by the payor 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 part of tax expense or benefit from continuing operations.

2.6.2 Accounting for a Withholding Tax by the Recipient

Most taxes on dividends are assessed on the recipient of the dividend but are required to be withheld and remitted to the taxing authority by the payor. In these instances, the remittance of the withholding tax to the tax authority by the dividend payor is accounted for by the payor in its financial statements as a reduction to equity (i.e., 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.

ASC 740 does not provide guidance on determining whether recipients of certain payments (e.g., dividends or royalties) should account for withholding taxes as income taxes within the scope of ASC 740.
ASC 740-10-55-24 states the following regarding taxes withheld from dividends:

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

It can be inferred from this guidance that the FASB intended withholding taxes on dividends to be a component of income taxes. However, ASC 946-220-45-3 discusses the presentation of certain items in the statement of operations of an investment company and suggests that withholding taxes might, in fact, be considered as “other taxes.” ASC 946-220-45-3 states, in part:

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

g. Federal and state income taxes (these expenses shall be shown separately after the income category to which they apply, such as investment income and realized or unrealized gains)

h. Other taxes (foreign withholding taxes shall be deducted from the relevant income item and presented parenthetically or shown as a separate contra item in the income section).

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

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

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

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

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

• Is the withholding tax creditable on an income tax return filed by the receiving entity or by the receiving entity’s parent?

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

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

When determining the classification of these credits, an entity may consider them to be a form of government grant or assistance. An entity may look to paragraphs 24 and 29 of IAS 20 for guidance on government grants. Under paragraph 24 of IAS 20, an entity presents government grants related to assets “either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.” Further, paragraph 29 of IAS 20 states, “[g]rants 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.

Credits whose realization ultimately depends on taxable income (e.g., investment tax credits (ITCs) and R&D credits) are generally recognized as a reduction of income tax expense, 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). See Section 3.5.9 for further information and illustrative examples of the application of these two methods.

2.8 Obligations for Indemnification of Uncertain Tax Positions of a Subsidiary Upon Sale — Subsidiary Previously Filed a Separate Tax Return

In a sale transaction, it is common for one party to indemnify the other for a particular contingency. If the acquiree previously filed a separate tax return from the parent (i.e., seller), the indemnification agreement between the buyer and seller might be related to income tax positions taken by the acquiree before the transaction. In these situations, we believe that the seller's indemnification obligation is not within the scope of ASC 740 (i.e., because the seller is not jointly and severally liable for the income tax obligations of the acquiree when the acquiree filed a separate return). Rather, the seller should account for the indemnification obligation in accordance with other applicable U.S. GAAP.

Example 2-2

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 unrecognized tax benefit (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.
**Example 2-2 (continued)**

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

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

Assume the following:

- The uncertain tax benefit is $110.
- 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 $100.
- Company A has an ETR of 25 percent.
- For A, the disposition of Z does not qualify for presentation as a discontinued operation in accordance with ASC 205-20.

The following entries illustrate A’s accounting for the UTB upon the sale of Z.

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain/loss on sale</td>
<td>100</td>
</tr>
<tr>
<td>Indemnification liability</td>
<td>100</td>
</tr>
</tbody>
</table>

To record the deductible temporary difference related to the difference between the reported amount and the tax basis of the indemnification liability (i.e., 25% of $100):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>25</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>25</td>
</tr>
</tbody>
</table>

If the UTB liability were ultimately settled with the tax authority for $76, 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indemnification liability</td>
<td>100</td>
</tr>
<tr>
<td>Cash</td>
<td>76</td>
</tr>
<tr>
<td>Gain/loss on settlement</td>
<td>24</td>
</tr>
</tbody>
</table>

To record the reduction in taxes payable related to the deduction for the payment of the indemnification and reversal of the related DTA, resulting in total net current and deferred tax expense in the period of payment of $6 ($25 deferred tax expense less $19 current tax benefit):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>25</td>
</tr>
<tr>
<td>DTA</td>
<td>25</td>
</tr>
<tr>
<td>Current tax payable</td>
<td>19</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>19</td>
</tr>
</tbody>
</table>

The acquirer in such a business combination may be required to record an indemnification asset under ASC 805. Section 11.3.6.6 provides interpretive guidance, including examples, related to the acquirer’s accounting in such circumstances.
Chapter 3 — Book-Versus-Tax Differences and Tax Attributes

3.1 Background
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, giving rise to book-versus-tax differences. Such differences may be “permanent” or “temporary.” Differences that arise from statutory provisions under which (1) specified revenues are exempt from taxation and (2) certain expenses are not allowed as deductions in the determination of taxable income are considered permanent. Permanent items generally affect income tax expense and the ETR. Typically, temporary differences do not affect total income tax expense or the ETR in the absence of a phased-in change in tax rate or other similar situations. In addition, the tax law may provide for tax incentives in the form of “special deductions” and tax credits that are not reflected in pretax income 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.

3.2 Permanent Differences

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis Differences That Are Not Temporary Differences</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

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.
The following table illustrates many of the more common permanent differences that result from the application of U.S. federal tax law to items recognized for financial reporting purposes.

<table>
<thead>
<tr>
<th>Accounting Description</th>
<th>Treatment</th>
<th>Tax Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-exempt securities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Interest income</td>
<td>Income</td>
<td>Tax exempt (IRC Section 103).</td>
</tr>
<tr>
<td>2. Interest paid on debt incurred to buy or carry tax-exempt securities</td>
<td>Expense</td>
<td>Not deductible (IRC Section 265).</td>
</tr>
<tr>
<td>3. Amortization of bond premium</td>
<td>Expensed by using interest method (ASC 835-30-35-2)</td>
<td>Not deductible (IRC Section 171(a)); however, basis of bond must be reduced by amount of amortization (IRC Section 1016(a)(5)).</td>
</tr>
</tbody>
</table>
| 4. Gains or losses upon disposition | Income (loss) | a. No gain or loss if held to maturity (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(e)(1)(c)). |
| Expenses paid or incurred with respect to legislative matters that are not in direct interest to the taxpayer's trade of business | Expense | Not deductible (IRC Treas. Reg. 1.162-20(c)). |
| Fines and penalties paid to the government of the United States, a territory or possession of the United States, the District of Columbia, a foreign country, or a political subdivision of any of the above for the violation of any law | Expense | Not deductible (IRC Section 162(f)). |
| Worthless debts from political parties | Expense | Generally, not deductible. May be deducted by banks and other taxpayers if more than 30 percent of all receivables accrued 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., foreign tax credit (FTC), jobs credit) | Expense | Not deductible. |
| Entertainment expense | Expense | 100 percent reduction in expense for tax purposes (IRC Section 274(a)). |
| Meals expense | Expense | 50 percent reduction in expense for tax purposes (IRC Section 274(m)). |
| Political contributions | Expense | Not deductible (IRC Treas. Reg. 1.162-20(c)(1)). |
3.2.1 Consideration of Special Deductions That Are Permitted Under the Tax Law

ASC 740-10

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. 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. 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:

a. 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
b. 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.

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.

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.

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. 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.
Other common permanent differences that result from the application of U.S. federal tax law include special deductions. The tax law permits certain entities to recognize certain tax benefits for special deductions. The term “special deduction” is not defined, but ASC 740-10-25-37 and ASC 740-10-55-27 through 55-30 offer four examples: (1) tax benefits for statutory depletion, (2) special deductions for certain health benefit entities (e.g., Blue Cross/Blue Shield providers), (3) special deductions for small life insurance companies, and (4) a deduction for domestic production activities. In addition, the deduction for foreign-derived intangible income (FDII) 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.”

Sections 3.2.1.1 through 3.2.1.5 summarize the special deductions discussed above.

### 3.2.1.1 Statutory Depletion

IRC Sections 611–613 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.

### 3.2.1.2 Blue Cross/Blue Shield

IRC Section 833 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.

### 3.2.1.3 Small Life Insurance Companies

IRC Section 806 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 LICITI from $3 million to $15 million. In addition, the small life insurance company deduction is disallowed if a company has assets of $500 million or more.
3.2.1.4 Domestic Production Activities Deduction

The domestic production activities deduction was enacted into law in the United States on October 22, 2004, as part of the American Jobs Creation Act of 2004 (the “Jobs Creation Act”). 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 was 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. The domestic production activities deduction was repealed upon enactment of the Tax Cuts and Jobs Act (the “Act”) on December 22, 2017.

3.2.1.5 FDII

IRC Section 250 allows a domestic corporation an immediate deduction in U.S. taxable income for a portion of its FDII. The amount of the deduction depends, in part, on the corporation's U.S. taxable income. The percentage of income that can be deducted is reduced in taxable years beginning after December 31, 2025.

Example 3-1

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:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0–$50,000</td>
<td>15%</td>
</tr>
<tr>
<td>$50,001–$75,000</td>
<td>25%</td>
</tr>
<tr>
<td>$75,001–$100,000</td>
<td>34%</td>
</tr>
<tr>
<td>$100,001–$335,000</td>
<td>39%</td>
</tr>
<tr>
<td>$335,001–$10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>$10,000,001–$15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>$15,000,001–$18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>$18,333,334 and over</td>
<td>35%</td>
</tr>
</tbody>
</table>

- 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.
Example 3-1 (continued)

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:

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Expected future taxable income (loss) for 20X2, excluding temporary differences</td>
<td>$1,000,000</td>
<td>$100,000</td>
<td>$(400,000)</td>
</tr>
<tr>
<td>2. Taxable temporary difference</td>
<td>300,000</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>3. Special deduction [(1+2) \times 60%]</td>
<td>(780,000)</td>
<td>(240,000)</td>
<td>—</td>
</tr>
<tr>
<td>4. Expected future taxable income (loss)</td>
<td>$520,000</td>
<td>$160,000</td>
<td>$(100,000)</td>
</tr>
<tr>
<td>5. Expected future tax liability*</td>
<td>$176,800</td>
<td>$45,650</td>
<td>—</td>
</tr>
<tr>
<td>6. Applicable tax rate (5 ÷ 4)**</td>
<td>34%</td>
<td>28.5%</td>
<td>15%</td>
</tr>
<tr>
<td>7. DTL (2 \times 6)</td>
<td>$102,000</td>
<td>$85,500</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

* 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 Section 3.3.4.1.1).

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.

3.3 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.
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. 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. Those differences will result in taxable or deductible amounts when the reported amounts of the assets or liabilities are recovered or settled, respectively.
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. 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. Those differences will result in taxable or deductible amounts when the reported amounts of the assets or liabilities are recovered or settled, respectively.
ASC 740-10 (continued)

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

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.

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.

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.

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

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

**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 and intra-entity transfers of assets other than inventory (the examples in paragraph 740-10-25-20(h) through (i)) may give rise to both taxable and deductible temporary differences.

**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.

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

**25-25** That occurs, for example, when revenue on a long-term contract 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). 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.

**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.

**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.
3.3.1 Overview

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 Section 3.3.3.1 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. The appropriate identification of temporary differences is important because DTAs and DTLs are recorded for all temporary differences unless an exception applies.

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.
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.

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.

There are two categories of basis differences: “inside” basis differences and “outside” basis differences. An inside basis difference is a difference between the carrying amount, for financial reporting purposes, of an individual asset or liability and its tax basis. 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.

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). See Section 3.4 for a discussion of outside basis differences.

Temporary differences are basis differences that will give rise to a tax deduction or taxable income when the related asset is recovered or liability is settled for its financial reporting carrying value.

### 3.3.2 Determining Whether a Basis Difference Is a Temporary Difference

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.” 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.

#### 3.3.2.1 Examples of Basis Differences That Are Not Temporary Differences

Some basis differences do not result in taxable or deductible amounts in future years and are not considered temporary differences. Examples include the following:

##### 3.3.2.1.1 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).

3.3.2.1.2 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 Section 3.4.3.

3.3.2.1.3 Nontaxable Entities
Under U.S. federal tax law, C corporations are taxed on their income and gains directly, whereas nontaxable flow-through entities such as S corporations and REITs are not directly taxed, but their income and gains are passed through to the individual tax returns of their shareholders. Generally, basis differences in assets and liabilities held by nontaxable entities are not taxable/deductible temporary differences for which deferred taxes should be recorded. However, see Section 3.5.4.2 for a discussion of unrealized built-in gains for which a DTL is required.

3.3.2.1.4 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 determined under ASC 715-60 (i.e., the postretirement benefit obligation is recorded net of the subsidy, and the net amount is actuarially determined). Under the 2003 Act, the subsidy received was not considered taxable income to the employer for federal income tax purposes, but the employer was permitted to deduct the entire cost of providing the prescription drug coverage. 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, when the employer first incorporated the subsidy into its measurement of its postretirement benefit obligation (thereby reducing it), that incorporation should not have resulted in an adjustment to the employer’s DTA (because the entire amount of the cost of the prescription drug coverage was still deductible when paid, irrespective of the fact that it would be partially offset by the nontaxable subsidy).

In March 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”). The 2010 Health Care Act repealed the provision in the 2003 Act that permitted deduction of the entire cost of prescription drug coverage but did not change the treatment of the subsidy (i.e., it remained nontaxable). Because the portion of the prescription drug costs that will be offset by the subsidy is no longer tax deductible, and the subsidy remains nontaxable, the temporary difference and related DTA should be determined without regard to (1) the portion of the cost of prescription drug coverage that will be offset by the subsidy and (2) the subsidy itself.
3.3.3 Measurement of Temporary Differences

As discussed in Section 3.3.1, 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, 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. Once the temporary difference is determined, an entity should determine the amount at which the DTAs and DTLs should be measured. Measurement of temporary differences involves identification of the financial reporting carrying value and tax basis as well as consideration of the level of uncertainty regarding each position taken by the entity.

3.3.3.1 Tax Bases Used in the Computation of Temporary Differences

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. See Chapter 4 for details.

3.3.3.2 Anticipation of Future Losses

When determining whether a basis difference is a taxable or deductible temporary difference, an entity should not anticipate losses expected in future years.

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:

a. 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

b. 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, ASC 740-10-25-38 goes on to state that the anticipation of the tax consequences of future tax losses is prohibited. Therefore, an entity is not permitted to anticipate the tax consequences of future tax losses when measuring temporary differences and deferred tax consequences of existing taxable temporary differences.

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.

As the complexity of an entity’s legal structure and jurisdictional footprint increases, so do the challenges with measuring tax assets and liabilities.
3.3.4 Measurement of Deferred Taxes

**ASC 740-10**

**General**

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.

30-3 Total income tax expense (or benefit) for the year is the sum of deferred tax expense (or benefit) and income taxes currently payable or refundable.

**Deferred Tax Expense (or Benefit)**

30-4 Deferred tax expense (or benefit) is the change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets recognized in a business combination or in an acquisition by a not-for-profit entity during the year, it is the change since the acquisition date. Paragraph 830-740-45-1 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred foreign tax liability or asset when the reporting currency is the functional currency.

30-5 Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify the types and amounts of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.

b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (see paragraph 740-10-30-8).

c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.

d. Measure deferred tax assets for each type of tax credit carryforward.

e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

**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.
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).

Applicable Tax Rate Used to Measure Deferred Taxes

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. Deferred taxes shall not be accounted for on a discounted basis.

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.

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).

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

**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.

**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.

**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.

**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].

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.”

ASC 740-10-55-23 states, in part:

> 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.
Determining the tax rate to apply to certain types of temporary differences and carryforwards may not always be straightforward.

### 3.3.4.1 Graduated Tax Rates

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.” 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 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 further 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 notional estimate begins with pretax accounting income adjusted for permanent differences and reversal of existing taxable and deductible temporary differences. Further, projections of future income should be consistent with projections made elsewhere by the entity. Example 3-2 below illustrates the measurement of DTAs and DTLs when graduated tax rates are a significant factor.

#### Example 3-2

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:

<table>
<thead>
<tr>
<th>Taxable Income Over</th>
<th>Not Over</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>0</td>
<td>$50,000</td>
</tr>
<tr>
<td>50,000</td>
<td>75,000</td>
<td>25%</td>
</tr>
<tr>
<td>75,000</td>
<td>100,000</td>
<td>34%</td>
</tr>
<tr>
<td>100,000</td>
<td>335,000</td>
<td>39%</td>
</tr>
<tr>
<td>335,000</td>
<td>10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>10,000,000</td>
<td>15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>15,000,000</td>
<td>18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>18,333,333</td>
<td></td>
<td>35%</td>
</tr>
</tbody>
</table>

- 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.
Example 3-2 (continued)

Estimated taxable income and estimated income taxes payable for those years are computed as follows:

<table>
<thead>
<tr>
<th>Future Years</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated pretax income — exclusive of temporary differences</td>
<td>$410,000</td>
<td>$110,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Reversing deductible temporary differences</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>(a) Estimated taxable income</td>
<td>$400,000</td>
<td>$100,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Tax based on graduated tax rates:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$(50,000 × 15%)</td>
<td>7,500</td>
<td>7,500</td>
<td>7,500</td>
</tr>
<tr>
<td>$(25,000 × 25%)</td>
<td>6,250</td>
<td>6,250</td>
<td>6,250</td>
</tr>
<tr>
<td>$(25,000 × 34%)</td>
<td>8,500</td>
<td>8,500</td>
<td>8,500</td>
</tr>
<tr>
<td>$(235,000 × 39%)</td>
<td>91,650</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(over $335,000 × 34%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Estimated tax</td>
<td>$136,000</td>
<td>$22,250</td>
<td>$7,500</td>
</tr>
<tr>
<td>(c) Applicable tax rate (b ÷ a)</td>
<td>34%</td>
<td>22.3%</td>
<td>15%</td>
</tr>
<tr>
<td>Deferred income tax ($10,000 × c)</td>
<td>$3,400</td>
<td>$2,230</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

Entity X's average applicable tax rate is 23.8 percent ([($3,400 + $2,230 + $1,500) ÷ $30,000]), Therefore, X recognizes a DTA of $7,130 ($30,000 × 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 from $335,000 to $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.

3.3.4.1.1 Measurement When Future Tax Losses Are Expected in a Graduated Tax Rate Structure

If tax losses that would otherwise expire unused are expected in future years, an entity would use the lowest tax rate in a graduated tax structure, rather than zero, to measure a DTL for tax consequences of taxable temporary differences. Example 3-3 illustrates the measurement of the deferred tax consequences of taxable temporary differences when tax losses are expected in future years.
Example 3-3

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:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1–$100,000</td>
<td>10%</td>
</tr>
<tr>
<td>$100,001 and above</td>
<td>20%</td>
</tr>
</tbody>
</table>

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 × 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).

3.3.4.2 Phased-In Changes in Tax Rates

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.

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 is expected to be offset by tax loss carryforwards.

3.3.4.2.1 Measurement When Contingent Phased-In Changes in Tax Rates Are Enacted

In certain jurisdictions, the change in tax rates may be contingent on an event outside an entity's control. 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 3-4 below 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 3-4**

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 corporate net income tax (CNIT) rate. The rate reduction schedule was as follows:

<table>
<thead>
<tr>
<th>Schedule — CNIT Rate</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax years beginning on or after January 1, 2009</td>
<td>8.50%</td>
</tr>
<tr>
<td>Tax years beginning on or after January 1, 2012</td>
<td>7.75%</td>
</tr>
<tr>
<td>Tax years beginning on or after January 1, 2013</td>
<td>7.00%</td>
</tr>
<tr>
<td>Tax years beginning on or after January 1, 2014</td>
<td>6.50%</td>
</tr>
</tbody>
</table>

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 be applied only 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.

### 3.3.4.3 Tax Rate Used in Measuring Receivables and DTAs Related to Operating Losses and Tax Credits

In measuring temporary differences and certain tax attributes, entities should pay close attention to the appropriate tax rate to be used. For example, 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 Section 3.3.4.1 for guidance on determining the applicable tax rate when an entity operates in a jurisdiction with graduated tax rates.) For details on determining whether a valuation allowance is needed, see Chapter 5.

Example 3-5

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 measure the taxable temporary difference related to the $2,000 current-year deductions at 40 percent, since the temporary difference will reverse after the statutory tax rate has increased to 40 percent, and measure the receivable related to the NOL of $500 at 35 percent, since A would carry back the $500 loss to offset prior-year income taxed at 35 percent.

3.3.4.4 Measuring Deferred Taxes on Indefinite-Lived Assets

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.

An entity would recognize deferred taxes for a temporary difference related to an indefinite-lived asset (e.g., land and indefinite-lived intangible assets). Although the tax effect related to these items may be delayed indefinitely, the ability to do so is not a factor in the determination of whether a temporary difference exists.

ASC 740-10-25-20 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.

Further, 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.”

Certain jurisdictions may impose a tax rate for ordinary income that is different from the tax rate for income that is capital (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 Section 5.3.1.3 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.

### 3.3.4.5 Effect of Tax Holidays on the Applicable Tax Rate

**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.

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, recognition of a DTA to reflect the fact that an entity will not be paying taxes for the period of the tax holiday is prohibited. However, an entity's use of a rate that reflects the tax holiday to record a DTA or DTL for temporary differences scheduled to reverse during the period of the tax holiday does not violate the “[r]ecognition 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 3-6** illustrates the accounting for the tax benefits of a tax holiday.
Example 3-6

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 × 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.

3.3.4.6 Consideration of Certain State Matters

An entity should consider the three factors below when (1) determining the enacted tax rate that is expected to apply in periods in which the DTAs or DTLs are expected to be recovered or settled and (2) measuring DTAs and DTLs in U.S. state income tax jurisdictions.

3.3.4.6.1 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 taxable income 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, and 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 applicable state deferred tax rate is the product of the applicable apportionment factor and the enacted state tax rate (expected apportionment factor × state tax rate = applicable state deferred tax rate). To calculate the state DTA/DTL, an entity multiplies the applicable state deferred tax rate by the temporary difference.

It is not uncommon for states to revise their apportionment rules, and an entity should consider enacted changes in the measurement of deferred taxes. 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. The 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.

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, an entity should not assume that taxable or deductible amounts related to temporary differences will be shifted to a different tax jurisdiction through future intra-entity transactions.
3.3.4.6.2 Optional Future Tax Elections

States may enact changes to the tax rate or apportionment factor that can be implemented through a tax election that is available for tax purposes only in periods after the reporting date. 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.

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, a state may change its tax law to allow a taxpayer to elect to apportion income on the basis of a single-sales factor election. If an entity expects to make the single-factor election, it must recognize, in the interim or annual period that includes the enactment date, 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 in which the election is effective.

3.3.4.6.3 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, 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.

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.

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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.
3.3.4.7 Determining the Applicable Tax Rate When Different Rates Apply to Distributed and Undistributed Earnings

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 (dual-rate jurisdictions). Below are two examples of situations in which determining the applicable tax rate may be complex.

3.3.4.7.1 Distributed and Undistributed Earnings and Tax Credit on Distribution

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 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.
3.3.4.7.2 Distributed Earnings and Deferral of Tax Payments

Unlike Germany, whose former tax law offers credits on distributed profits, Mexico’s former tax law enabled taxpayers to defer tax payments. Under this law, income taxes were assessed on current earnings at a rate of 35 percent. However, the law required current payment only of income taxes computed at a lower tax rate (e.g., 30 percent for the year 2000) of taxable income at the time the tax return was filed. The remaining payment of 5 percent was due to the government as dividend payments were made to the entity’s shareholders.

In this situation, an entity should use the tax rate of 35 percent to record taxes in its separate financial statements because the deferred tax amount represents an unavoidable liability for the 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 subsidiary entity 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 be possible only 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 cancelled 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 former 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 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 former Mexican tax law, an entity incurred a liability at the time it earned taxable income. While the entity was permitted to defer the liability until a distribution was made, the “net” unpaid tax would never represent earnings attributable to shareholders. Rather, the entity would 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 former 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 former Mexican tax law, however (irrespective of the ultimate payment terms), tax was assessed only at the time income was generated. In addition, withholding taxes are generally intended as a tax on shareholders, whereas the Mexican tax was assessed as a tax on the corporation and its income.

Accordingly, under the former tax law for income subject to Mexican income tax, the statutory 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 that is not a DTL.

3.3.4.8 Measurement of Deferred Taxes 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 base. In applying the principles of ASC 740 to the differences in these individual tax jurisdictions, an entity may encounter various complexities.

Because the starting point for a jurisdictional assessment of business taxes on adjusted gross receipts is typically total revenues and not net income, recovery and settlement of book assets and liabilities, respectively, with a tax basis different from their respective book carrying values will result in a subsequent-period tax consequence. Accordingly, an entity must apply the principles in ASC 740 carefully when assessing whether to recognize a DTL or DTA for the estimated future tax effects attributable to temporary differences. An entity must determine:

1. Whether there is a basis difference under ASC 740 for all or a portion of the book carrying value of assets and liabilities in the statement of financial position.
2. If there is a basis difference, whether it is temporary and thus must be recognized under ASC 740.
3. If there is a temporary difference, whether it is a taxable or deductible temporary difference for which a DTA or DTL must be recognized.

Consider the following scenarios:

- **Scenario 1** — A tax jurisdiction permits raw material purchases to be deducted from gross receipts in the period in which the materials are acquired but prohibits any deduction for internal labor costs incurred in any period. At the end of the reporting period, the book carrying value of an entity’s inventory of $100 includes $80 of raw materials purchased from third parties and $20 of capitalized labor costs. Accordingly, the tax basis of the inventory is $0 at the end of the reporting period.

- **Scenario 2** — A tax jurisdiction prohibits deductions for acquired capital assets. The entity is permitted to compute the period taxable gross receipts on the basis of total revenues less either a cost of goods sold deduction, a compensation deduction, or 30 percent of total revenues. Accordingly, the tax basis of the entity’s property, plant, and equipment (PP&E) is $0 at the end of the reporting period.
In practice, there are two views on how an entity should recognize the DTL related to its inventory and PP&E book-versus-tax basis difference that exists at period-end.

Information from Scenario 1 above is used to illustrate the two views.

### 3.3.4.8.1 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.

### 3.3.4.8.2 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.

### 3.3.4.9 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.

*Section 2.5* 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. If, after making that determination, 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, the 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, the 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 3-7**

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):

<table>
<thead>
<tr>
<th>Deferred Tax Computation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected book pretax income in year 2</td>
<td>$ 72,000</td>
</tr>
<tr>
<td>Expected reversal of taxable temporary difference in year 2</td>
<td>3,000</td>
</tr>
<tr>
<td>Expected taxable income in year 2</td>
<td>75,000</td>
</tr>
<tr>
<td>Enacted statutory income tax rate expected to apply in year 2</td>
<td>25%</td>
</tr>
<tr>
<td>Expected year 2 current tax computed on income</td>
<td>18,750</td>
</tr>
<tr>
<td>Expected year 2 capital tax (same as year 1 because of distributions)</td>
<td>8,000 (800,000 × 1%)</td>
</tr>
<tr>
<td>Expected year 2 current tax within the scope of ASC 740</td>
<td>$ 10,750</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deferred Taxes Calculated by Using Graduated Tax Method</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate to be applied to temporary difference</td>
<td>14.3% (10,750 ÷ 75,000)</td>
</tr>
<tr>
<td>Deferred tax to be provided in year 1</td>
<td>$ 430 (3,000 × 14.3%)</td>
</tr>
</tbody>
</table>
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 such a 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 ETR in a hybrid tax regime makes it analogous to a graduated-rate system, the graduated-rate guidance is not directly applicable, and (2) ASC 740-10-10-3 states, in part:

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

a. The amount of taxes that will be payable or refundable in future years inclusive of reversing temporary differences and carryforwards

b. The amount of taxes that would be payable or refundable in future years exclusive of reversing temporary differences and carryforwards.

While the FASB ultimately decided to require that entities measure DTAs and DTLs by using enacted rates in light of constraints associated with implementing the incremental approach, we believe that, given the unique nature of hybrid tax regimes, application of the principle described in ASC 740-10-10-3 would be acceptable in the limited circumstances discussed above.

Use of this method would not be acceptable, however, if the deferred tax items, in and of themselves (e.g., existing NOL carryforwards or other similar large deductible temporary differences), would reduce the amount of income tax payable to an amount that is less than the non-income-based tax payable (i.e., the “floor”), since no benefit is realized for those deductions. This scenario is illustrated in the example below.
**Example 3-8**

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Graduated Tax Method</th>
<th>Statutory Tax Method</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Year 1</strong></td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Capital</td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Pretax income (loss)</td>
<td>100</td>
<td>(100)</td>
</tr>
<tr>
<td>Taxable income before NOL carryforward</td>
<td>100</td>
<td>(100)</td>
</tr>
<tr>
<td>NOL carryforward*</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Taxable income</td>
<td>100</td>
<td>(100)</td>
</tr>
<tr>
<td>statutory tax rate</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Total current tax computed on income (greater of capital or income)</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Capital tax</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Current tax within scope of ASC 740</td>
<td>2</td>
<td>—</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>—</td>
<td>(2)</td>
</tr>
<tr>
<td>Total taxes — capital and income</td>
<td>$ 10</td>
<td>$ 8</td>
</tr>
<tr>
<td><strong>Year 2</strong></td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Capital</td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Pretax income (loss)</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Taxable income before NOL carryforward</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>NOL carryforward*</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Taxable income</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>statutory tax rate</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Total current tax computed on income (greater of capital or income)</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Capital tax</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Current tax within scope of ASC 740</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>—</td>
<td>(10)</td>
</tr>
<tr>
<td>Total taxes — capital and income</td>
<td>$ 8</td>
<td>$ (2)</td>
</tr>
<tr>
<td><strong>Year 3</strong></td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Capital</td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Pretax income (loss)</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Taxable income before NOL carryforward</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>NOL carryforward*</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>statutory tax rate</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Total current tax computed on income (greater of capital or income)</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Capital tax</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Current tax within scope of ASC 740</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>—</td>
<td>2</td>
</tr>
<tr>
<td>Total taxes — capital and income</td>
<td>$ 8</td>
<td>$ 10</td>
</tr>
</tbody>
</table>

* NOLs can be only 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.
Changing Lanes
Stakeholders indicated that the guidance on hybrid tax regimes increased the cost and complexity of applying ASC 740, particularly when the tax amount deemed to be a non-income tax was insignificant. Further, the guidance introduced complexity in the determination of the appropriate tax rate an entity should use when recording deferred taxes. In December 2019, the FASB issued ASU 2019-12, which amends the requirements related to the accounting for hybrid tax regimes. Such regimes are tax jurisdictions that impose the greater of two taxes — one that is based on taxable profit and one that is based on items other than income. Although ASC 740 does not apply to taxes that are based on items other than income, ASC 740-10-15-4 specified that in the context of a franchise tax that is based on capital, if there is a tax based on income that is greater than the tax that is based on capital, only that excess is subject to the guidance in ASC 740.

To reduce the cost and complexity of applying ASC 740, ASU 2019-12 amends ASC 740-10-15-4(a) to state that if there is an amount that is based on taxable profit, it should be included in the tax provision, with any incremental amount recorded as a non-income-based tax. This amendment effectively reverses the order in which an entity determines the type of tax under U.S. GAAP. In addition, the ASU provides related amendments to the illustrative examples in ASC 740-10-55-26 and ASC 740-10-55-139 through 55-144. The FASB notes that the amendments are consistent with the accounting for other incremental taxes, such as the base erosion anti-abuse tax.

These amendments should be applied by using either a full retrospective approach for all periods presented or a modified retrospective approach, with a cumulative-effect adjustment recorded through earnings as of the period of adoption. For more information about ASU 2019-12, see Appendix B.

3.3.4.10 Consideration of U.S. AMT Credit Carryforwards

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
</tbody>
</table>
The Act repealed corporate alternative minimum tax (AMT) for tax years beginning after December 31, 2017. Taxpayers with AMT credit carryforwards that have not yet been used may claim a refund in future years for those credits even though no income tax liability exists. Companies can continue using AMT credits to offset any regular income tax liability in years 2018 through 2020, with 50 percent of remaining AMT credits refunded in each of the 2018, 2019, and 2020 tax years and all remaining credits refunded in tax year 2021. See Section 3.3.4.11 below for certain considerations for companies subject to the corporate AMT before the enactment of the Act.

3.3.4.11 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 tax 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.

3.3.4.12 Measurement of Deferred Taxes When Entities Are Subject to BEAT

For tax years beginning after December 31, 2017, a corporation is potentially subject to tax under the BEAT provision if the controlled group of which it is a part has sufficient gross receipts and derives a sufficient level of “base erosion tax benefits.” Under the BEAT, a corporation must pay a base erosion minimum tax amount (BEMTA) in addition to its regular tax liability after credits. The BEMTA is generally equal to the excess of (1) a fixed percentage of a corporation’s modified taxable income (taxable income determined without regard to any base erosion tax benefit related to any base erosion payment, and without regard to a portion of its NOL deduction) over (2) its regular tax liability (reduced by certain credits). The fixed percentage is generally 5 percent for taxable years beginning in 2018, 10 percent for years beginning after 2018 and before 2026, and 12.5 percent for years after 2025. However, the fixed percentage is 1 percentage point higher for banks and securities dealers (i.e., 6, 11, and 13.5 percent, respectively).

In January 2018, the FASB staff issued a **Q&A** document stating that companies should measure deferred taxes without regard to BEAT (i.e., should continue to measure deferred taxes at the regular tax rate), with any payment of incremental BEAT reflected as a period expense. The BEAT system can be analogized to an AMT system in place before enactment of the Act. ASC 740 notes that when alternate tax systems like the AMT exist, deferred taxes should still be measured at the regular tax rate. Because the BEAT provisions are designed to be an “incremental tax,” an entity can never pay less than its statutory tax rate of 21 percent. Like AMT preference items, related-party payments made in the year of the BEMTA are generally the BEMTA’s driving factor. The AMT system and the BEAT system were both designed to limit the tax benefit of such “preference items.” Further, as was the case under the AMT
system, an entity may not know whether it will always be subject to the BEAT tax, and we believe that most (if not all) taxpayers will ultimately take measures to reduce their BEMTA exposure and therefore ultimately pay taxes at the regular rate or as close to it as possible. Accordingly, while there is no credit under the Act such as the one that existed under the AMT regime, the similarities between the two systems are sufficient to allow BEAT taxpayers to apply the existing AMT guidance in ASC 740 and measure deferred taxes at the 21 percent statutory tax rate. (See ASC 740-10-30-8 through 30-12 and ASC 740-10-55-31 through 55-33.)

3.3.5 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.

3.3.5.1 Considering the Impact of Tax Method Changes

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.

3.3.5.1.1 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 a 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 IRC Section 481(a), 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.

In substance, a positive IRC Section 481(a) adjustment results in a deferred revenue item for tax purposes with no corresponding amount for book purposes. Therefore, the positive IRC Section 481(a) adjustment represents a taxable temporary difference, and the related tax consequences should be accounted for as a DTL.

3.3.5.1.2 Permissible to Permissible

An entity that is 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 3-9**

**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 on the basis of amounts earned under its corporate bonus plan. As of December 31, 20X3, the liability for accrued bonuses was $400. 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 ($400 × 25% tax rate) for the UTB and accrued a $5 liability for accrued interest as of the year ended December 31, 20X3. Company A's policy is to classify interest related to UTBs as income taxes payable. Further, A recognized a DTA of $100 for the accrued bonuses that is actually deductible in future years.
Example 3-9 (continued)

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

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Before</th>
<th>Impact of Form 3115/Current-Year Change</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA — accrued bonus</td>
<td>$ 100</td>
<td>—</td>
<td>$ 100</td>
</tr>
<tr>
<td>UTB liability</td>
<td>(105)</td>
<td>$ 105*</td>
<td>—</td>
</tr>
<tr>
<td>Current tax payable</td>
<td>—</td>
<td>(25)**</td>
<td>(25)</td>
</tr>
<tr>
<td>Noncurrent DTL — IRC Section 481(a) adjustment***</td>
<td>—</td>
<td>(75)†</td>
<td>(75)</td>
</tr>
<tr>
<td>Income tax (benefit)</td>
<td>—</td>
<td>(5)*</td>
<td>—</td>
</tr>
</tbody>
</table>

* Reversal of UTB and interest liability upon IRS consent (either automatic deemed consent or express written consent).
** Current liability for the IRC Section 481(a) adjustment that is taxable in the current year.
*** Before the adoption of ASU 2015-17, a current DTL of $25 would have been recorded with a corresponding reduction in noncurrent DTL.
† DTL for the IRC Section 481(a) taxable temporary difference that is taxable in periods beyond one year.

Example 3-10

Change From a Permissible Federal Income Tax Accounting Method to Another Permissible Method With a Negative (Favorable) Adjustment

For federal income tax purposes, Company B, a profitable company, uses the full inclusion method for advance payments received for the sale of goods (i.e., for federal income tax purposes, the full amount of advance payments is included in taxable income in the period in which they are received). For financial reporting purposes, B defers the recognition of revenue upon receipt of the $800 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 $800 that will be recognized on the current-year federal income tax return. Since this item is a change from a permissible method to another permissible method, there is no UTB. Assume that B has a current tax payable of $1,000 before the IRC Section 481(a) adjustment. The accounting method change results in the following adjustments to the income tax accounts:

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Before</th>
<th>Impact of Form 3115</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA — advance payments</td>
<td>$ 200</td>
<td>(200)*</td>
<td>$ —</td>
</tr>
<tr>
<td>Current tax payable</td>
<td>(1,000)</td>
<td>200**</td>
<td>(800)</td>
</tr>
</tbody>
</table>

* Reversal of original DTA recorded.
** Decrease to current tax payable because of favorable IRC Section 481(a) adjustment.
3.3.5.2 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.

3.3.5.2.1 Impermissible to Permissible

3.3.5.2.1.1 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.

3.3.5.2.1.2 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.

3.3.5.2.2 Permissible to Permissible

3.3.5.2.2.1 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.

3.3.5.2.2.2 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.
3.3.5.2.3 Summary

The following flowchart summarizes the timing for recognition of changes in U.S. federal income tax accounting method:
Chapter 3 — Book-Versus-Tax Differences and Tax Attributes

3.3.6 Foreign Operations

3.3.6.1 Foreign Subsidiaries' Basis Differences

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. 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) because 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.”

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 3-11**

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.

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 million – $4 million] × 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 million – $4 million), resulting in the recording of a $0.4 million ($2 million × 20%) DTL in FS's statutory financial statements. FS's stat-to-GAAP adjustment (difference) is $1 million ($7 million – $6 million), resulting in an additional DTL of $0.2 million ($1 million × 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.

### 3.3.6.2 Revaluation Surplus

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.

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2 For ease of illustration, currency differences are ignored.
3.3.6.3 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).

A foreign branch is not considered a separate taxable entity for U.S. income tax reporting purposes; 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 an 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 at least 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:

<table>
<thead>
<tr>
<th></th>
<th>Foreign Branch</th>
<th>U.S. State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Files local tax return</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Maintains local DTAs and DTLs</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Computes U.S. federal tax consequences of local DTAs’ and DTLs’ reversing</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

In accordance with U.S. income tax law, an entity incurring foreign income taxes may, year to year, elect to either claim an 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 FTCs 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 Section 5.7.3 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 (i.e., foregone FTCs).

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 3-12
**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 21 percent, and Branch Co. is subject to tax in X at 15 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 X and the United States, as shown below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Book Basis</th>
<th>Tax Basis</th>
<th>Deductible (Taxable) Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>PP&amp;E</td>
<td>$2,500,000</td>
<td>$1,500,000</td>
<td>$(1,000,000)</td>
</tr>
</tbody>
</table>

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 $150,000, which is equal to the temporary difference shown above multiplied by the local tax rate in X.

In the United States, Parent Co. determines that it has a DTL of $210,000 related to the PP&E, which is equal to the temporary difference shown above multiplied by the U.S. tax rate of 21 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 ($150,000). That is, when the temporary difference reverses, Branch Co. will pay additional taxes of $150,000 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 $150,000. A summary of the impact on the consolidated balance sheet of the above is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Parent Co.</th>
<th>Branch Co.</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred taxes related to PP&amp;E</td>
<td>$(210,000)</td>
<td>$(150,000)</td>
<td>$(360,000)</td>
</tr>
<tr>
<td>Anticipatory FTC</td>
<td>150,000</td>
<td>—</td>
<td>150,000</td>
</tr>
<tr>
<td>Total deferred taxes</td>
<td>$(60,000)</td>
<td>$(150,000)</td>
<td>$(210,000)</td>
</tr>
</tbody>
</table>
**Example 3-13**

**Foreign Tax Deduction Anticipated in the United States**

Assume that the facts are the same as those in Example 3-12, except that Parent Co. anticipates deducting the foreign taxes in its income tax return when the temporary difference reverses (instead of claiming them as an 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 21 percent of Branch Co.’s DTL. That is, because Parent Co. will deduct the foreign taxes on its income tax return, it will receive a benefit equal to only 21 percent (i.e., the statutory rate) of the deduction. The following table summarizes the impact on the consolidated balance sheet of the above:

<table>
<thead>
<tr>
<th>Description</th>
<th>Parent Co.</th>
<th>Branch Co.</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred taxes related to PP&amp;E</td>
<td>$ (210,000)</td>
<td>$ (150,000)</td>
<td>$ (360,000)</td>
</tr>
<tr>
<td>Future foreign tax deduction</td>
<td>31,500</td>
<td>—</td>
<td>31,500</td>
</tr>
<tr>
<td>Total deferred taxes</td>
<td>$ (178,500)</td>
<td>$ (150,000)</td>
<td>$ (328,500)</td>
</tr>
</tbody>
</table>

**Example 3-14**

**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 21 percent, and Branch Co. is subject to tax in X at 15 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 $150,000 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 $210,000 ($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. ($210,000), as shown below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Parent Co.</th>
<th>Branch Co.</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA (deferred benefit) related to Branch Co. loss</td>
<td>—</td>
<td>$ 150,000</td>
<td>$ 150,000</td>
</tr>
<tr>
<td>Current benefit related to Branch Co. loss</td>
<td>210,000</td>
<td>—</td>
<td>210,000</td>
</tr>
<tr>
<td>DTL (deferred expense) related to Branch Co. loss</td>
<td>(150,000)</td>
<td>—</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Total tax benefit (TTB) (expense)</td>
<td>$ 60,000</td>
<td>$ 150,000</td>
<td>$ 210,000</td>
</tr>
</tbody>
</table>
Example 3-14 (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 X). Branch Co. would reverse its DTA related to the loss carryforward and recognize a deferred tax expense of $150,000. 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 $210,000 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 $150,000. 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. ($210,000), as shown below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Parent Co.</th>
<th>Branch Co.</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction of DTA (deferred tax expense) related to Branch Co. loss</td>
<td>$ —</td>
<td>$ (150,000)</td>
<td>$ (150,000)</td>
</tr>
<tr>
<td>Current expense related to Branch Co. income</td>
<td>(210,000)</td>
<td>—</td>
<td>(210,000)</td>
</tr>
<tr>
<td>Reduction of DTL (deferred tax benefit) related to Branch Co. loss</td>
<td>150,000</td>
<td>—</td>
<td>150,000</td>
</tr>
<tr>
<td>TTB (expense)</td>
<td>$ (60,000)</td>
<td>$ (150,000)</td>
<td>$ (210,000)</td>
</tr>
</tbody>
</table>

3.4 Outside Basis Differences

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.
The only exceptions in applying those basic requirements are:

a. Certain exceptions to the requirements for recognition of deferred taxes 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.

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 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. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.
### ASC 740-10 (continued)

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

<table>
<thead>
<tr>
<th>25-3</th>
<th>The only exceptions in applying those basic requirements are:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Certain exceptions to the requirements for recognition of deferred taxes 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:</td>
</tr>
<tr>
<td>1.</td>
<td>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.</td>
</tr>
<tr>
<td>2.</td>
<td>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.</td>
</tr>
<tr>
<td>3.</td>
<td>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.</td>
</tr>
<tr>
<td>4.</td>
<td>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.</td>
</tr>
<tr>
<td>b.</td>
<td>Recognition of temporary differences related to deposits in statutory reserve funds by U.S. steamship entities (see paragraph 995-740-25-2).</td>
</tr>
<tr>
<td>c.</td>
<td>The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 840-30.</td>
</tr>
<tr>
<td>d.</td>
<td>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).</td>
</tr>
<tr>
<td>e.</td>
<td>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 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. Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.</td>
</tr>
<tr>
<td>f.</td>
<td>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. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.</td>
</tr>
</tbody>
</table>
**ASC 740-10 (continued)**

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

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

a. Certain exceptions to the requirements for recognition of deferred taxes 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.


c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 840-30.

d. A prohibition on recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (see paragraph 805-740-25-3).

e. A prohibition on recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements 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. 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. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.
The only exceptions in applying those basic requirements are:

a. Certain exceptions to the requirements for recognition of deferred taxes 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.


c. The pattern of recognition of after-tax income for leveraged leases or the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Subtopic 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 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. 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. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

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.

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.
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.

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.

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.

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.

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.

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.
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.

**Recognition of Deferred Tax Assets**

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.

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, 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.

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.

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.

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.

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.
Ownership Changes in Investments

25-15 An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent entity sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If the remaining investment in common stock shall be accounted for by the equity method, the investor shall recognize income taxes on its share of current earnings of the investee entity in accordance with the provisions of Subtopic 740-10. If a parent entity did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 740-30-25-17 (and the entity in which the investment is held ceases to be a subsidiary), it shall accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent that any of those undistributed earnings (prior to the change in status) will be remitted. The change in the status of an investment would not by itself mean that remittance of these undistributed earnings shall be considered apparent. If a parent entity recognizes a deferred tax liability for the temporary difference arising from its equity in undistributed earnings of a subsidiary and subsequently reduces its investment in the subsidiary through a taxable sale or other transaction, the amount of the temporary difference and the related deferred tax liability will change.

Pending Content (Transition Guidance: ASC 740-10-65-8)

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 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 in the current period income taxes on the temporary difference related to its remaining investment in common stock in accordance with the guidance in Subtopic 740-10.

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.

Pending Content (Transition Guidance: ASC 740-10-65-8)


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.

How an investor should apply the guidance in ASC 740-30 on temporary differences related to investments depends on the type of investment and whether the financial reporting carrying value exceeds the tax basis or vice versa.
The following table summarizes the types of investments and the relevant guidance:

<table>
<thead>
<tr>
<th>Investment</th>
<th>DTA Considerations</th>
<th>DTL Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Domestic subsidiary</td>
<td>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.”</td>
<td>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:</td>
</tr>
<tr>
<td>• Domestic corporate joint venture that is essentially permanent in nature</td>
<td></td>
<td>• 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.</td>
</tr>
<tr>
<td>• Foreign subsidiary</td>
<td>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.”</td>
<td>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).</td>
</tr>
<tr>
<td>• Foreign corporate joint venture that is essentially permanent in nature</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity method investee (generally, ownership of less than 50 percent but more than 20 percent) that is not a corporate joint venture</td>
<td>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).</td>
<td>A DTL is recorded on the excess of the financial reporting basis over the tax basis of the investment.</td>
</tr>
<tr>
<td>Cost method investee</td>
<td>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).</td>
<td>Generally, a DTL is recorded on the excess of the financial reporting basis over the tax basis of the investment (if applicable).</td>
</tr>
</tbody>
</table>

Deferred taxes are always recorded on taxable and deductible temporary differences unless a specific exception applies.

---

3 There may be situations in which the reversal of the excess of financial reporting over tax basis is apparent because of future global intangible low-taxed income (GILTI) inclusions (e.g., excess of financial reporting over tax basis inside the controlled foreign corporation (CFC); see Section 3.4.10.
3.4.1 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 an entity is 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 3-15 through 3-19 below illustrate this concept.

Example 3-15

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, FCJV1. In preparing its consolidated financial statements, S1 consolidates FS1 and applies the equity method of accounting to its investment in FCJV1. Under ASC 740, S1 would consider its investments in FS1 and FCJV1 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 3-16

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 3-17

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 3-18

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 3-19

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.

3.4.1.1 Definition of Subsidiary and Corporate Joint Venture

An entity should use the following guidance to determine whether an investment is in either a subsidiary or a corporate joint venture:

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

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

However, ASC 740-10-20 does not specifically define the term “subsidiary” and does not refer to the definition in ASC 810-10. Rather, in practice, the definition of subsidiary in Opinion 18 (codified in ASC 323) has been applied. Opinion 18 states that subsidiary refers to “a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock.” Accordingly, while the definition in ASC 810 includes partnerships and trusts, those entities are not considered subsidiaries under ASC 740 because the earnings of such entities generally pass directly through to their owners. See Section 3.4.15 for further discussion of pass-through entities.

The term corporate joint venture is defined in ASC 740-10-20 as follows:

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.
### 3.4.1.2 Potential DTA: Foreign and Domestic Subsidiaries and Corporate Joint Ventures

ASC 740-30-25-9 states:

A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture [foreign or domestic] that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future.

As used in ASC 740-30-25-9, the term “foreseeable future” refers to an entity’s ability to reasonably anticipate the reversal of the outside basis difference. Further, we believe that in this context, “reverse” is intended to mean “be realized” (i.e., be taken as a deduction on the parent’s income tax return). Since a deductible outside basis difference in a subsidiary generally results in a deduction on the parent’s income tax return only upon sale or taxable liquidation of the subsidiary, under ASC 740-30-25-9, a DTA would rarely be recognized before the criteria in ASC 360-10-45-9 through 45-11 are met for classification of assets as held for sale. While future earnings of the subsidiary may reduce the deductible outside basis temporary difference, those future earnings do not result in a reversal of the temporary difference, as the term “reverse” is used in ASC 740-30-25-9. In other words, future earnings of the subsidiary do not result in a temporary difference deduction on the parent’s income tax return. Therefore, anticipated future earnings of the subsidiary should not be relied upon to support a conclusion that “the temporary difference will reverse in the foreseeable future” and that a DTA can be recorded under ASC 740-30-25-9.

At the point at which the criteria in ASC 360-10-45-9 through 45-11 for a measurement date have been satisfied, the deferred tax consequences of the deductible outside basis difference should be recognized as a DTA. In accordance with ASC 740-10-30-18, realization of the related DTA “depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law.” If it is not more likely than not that all or a portion of the DTA will be realized, a valuation allowance is necessary.

ASC 740-30-25-9 through 25-13 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 variable interest entity (VIE) guidance when less than 50 percent of the voting interest is owned by the investor. See Section 3.4.17.1 for consideration of the VIE model in ASC 810-10 in the evaluation of whether to recognize a DTL.

### 3.4.1.3 Potential DTL: Domestic Subsidiary

ASC 740-30-25-7 applies to investments in a more-than-50-percent-owned domestic subsidiary and assumes that the subsidiary would be consolidated under ASC 810 (see Section 3.4.1.1). ASC 740-30-25-7 does not allow for the application of the indefinite reversal exception to the recognition of DTLs for undistributed earnings of a domestic subsidiary or corporate joint venture generated in fiscal years beginning on or after December 15, 1992. Therefore, under ASC 740-30-25-3, DTLs must be recognized “unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free” and the entity expects that it will ultimately use that means. The holder of the investment must meet both criteria to avoid recording the DTL.

While ASC 740-30-25-7 states that it applies only to more-than-50-percent-owned domestic subsidiaries, 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 Section 3.4.17.1 for considerations related to the VIE model in ASC 810-10 in the evaluation of whether to recognize a DTL.
3.4.2 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 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 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:

- 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 . . . 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. . . .

- 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.

Example 3-20

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 are related to income generated in post-1993 years, which was previously accrued in 20X1.

3.4.3 Tax-Free Liquidation or Merger of a Subsidiary

There may be instances in which it is acceptable to treat an outside basis difference in a domestic subsidiary as a nontaxable temporary difference. An analysis to achieve this treatment has quantitative and qualitative thresholds.

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).

3.4.4 Potential DTL: Foreign Subsidiary and Foreign Corporate Joint Venture

**ASC 740-30**

*Exceptions to Comprehensive Recognition of Deferred Income Taxes*

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. The indefinite reversal criteria shall not be applied to the inside basis differences of foreign subsidiaries.
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:

- 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.
- 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.

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.

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 740-30-25-18(a) applies.

ASC 740-30-25-18(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" unless "it becomes apparent that the temporary difference will reverse in the foreseeable future." See Section 3.3.1 for a discussion of inside and outside basis differences.

### 3.4.5 DTL for a Portion of an Outside Basis Difference

As noted above, ASC 740-30-25-18(a) 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 3-21

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.
Example 3-21 (continued)

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 Section 3.4.5.1 below for further discussion.

Example 3-22

Assume the same facts as in Example 3-21, 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.

3.4.5.1 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 above 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 and determined by using a bottom-up approach. An entity could reach different conclusions for two subsidiaries within the same jurisdiction.
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.

3.4.5.2 Ability to Overcome the Presumption in ASC 740-30-25-3 After a Change in Management’s Plans for Reinvestment or Repatriation of Foreign Earnings

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.

3.4.5.3 Change in Indefinite Reinvestment Assertion — Recognized or Nonrecognized Subsequent Event

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 3-23

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.

3.4.6 Measuring Deferred Taxes on Outside Basis Differences in Foreign Investments

As discussed above, analysis of deferred taxes on outside basis differences requires a bottom-up approach whereby an entity must consider its outside basis difference at each level in the organization chart. The entity should start with the lowest entity in the organization structure and determine whether such entity’s direct parent’s financial reporting carrying amount is greater or less than its tax basis. When performing this analysis, the entity should consider the expected manner of recovery (e.g., sale, liquidation, dividend). 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 foreign tax credits, and taxes that would be withheld from the dividend.” Thus, the parent entity should consider withholding taxes, FTCs, and participation exemptions (i.e., a dividends received deduction) when determining the amount of DTL to be recognized.

While the Act fundamentally changed how U.S. companies are taxed on earnings of CFCs, there are still many jurisdictions that tax earnings of foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration (collectively, “foreign investments”) upon distribution of such earnings. Where the immediate parent entity’s outside basis taxable temporary difference in a foreign investment would close upon remittance of foreign earnings and is not indefinitely reinvested, the parent entity would need to recognize a DTL for the additional tax to be imposed in its jurisdiction upon receipt of the earnings. The parent entity may be able to avail itself of a participation exemption and, as stated above, should factor such an exemption into the amount of DTL to be recognized.
One result of enactment of the Act is that U.S. companies may be entitled to a 100 percent dividends received deduction on the repatriation of earnings that have not previously been taxed. Further, any foreign taxes properly attributable to the earnings that are subject to the 100 percent dividends received-deduction are not available as an FTC since those earnings are not subject to U.S. federal income tax. The repatriation of earnings to which the 100 percent dividends received deduction applies generally should reduce the outside basis difference because the distribution reduces the financial reporting carrying value of the investment but does not reduce the U.S. tax basis in the investment. While there may be no U.S. federal income tax implications of the distribution, there can nonetheless be additional foreign withholding tax and state taxes.

As discussed in more detail below, there are situations in which an outside basis difference is expected to reverse in a taxable manner, irrespective of whether there is a distribution (e.g., through future Subpart F or GILTI inclusions).

To the extent that earnings have been previously taxed (situations involving Subpart F, GILTI, or IRC Section 965 are discussed further below), the U.S. company receives a basis increase for U.S. income tax purposes. Upon distribution, such earnings are not taxed again; rather, the U.S. tax basis in the investment is reduced by the amount of the previously taxed earnings distributed. In a manner similar to earnings subject to the 100 percent dividends received deduction, there can still be additional withholding taxes and state taxes incurred on a repatriation of earnings to the U.S. company; see Section 3.4.13 for a discussion of withholding taxes. In addition, there may be foreign exchange gains or losses or losses that are taxable/deductible upon repatriation, capital gains upon sale of an investment, or foreign income taxes. If a U.S. company is not indefinitely reinvested in the outside basis difference in its investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration, it may need to recognize a DTL with respect to its investment.

3.4.7 Unremitted Earnings of a Foreign Subsidiary When There Is an Overall Deductible Outside Basis Difference — Pre-Act

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 differences 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 be recognized for only 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 Section 9.7.2 for more information.

**Example 3-24**

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 (E&P) is $200. Entity A would not record a DTL for its investment in B since A has a deductible temporary difference in B. Further, A would not recognize a DTA for its deductible temporary difference in B unless it becomes apparent that the deductible temporary difference will reverse in the foreseeable future. A distribution of the $200 earnings would result in a decrease in the outside financial reporting basis in B that is equal to the $200 distributed. The outside tax basis would continue to be $1,000 after the distribution (since the distribution was out of the $200 of E&P and therefore is taxable), resulting in a net increase in the deductible outside basis difference that is equal to the $200 reduction in the outside financial reporting basis.

The current-year tax expense recorded when the actual distribution occurs can be viewed as attributable to A's inability to record a DTA on the outside basis related to the deductible temporary difference (i.e., there is an increase in the deductible temporary difference that is subject to the exception under ASC 740-30-25-9) rather than to the lack of establishing a DTL in a prior period.

**3.4.8 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 those temporary differences will reverse in the foreseeable future” (emphasis added). 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 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 financial reporting purposes by the foreign subsidiary (and thus in the U.S. parent's consolidated financial statements), such income increases the U.S. parent's book basis in the foreign subsidiary.
Subpart F income may result in taxable income for the U.S. parent in the same amount and same period as that in which the income is recognized by the foreign subsidiary for financial reporting purposes. In such cases, current taxable income would be recognized in the period in which the income is recognized for financial reporting purposes, and there would generally be no change in the U.S. parent's outside basis difference in the foreign subsidiary (i.e., because the book basis and tax basis both generally increase by an equal amount). However, Subpart F income may be taxed in a later period than the period in which the income is recognized for financial reporting purposes. In these cases, there will be an increase in the parent's book basis in the subsidiary attributable to Subpart F income recognized for financial reporting purposes with no change in the corresponding tax basis. This section does not apply to situations involving Subpart F income that will not be immediately taxable as a result of other circumstances (e.g., a situation in which the Subpart F income is deferred when there is a deficit in E&P but will become includable when the foreign subsidiary in question has positive earnings).

A U.S. parent that, according to ASC 740-30-25-18(a), does not recognize a DTL on its outside basis taxable temporary difference in a foreign subsidiary should generally recognize a DTL for the portion of the outside basis difference that corresponds to amounts already recognized for financial reporting purposes by the foreign subsidiary that will be treated as Subpart F income when considered to be earned for tax reporting purposes (i.e., amounts within the foreign subsidiary that would give rise to taxable temporary differences under U.S. tax law).

The portion of the outside basis taxable temporary difference that corresponds to an inside Subpart F temporary difference should be treated as though it is apparent that it will reverse “in the foreseeable future” and will thus require the recognition of a DTL. Since Subpart F income is often related to passive types of income, in most cases neither the U.S. parent nor the foreign subsidiary can control when it will become taxable to the U.S. parent. Therefore, a deferred tax expense and outside basis DTL should be recognized in the period in which the income is recognized for financial reporting purposes. This is true even if the U.S. parent does not intend to distribute the associated earnings of the foreign subsidiary and irrespective of whether the U.S. parent has elected to treat GILTI as a period cost. See Section 3.4.10 for a discussion of GILTI deferred taxes.

For example, a U.S. parent may own a foreign subsidiary that, in turn, owns an equity method investment that does not meet the ASC master glossary's definition of a corporate joint venture. Assume that the U.S. parent's tax basis would not be affected by undistributed earnings of the equity investee. 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 was not affected by the undistributed earnings of the equity investee). Assume that when the foreign subsidiary sells 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; nor can it assert indefinite reinvestment in the equity method investee because it is not a subsidiary or a corporate joint venture that is essentially permanent in duration, 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 investment in the equity investee is recovered, 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).
3.4.9 **Outside Basis Difference in a Foreign Subsidiary — Deferred Subpart F Income**

Section 3.4.8 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 CFC for any taxable year may not exceed such CFC’s E&P for the year. Accordingly, while such amounts may be deferred and recaptured in a future year, current-year Subpart F income is limited to actual E&P earnings.

Assume, for example, that Company Y, a CFC, earns $100 of Subpart F income and generates a non-Subpart F loss of $40 in year 1. Company Y earns $200 of Subpart F income in each of years 2 and 3, $10 of non-Subpart F income in year 2, and $100 of non-Subpart F income in year 3. Because Y’s E&P is $60 in year 1, the amount of Subpart F income attributable to Y in year 1 that Y’s U.S. shareholder must include in its year 1 taxable income is limited to $60. However, in year 2, Y’s U.S. shareholder must include $10 of Y’s deferred Subpart F income from year 1. Likewise, in year 3, the U.S. shareholder must include the remaining $30 of Company Y’s deferred Subpart F income from year 1 that was not taxed in years 1 and 2. Thus, all the deferred Subpart F income from year 1 is recaptured.

If the existence of deferred Subpart F income suggests that some part of the outside basis difference will reverse in the foreseeable future, a DTL should be recorded. However, the mere existence of deferred Subpart F earnings does not automatically suggest that a part of the outside basis difference will reverse in the foreseeable future. Rather, all the facts and circumstances must be assessed. For example, if a recovery and settlement of the subsidiary’s assets and liabilities were to give rise to the taxation of the deferred Subpart F income, a DTL would be recognized provided that the amount of the deferred Subpart F income does not exceed the outside basis difference in the foreign subsidiary.

If an entity uses the financial reporting carrying amounts of the assets and liabilities to determine whether some part of the outside basis difference would be expected to reverse in the foreseeable future, the DTL recognized would take into account only 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.

3.4.10 **GILTI**

The Act created a new requirement that certain income (i.e., GILTI) earned by CFCs must be included currently in the gross income of the CFCs’ U.S. shareholder. GILTI is the excess of the shareholder’s “net CFC tested income” over the net deemed tangible income return (the “routine return”), which is defined as the excess of (1) 10 percent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a U.S. shareholder over (2) the amount of certain interest expense taken into account in the determination of net CFC-tested income.
A domestic corporation is permitted a deduction of up to 50 percent of the sum of the GILTI inclusion and the amount treated as a dividend in accordance with IRC Section 78 (“IRC Section 78 gross-up”). If the sum of the GILTI inclusion (and related IRC Section 78 gross-up) and the corporation’s FDII (see Section 3.2.1.5) exceeds the corporation’s taxable income, the deductions for GILTI and for FDII are reduced by the excess. As a result, the GILTI deduction can be no more than 50 percent of the corporation’s taxable income (and will be less if the corporation is also entitled to an FDII deduction). The maximum GILTI deduction is reduced to 37.5 percent for taxable years beginning after December 31, 2025.

### 3.4.10.1 GILTI Accounting Policy Election

Assume that a U.S. investor in a CFC has a financial reporting carrying value (i.e., book basis) and an outside tax basis for U.S. tax purposes in its foreign investment. If those amounts are not the same, the U.S. investor would have an outside basis difference in the foreign investment. In addition, the U.S. investor has a U.S. tax basis in the CFC’s underlying assets and liabilities held that will be used for calculating GILTI inclusions. Accordingly, a U.S. investor may have book/U.S. tax inside basis differences that, upon reversal, will increase or decrease the GILTI inclusion and, because GILTI inclusions increase the U.S. tax basis in the foreign investment, will also affect the outside basis difference in the foreign investment. Questions arose concerning whether a company was required to record U.S. deferred taxes for foreign investments.

In January 2018, the FASB staff issued a Q&A document, which states that a company may elect, as an accounting policy, to either (1) treat taxes due on future U.S. inclusions in taxable income under the GILTI provision as a current-period expense when incurred or (2) factor such amounts into the company’s measurement of its deferred taxes (the “GILTI deferred method”).

The decision tree below illustrates the approach for determining the deferred tax accounting for outside basis differences in foreign investments that are expected to reverse as a result of the GILTI provision.
3.4.10.2 GILTI Deferred Method — Overview

We believe that in a manner consistent with the mechanics of the GILTI computation, GILTI DTAs and DTLs should generally be computed on a U.S.-shareholder-by-U.S.-shareholder basis if the GILTI deferred method is elected. Further, when multiple U.S. shareholders are includable in a U.S. consolidated income tax return, the aggregation rules applicable to such consolidated tax filings should be considered. Multiple CFCs within the same U.S. consolidated tax return group would be analyzed in the aggregate. If a U.S. shareholder has a mixture of profitable and unprofitable CFCs that, in the aggregate, are not profitable to the extent that future GILTI inclusions are not expected at the U.S. shareholder level, no GILTI DTAs and DTLs would be recorded. Conversely, if a U.S. shareholder has a mixture of profitable and unprofitable CFCs that, in the aggregate, are profitable to the extent that future GILTI inclusions are expected, that U.S. shareholder should measure GILTI DTAs and DTLs as discussed below.

3.4.10.3 GILTI Deferred Method — Measurement of Deferred Taxes

In determining the amount of U.S.-investor-level deferred taxes necessary for foreign investments under this model, companies should “look through” the outside basis of the CFC to determine how the book/U.S. tax inside basis differences will reverse and how such reversals will affect future GILTI inclusions and the outside basis difference.

Any residual outside basis difference that is not related to the CFC’s underlying assets or liabilities (i.e., inside/outside tax basis disparities) should then be analyzed in the determination of whether the basis difference would result in a taxable or deductible amount when the investment is recovered and, if so, whether an ASC 740 outside basis exception (i.e., ASC 740-30-25-18(a) or ASC 740-30-25-9) applies. Unlike other situations involving outside basis differences in foreign subsidiaries, this “look through” approach (see Section 3.4.15) would be employed even if no overall outside basis difference in the CFC exists, or if only an overall deductible outside basis difference in the CFC exists.

In addition, in assessing the GILTI impact of the CFC’s underlying assets and liabilities, a company would, in a fashion similar to branch accounting, establish U.S. DTAs or DTLs to account for the U.S. income tax effects of the future reversal of any in-country DTAs and DTLs (also referred to as “anticipatory foreign tax credit/deduction” or “anticipatory” DTAs and DTLs). When determining the amount of a U.S. anticipatory DTA or DTL, an entity must carefully consider all applicable provisions in the tax law, since the amount of the incremental foreign taxes that will be creditable and realizable, or forgone, because of the future reversal of the local in-country DTAs and DTLs may be difficult to assess and subject to limitations (e.g., an 80 percent limitation, limitations as a result of expense allocations, and a limitation on utilization as a result of the absence of a carryforward or carryback period). For example, a local-country DTL that will reverse in the same year(s) in which a GILTI inclusion is expected may be creditable against the U.S. tax in that year, subject to the 80 percent limitation. In addition, U.S. DTAs that reverse in the same year as the local in-country deferred might further limit the FTC. Future FTCs directly related to future book income and future expense allocation limitations directly related to future book expense generally should not be included in the measurement of the anticipatory DTA or DTL until such income or expense, or both, are recognized (i.e., such FTCs and expense allocation limitations should be limited to those directly tied to existing temporary differences).

While many “branch-like” principles are employed in the look-through model described above, unlike a branch, a CFC that will have substantially all of its income taxable in the United States as a result of a GILTI inclusion still has an outside tax basis that is relevant in certain instances, such as a sale or distribution. Accordingly, measurement of deferred taxes should also factor in the residual outside basis difference as described above.
For more information about accounting for foreign branch operations, see Section 3.3.6.3.

In summary, recorded GILTI DTAs and DTLs under the look-through model will consist of the following three items:

- DTAs and DTLs related to inside book/U.S. tax basis differences that will affect future GILTI inclusions, identified by “looking through” the CFC’s outside basis to the CFC’s underlying assets and liabilities.
- DTAs and DTLs related to the U.S. tax consequences of settling the CFC’s in-country DTAs or DTLs (i.e., anticipatory DTAs and DTLs).
- Any DTA or DTL related to a residual outside basis temporary difference for which an exception has not been applied.

We have discussed a number of the more significant aspects of this guidance on measuring GILTI-related deferred taxes with the FASB and SEC staff. Accordingly, while other acceptable accounting approaches may exist, entities that plan to apply methods that are inconsistent with those discussed herein are strongly encouraged to consult with their income tax accounting advisers.

### 3.4.10.4 GILTI Deferred Method — Other Considerations

#### 3.4.10.4.1 Net Deemed Tangible Income Return

Given that the CFC’s routine return is excluded from the GILTI inclusion, we believe that there is more than one acceptable approach to accounting for the routine return in the measurement of GILTI DTAs and DTLs, including the following:

- **Special deduction** — The routine return could be treated akin to a special deduction, with the benefit recognized when the GILTI inclusion is reduced by the routine return. Under this approach, the routine return is viewed as dependent on future events, including future investments in QBAI and interest expense deductions, and it therefore would not be factored into the tax rate expected to apply to the temporary differences.

- **Graduated tax rate** — Under this approach, the amount of taxable income equal to the routine return would be considered income taxed at a zero rate. Accordingly, if the routine return represents a significant factor, companies would measure GILTI DTAs and DTLs by using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the aforementioned deferred taxes are estimated to be settled or realized. Companies will need to use judgment in determining the periods in which GILTI DTAs and DTLs will reverse and the estimated annual taxable income in each of those periods. See Section 3.3.4.1.

Other models may also be acceptable in certain situations (e.g., a portion of the book/U.S. tax basis difference that will reverse and represent a routine return might not be considered a taxable temporary difference for which a deferred tax would be recorded in accordance with ASC 740-10-25-30).

The approach an entity selects would be an accounting policy election that, like all other such elections, must be applied consistently.
3.4.10.4.2 IRC Section 250 Deduction (the “GILTI Deduction”)

The GILTI deduction is intended to lower the GILTI income inclusion (with the intent of lowering the ETR on the included income) and, in many cases, will immediately apply when a company has a GILTI inclusion. Accordingly, we believe that if a company generally expects to be able to apply the full GILTI deduction in the period in which the GILTI DTAs and DTLs reverse, it should consider the deduction in the measurement of the GILTI DTAs and DTLs in accordance with ASC 740-10-55-24. As noted above, however, the GILTI deduction is “up to,” rather than “guaranteed” to be, 50 percent and could be reduced by the taxable income limitation, which is applied in combination with the FDII deduction. An entity should carefully consider this limitation when factoring the GILTI deduction into the measurement of U.S. GILTI DTAs and DTLs. For example, when the taxable income limitation and expense allocation limitations are expected to apply and be significant (e.g., in situations in which the U.S. operations generate significant losses or an entity expects to forgo the GILTI deduction because it expects to use existing NOL carryforwards), entities may conclude that factoring the GILTI deduction into the rate is not appropriate. See additional discussion in Section 5.7.2.

3.4.11 Deemed Repatriation Transition Tax (IRC Section 965)

Under the Act, a U.S. shareholder of a specified foreign corporation (SFC)\(^4\) was required to include in gross income, at the end of the SFC’s last tax year beginning before January 1, 2018, the U.S. shareholder’s pro rata share of certain of the SFC’s undistributed and previously untaxed post-1986 foreign E&P. The inclusion generally was reduced by foreign E&P deficits that were properly allocable to the U.S. shareholder. In addition, the mandatory inclusion was reduced by the pro rata share of deficits of another U.S. shareholder that is a member of the same affiliated group. A foreign corporation’s E&P were taken into account only to the extent that they were accumulated during periods in which the corporation was an SFC (referred to below as a “foreign subsidiary”). The amount of E&P taken into account was the greater of the amount determined as of November 2, 2017, or December 31, 2017, unreduced by dividends (other than dividends to other SFCs) during the SFC’s last taxable year beginning before January 1, 2018.

The U.S. shareholder’s income inclusion was offset by a deduction designed to generally result in an effective U.S. federal income tax rate of either 15.5 percent or 8 percent. The 15.5 percent rate applied to the extent that the SFCs held cash and certain other assets (the U.S. shareholder’s “aggregate foreign cash position”), and the 8 percent rate applied to the extent that the income inclusion exceeded the aggregate foreign cash position.

The Act permits a U.S. shareholder to elect to pay the net tax liability\(^5\) interest free over a period of up to eight years.

3.4.11.1 Classification of the Transition Tax Liability

The transition liability should be recorded as a current/noncurrent income tax payable. ASC 210 provides general guidance on the classification of accounts in statements of financial position. An entity should classify as a current liability only those cash transition tax payments that management expects to make within the next 12 months. The installments that the entity expects to settle beyond the next 12 months should be classified as a noncurrent income tax payable.

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\(^4\) An SFC includes all CFCs and all other foreign corporations (other than passive foreign investment companies) in which at least one domestic corporation is a U.S. shareholder.

\(^5\) Net tax liability under IRC Section 965 is the excess, if any, of the taxpayer’s net income tax for the taxable year in which the IRC Section 965 inclusion amount is included over such taxpayer’s net income tax for the taxable year, excluding (1) the IRC Section 965 amount and (2) any income or deduction properly attributable to a dividend received by such U.S. shareholder from any deferred foreign income corporation.
3.4.11.1.1 Classification of Transition Tax Obligation in Periods Before Inclusion on the Income Tax Return

In certain circumstances, the transition tax was not reported on an entity’s tax return for the year that included the enactment date. On the basis of the unique nature of tax reform and the mandatory one-time deemed repatriation income inclusion, we believe that it would be appropriate, in those circumstances, to classify the deemed repatriation transition tax liability as a current/noncurrent income tax payable in the period that includes the enactment date.

3.4.11.2 Measurement of Transition Tax Obligation in Periods Before Inclusion on the Income Tax Return

Although we generally believe that the recognition of a DTL related to a foreign subsidiary would be limited to the amount that corresponds to the entity’s outside basis difference in the foreign subsidiary, we also believe that, given the unique circumstances presented in Section 3.4.11, it would be appropriate to record the entire amount of the deemed repatriation transition tax in the period of enactment even if it exceeds the outside basis difference in the foreign subsidiary. Under these circumstances, the E&P subject to taxation related to past events and transactions are simply payable in a subsequent year.

3.4.11.3 Measurement of the Transition Tax Obligation — Discounting

Although ASC 740-10-30-8 clearly prohibits discounting of DTAs and DTLs, it does not address income tax liabilities payable over an extended period. In January 2018, the FASB staff issued a Q&A document, which states that the deemed repatriation transition tax liability should not be discounted. The FASB staff stated in the Q&A that “paragraph 740-10-30-8 prohibits the discounting of deferred tax amounts. Because of the unique nature of the tax on the deemed repatriation of foreign earnings, the staff believes that the guidance in paragraph 740-10-30-8 should be applied by analogy to the payable recognized for this tax.” The FASB staff also noted the following in the Q&A:

- ASC 835-30 applies to the accounting for business transactions conducted at arm’s length and the interest rate “should represent fair and adequate compensation to the supplier.”
- “[T]he transition tax liability is not the result of a bargained” arm’s length transaction.
- The scope exception in ASC 835-30-15-3(e) that indicates that ASC 835-30 does not apply to “transactions where interest rates are affected by tax attributes or legal restrictions prescribed by a governmental agency (such as, income tax settlements)” would apply to the transition tax obligation.
- Because the amount of the deemed repatriation transition tax is inherently subject to uncertain tax positions, measurement of the ultimate amount to be paid is potentially subject to future adjustment. Since uncertain tax positions are not discounted, it would not be appropriate to discount the transition tax liability “when the uncertain tax position is undiscounted.”
### 3.4.11.4 Measurement of the Transition Tax Liability — Tax Planning

Typically, we would expect the one-time deemed repatriation transition tax to be based on the facts that exist as of the balance sheet date (e.g., E&P amounts, cash and other asset balances) or a prior date if required by law. However, in some instances, certain actions (or elections) that management expects to take (make) in a subsequent reporting period and for which no other impediments or regulatory hurdles to execution exist (i.e., the plans are within the entity’s control) can be considered in the measurement of the tax liability. In such cases, an entity would need to use significant judgment and assess its individual facts and circumstances.

**Changing Lanes**

The Act made many changes to how U.S. shareholders are taxed on earnings of foreign investees. One of the areas affected was FTCs. The Act removed from U.S. federal tax law the “pooling concept.” Under the pooling concept, a particular CFC had a pool of post-1986 unretrained E&P and a pool of post-1986 foreign taxes; upon repatriation, a portion of such foreign taxes was attributed to the repatriation on the basis of the percentage of the post-1986 unretrained E&P that was repatriated compared with the total pool of post-1986 unretrained E&P. As a result, the foreign taxes in the pool may have accumulated over a number of years and potentially at different rates. Under the Act, U.S. shareholders calculate foreign taxes on the basis of taxes that are “properly attributable to” the foreign earnings (e.g., GILTI, Subpart F income) of the particular year in such a way that foreign taxes are no longer pooled.

### 3.4.12 “Unborn” FTCs — Pre-Act

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 3-25

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 (USDs) 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.

<table>
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<th>Sub A</th>
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### 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**

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>USD amount to be received</td>
<td>$110</td>
</tr>
<tr>
<td>Foreign taxes deemed paid (% of E&amp;P distributed × the tax pool)</td>
<td>250</td>
</tr>
<tr>
<td>U.S. taxable income recognized</td>
<td>360</td>
</tr>
<tr>
<td>U.S. tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>U.S. tax liability before FTC</td>
<td>(126)</td>
</tr>
<tr>
<td>FTC</td>
<td>250</td>
</tr>
<tr>
<td>Excess FTC</td>
<td>$124</td>
</tr>
</tbody>
</table>

When Sub A distributes 100 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 LC. Because it is distributing 100 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 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). As noted in **Section 3.4.10**, such gross-ups are required by IRC Section 78 and are often referred to as “IRC 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 IRC 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 foreign tax credits, 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 3-25, 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. ASC 740-10-20 defines deferred tax asset as the “deferred tax consequences attributable to deductible temporary differences and carryforwards.”

Further, 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.

### 3.4.13 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 foreign jurisdiction view.

### 3.4.13.1 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).

### 3.4.13.2 View 2 — Foreign Jurisdiction Perspective

From the perspective of the local jurisdiction (i.e., the disregarded entity or subsidiary), 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.

### 3.4.14 Withholding Taxes — Foreign Currency Considerations

While foreign withholding taxes are generally considered a liability of the investor rather than the investee (i.e., are attributable to the investor’s outside basis difference), such taxes will ultimately be payable to the foreign government in local currency and, provided that the investor’s functional currency is different from the investee’s local currency, represent foreign-currency-denominated liabilities of the investor.

When the investor is a U.S. entity, the amount of a non-USD-denominated, foreign withholding tax liability will change as a result of fluctuations in the corresponding exchange rate between the U.S. parent (i.e., the USD) and the applicable local currency of the first-tier foreign subsidiary. Because the U.S. parent is the primary obligor, such a liability is not recorded by the first-tier foreign subsidiary and is therefore not subject to translation. Accordingly, the impact of fluctuations between the reporting currency of the U.S. parent and the functional currency of the first-tier foreign subsidiary should be recorded through continuing operations of the U.S. parent as the related liability is remeasured in each reporting period in accordance with ASC 830-20.
Questions have arisen related to how a first-tier foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) should account for fluctuations in the value of a foreign withholding tax liability related to earnings of a second-tier foreign subsidiary (or foreign corporate joint venture that is essentially permanent in duration) (the “second-tier foreign subsidiary”) that are not indefinitely reinvested when the first-tier foreign subsidiary has the same local and functional currency as that of the second-tier foreign subsidiary, which is not the reporting currency.

Because the first-tier foreign subsidiary and the second-tier foreign subsidiary have the same functional currency, the amount of the withholding tax liability on the functional currency books of the first-tier foreign subsidiary will not change as a result of exchange rate fluctuations. Accordingly, the related liability would not be remeasured in each reporting period, and the first-tier foreign subsidiary would not record transaction gain or loss in accordance with ASC 830-20. However, because the first-tier foreign subsidiary is the primary obligor, such a liability is recorded by the first-tier foreign subsidiary and is therefore subject to translation. Accordingly, the impact of fluctuations between the reporting currency of the U.S. parent and the functional currency of the first-tier foreign subsidiary should be recorded as a CTA through other comprehensive income (OCI).

If the first-tier foreign subsidiary has a functional currency that is different from (1) the local currency of the second-tier foreign subsidiary or (2) the reporting currency, the reporting entity needs to account for the fluctuations in the value of a foreign withholding tax liability related to the earnings of a second-tier foreign subsidiary. The amount of a foreign withholding tax liability denominated in the local currency of the second-tier foreign subsidiary will change as a result of fluctuations in the corresponding exchange rate between the applicable local currencies of the first-tier foreign subsidiary and the second-tier foreign subsidiary. Accordingly, the impact of fluctuations between the functional currencies of the first-tier foreign subsidiary and the second-tier foreign subsidiary should be recorded through continuing operations of the first-tier foreign subsidiary as the related liability is remeasured in each reporting period in accordance with ASC 830-20. In addition, because the first-tier foreign subsidiary is the primary obligor, such a liability is recorded by the first-tier foreign subsidiary and is therefore subject to translation. Accordingly, the impact of fluctuations between the reporting currency of the parent and the functional currency of the first-tier foreign subsidiary should be recorded as a CTA through OCI.

### 3.4.15 Tax Consequences of Investments in Pass-Through or Flow-Through Entities

Generally, “pass-through” or “flow-through” entities (e.g., partnerships and LLCs 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 FASB Statement 109 (codified in ASC 740) was issued, Opinion 18 (codified in ASC 323) defined a subsidiary as “a corporation which is controlled, directly or indirectly, by another corporation.”

An investor in a pass-through or flow-through entity should determine the deferred tax consequences of its investment. Because pass-through or flow-through entities are not subject to tax, an investor should not recognize deferred taxes on the book and tax basis differences associated with the underlying assets and liabilities of the entity (i.e., “inside basis differences”) regardless of how the investor accounts
for its interest in the entity (e.g., consolidation, equity method, or cost method). Rather, because any taxable income or tax losses resulting from the recovery of the financial reporting carrying amount of the investment will be recognized and reported by the investor, the investor's temporary difference should be determined by reference to the investor's tax basis in the investment itself.

Often, this outside basis difference will fully reverse as the underlying assets and liabilities are recovered and settled, respectively. However, differences can exist between the investor's share of inside tax basis and the investor's outside tax basis in the investment, leading to a temporary difference that will generally not reverse as a result of the operations of the entity (a “residual” temporary difference). Nonetheless, because that residual temporary difference will still ultimately be recognized as additional taxable income or loss upon the dissolution of the partnership (if the dissolution is taxable) or will be attached to the assets distributed in liquidation of the investor's interest (if the dissolution is nontaxable), the recognition of deferred taxes related to an investment in a pass-through or flow-through entity should always take into account (and reconcile back to) the entirety of the outside basis difference.

Two acceptable approaches have developed in practice for measuring the DTA or DTL to be recognized for an outside basis difference related to an investor's investment in a consolidated pass-through or flow-through entity: (1) the outside basis approach and (2) the look-through approach.

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, (2) the pass-through of income or loss to the owner that is ordinary rather than capital in character, or (3) both. 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 investors applying an outside basis approach for measurement should generally 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.

### 3.4.16 Accounting for the Tax Effects of Contributions to Pass-Through Entities in Control-to-Control Transactions

ASC 810-10-45-22 provides examples of transactions in which a parent’s ownership in a subsidiary changes but the parent retains control of the subsidiary. Specifically:

- A “parent purchases additional ownership interests in its subsidiary.”
- A “parent sells some of its ownership interests in its subsidiary.”
- A “subsidiary reacquires some of its ownership interests” held by a nonaffiliated entity.
- A “subsidiary issues additional ownership interests” to a nonaffiliated entity.

When the parent maintains control over the subsidiary, the parent accounts for changes in its ownership interest as equity transactions. See Section 12.2.1.

When there are subsequent contributions by either the controlling interest or the noncontrolling interest to the pass-through entity, recognition of a gain or loss in equity by the controlling shareholder will typically create an additional basis difference that will need to be addressed (i.e., the controlling interest’s basis for financial and income tax reporting purposes may change by different amounts). Further, under the look-through approach, additional complexities can arise because of the applicable income tax regulations governing the allocation to partners of items of income, gain, loss, or deduction for U.S. tax purposes. For example, such transactions can often result in residual outside basis differences (i.e., the investor’s outside tax basis will not equal its share of the inside tax basis) that will usually not be deductible or taxable until a sale or taxable liquidation of the partnership (e.g., distribution of cash following a sale of the partnership’s assets).

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6 Treasury regulations promulgated under IRC Section 704(c) account for the difference between the fair value and the adjusted tax basis in property at the time they are contributed to the partnership. In addition, such regulations can result in adjustments in certain other situations, including when the fair value of property owned by the partnership is in excess of its adjusted tax basis at the time of a contribution to the partnership.
Chapter 3 — Book-Versus-Tax Differences and Tax Attributes

Typically, an investor accounts for changes in the measurement of deferred taxes on its investment in a pass-through entity that result from a control-to-control transaction in equity in accordance with the intraperiod tax allocation guidance in ASC 740-20-45-11. If the investor uses the look-through approach in measuring deferred taxes on its investment in the pass-through entity, such changes would include the impact of any residual outside basis difference. If the residual outside basis difference represents future deductible amounts, the investor must consider its policy on applying ASC 740-30-25-9, by analogy, to its investment in the pass-through entity. See Section 3.4.16 for additional discussion.

Example 3-26

On January 1, 20X9, Company A contributes a recently acquired business (net assets including cash, subject to debt) with a fair value and financial reporting and income tax bases of $20 million to Partnership P for an 80 percent interest in P, and Company B contributes cash of $5 million for a 20 percent interest in P. Partnership P is a pass-through entity and is not subject to income taxes in any jurisdiction in which it operates. Company A uses the look-through approach in measuring deferred taxes with respect to investments in consolidated pass-through entities. At the time of the contribution, A’s outside basis for financial and income tax reporting purposes are $20 million and $20 million, respectively. Company B’s and A’s share of inside bases held by the investment upon formation were as follows:

<table>
<thead>
<tr>
<th>Total</th>
<th>B’s Basis</th>
<th>A’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Cash</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Intangibles</td>
<td>15.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(10.0)</td>
<td>(10.0)</td>
</tr>
<tr>
<td>Total</td>
<td>25.0</td>
<td>25.0</td>
</tr>
</tbody>
</table>

During 20X9, P generates $12.5 million of income through normal operations for both financial and income tax reporting purposes and makes no distributions. Company A’s outside basis for financial and income tax reporting purposes are $30 million and $30 million, respectively. Company B’s and A’s share of inside bases held by the investment are as follows:

<table>
<thead>
<tr>
<th>Total</th>
<th>B’s Basis</th>
<th>A’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Cash</td>
<td>27.5</td>
<td>27.5</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>8.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Intangibles</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(10.0)</td>
<td>(10.0)</td>
</tr>
<tr>
<td>Total</td>
<td>37.5</td>
<td>37.5</td>
</tr>
</tbody>
</table>

95
Example 3-26 (continued)

As of December 31, 20X9, P has appreciated in value to $80 million; assume such appreciation is attributable entirely to P’s goodwill. Further assume that on December 31, 20X9, B contributes an additional $20 million to P. The contribution decreases A’s ownership to 64 percent, which results in A’s having a financial reporting basis of $36.8 million in its investment in P. As a result of the contribution, A must recognize a control-to-control gain of $6.8 million ($36.8 million – $30 million) for financial statement reporting purposes; essentially A transitions from owning 80 percent of P’s $37.5 million net book value to owning 64 percent of P’s $57.5 million net book value after the contribution.

Immediately after the $20 million contribution by the noncontrolling interest holders, B’s and A’s shares of inside bases held by the investment would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>B’s Basis</th>
<th>A’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
<td>Book</td>
</tr>
<tr>
<td>Cash</td>
<td>47.5</td>
<td>47.5</td>
<td>17.1</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>8.0</td>
<td>8.0</td>
<td>2.9</td>
</tr>
<tr>
<td>Intangibles</td>
<td>12.0</td>
<td>12.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Goodwill*</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(3.6)</td>
</tr>
<tr>
<td>Total</td>
<td>57.5</td>
<td>57.5</td>
<td>20.7</td>
</tr>
</tbody>
</table>

* Would represent notional future income allocable to A if the remedial allocation method is applicable.

However, the contribution does not affect A’s tax basis in its investment in P, which creates a taxable temporary difference of $6.8 million and a DTL of $1.7 million. In this case, the allocation method chosen in accordance with the applicable income tax regulations will affect only whether the $6.8 million becomes taxable over time through certain partnership allocations or not until the ultimate sale or taxable liquidation of the partnership; in either case, a DTL is required.

Assume a 25 percent tax rate. Company A will make the following consolidated journal entry to recognize the contribution made by the noncontrolling interest holders:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital (APIC)</td>
<td>5,100,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>13,200,000</td>
</tr>
<tr>
<td>DTL</td>
<td>1,700,000</td>
</tr>
</tbody>
</table>

7 (80 percent × $80 million [fair value of the company]) + ($80 million [fair value of the company] + $20 million contribution) = 64 percent.
8 ($37.5 million + $20 million) × 64 percent = $36.8 million.
9 $25 million (initial GAAP basis) + $12.5 million (20X9 income) = $37.5 million.
10 IRC Section 704(c), as noted in footnote 6, applies to reverse IRC Section 704(c) layers created as a result of a revaluation. Upon the contribution of $20 million by B, the partners revalued the partnership property. Under IRC Section 704(c), use of the “remedial method” will generally result in the $6.8 million’s becoming taxable over time, whereas use of the “traditional method” will generally result in the $6.8 million’s becoming taxable upon the ultimate sale or taxable liquidation of the partnership since the goodwill has no tax basis in the hands of the partnership.
Example 3-27

Assume the same facts as in Example 3-26 except that on December 31, 20X9, Company A (not B) contributes an additional $20 million to Partnership P. The contribution increases A's ownership to 84 percent.\(^{11}\) As a result of the contribution, A must recognize a control-to-control loss of $1.7 million (A has paid a $1.7 million premium above book value to acquire the additional interest); essentially A transitions from owning 80 percent of P's $37.5 million net book value\(^{12}\) to owning 84 percent of P's $57.5 million net book value after the contribution. Company A's basis in P for financial reporting purposes increases by $18.3 million; however, its basis for income tax reporting purposes increases by the entire $20 million contribution, resulting in a deductible temporary difference of $1.7 million.

Because there is a difference between the fair value and adjusted tax basis of the property owned by the partnership at the time of A's additional contribution, consideration needs to be given to whether, as a matter of tax law, A will be allocated deductions equal to the fair value of its contribution of $20 million. If the partnership's allocation method (the remedial method in this case since the goodwill has no tax basis in the hands of the partnership) under the applicable income tax regulations will allocate such deductions to A, A should record a DTA for the deductible temporary difference given that such a difference will close through normal business operations. Company A's outside book and tax basis are $48.3 million and $50 million, respectively. Company B's and A's share of inside bases held by the investment would be as follows:

<table>
<thead>
<tr>
<th>Total</th>
<th>B's Basis</th>
<th>A's Basis</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
<td>Book</td>
</tr>
<tr>
<td>Cash</td>
<td>47.5</td>
<td>47.5</td>
<td>7.6</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>8.0</td>
<td>8.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Intangibles</td>
<td>12.0</td>
<td>12.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Goodwill*</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(1.6)</td>
</tr>
<tr>
<td>Total</td>
<td>57.5</td>
<td>57.5</td>
<td>9.2</td>
</tr>
</tbody>
</table>

* Represents notional future income allocable to B in accordance with the remedial allocation method.

Assume a 25 percent tax rate. The resulting entry to record the control-to-control loss in equity would be as follows:

- DTA: 425,000
- APIC: 1,275,000
- Noncontrolling interest: 1,700,000

\(^{11}\) \((80 \text{ percent } \times 80 \text{ million } \text{[fair value of the company]}) + \$20 \text{ million contribution} ÷ (80 \text{ million } \text{[fair value of the company]} + \$20 \text{ million contribution}) = 84 \text{ percent}\).

\(^{12}\) $25 \text{ million (initial GAAP basis)} + 12.5 \text{ million (20X9 income)} = \$37.5 \text{ million}.$
Example 3-27 (continued)

If the partnership's allocation method will not allocate A deductions equal to its $20 million contribution (i.e., the "traditional method" in this case since the goodwill has no tax basis in the hands of the partnership), such a deductible temporary difference will reverse only upon P's sale or taxable liquidation. Company A should consider the application of ASC 740-30-25-9, by analogy, to such a residual temporary difference. A summary of A's outside basis and related look-through temporary differences in its investment in such a case would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>B's Basis</th>
<th>A's Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
<td>Book</td>
</tr>
<tr>
<td>Cash</td>
<td>47.5</td>
<td>47.5</td>
<td>7.6</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>8.0</td>
<td>8.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Intangibles</td>
<td>12.0</td>
<td>12.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(1.6)</td>
</tr>
<tr>
<td>Residual</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>57.5</td>
<td>57.5</td>
<td>9.2</td>
</tr>
</tbody>
</table>

Applying ASC 740-30-25-9 by analogy, A will record the entry for the control-to-control loss as follows:

APIC 1,700,000
Noncontrolling interest 1,700,000

3.4.17 Other Considerations

3.4.17.1 Consideration of the VIE Model in ASC 810-10 in the Evaluation of Whether to Recognize a DTL

For VIEs, an analysis of voting rights may not be effective in the determination of control. Under the VIE model in ASC 810-10, a reporting entity could be determined to have a controlling financial interest in a VIE, and thus consolidate the VIE, if the reporting entity has (1) the power to direct the activities that most significantly affect the VIE's economic performance and (2) the obligation to absorb losses of (or right to receive benefits from) the VIE that could potentially be significant to the VIE. A reporting entity that consolidates a VIE is known as the primary beneficiary.

When accounting for a VIE under ASC 740, the reporting entity must consider both inside and outside basis differences.

When determining whether an exception to recording an outside basis difference applies to the primary beneficiary's investment in a VIE, the reporting entity should carefully consider the facts and circumstances. The primary beneficiary should not assume that its controlling financial interest (through which it has the power to direct the activities that most significantly affect the VIE's economic performance) also gives it the power to direct all of the activities of the VIE that are relevant to the determination of whether an exception to recording an outside basis difference is applicable (e.g., when and if the VIE will distribute earnings, the manner in which the primary beneficiary will recover its investment, and so forth). Provided that the criteria for an exception are met, a primary beneficiary
of a VIE may apply the outside basis exceptions. However, meeting some of these exceptions may be challenging. When determining which party has the power to control decisions regarding the distribution of earnings, for example, an entity should consider how the VIE is controlled (i.e., through contract or governing documents rather than voting interests) and the rights of other parties to the arrangement.

### 3.4.17.2 Recognition of a DTA or DTL Related to a Subsidiary Classified as a Discontinued Operation

ASC 740-30-25-9 states that “[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.” This criterion (i.e., a reversal of a temporary difference in the foreseeable future) would be met no later than when the “held-for-sale” criteria in ASC 360-10-45-9 are met. 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.

Similarly, 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 manner, 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.

The tax effects of the recognition of DTAs and DTLs for preexisting outside basis differences when an investee meets the criteria to be classified as held for sale generally will give rise to an “out-of-period” adjustment in the current period (see Section 6.2.5 for further information on out-of-period adjustments and Section 6.2.5.1 for guidance on the intraperiod allocation of such adjustments resulting from the recognition of an outside basis difference associated with a subsidiary classified as a discontinued operation).

Note that if the unrecognized outside basis difference DTL will close through a GILTI inclusion, entities that have elected to treat GILTI as a current-period expense, as discussed in Section 3.4.10.1, would recognize the tax expense in the period in which the tax is incurred. In other words, recognition of the tax expense may not coincide with the held-for-sale date, as described above.

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13 While the exception in ASC 740-30-25-7 refers to a “more-than-50-percent-owned domestic subsidiary,” the exception was written at a time when the usual condition for control was ownership of a majority (over 50 percent) of the outstanding voting stock. Accordingly, we believe that an entity is not automatically prohibited from applying that exception simply because it owns less than 50 percent of the VIE.
3.4.17.3  State Tax Considerations

In recognizing outside basis differences associated with various investments, entities should pay close attention to certain state tax considerations. 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 Section 3.4.3 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 Section 3.3.4.6 for a discussion of further considerations related to certain state matters, including optional future tax elections in the measurement of DTAs and DTLs.

Example 3-28
Subsidiary B, a 90 percent owned subsidiary of Entity A, operates in only 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 C. Subsidiary B is consolidated in A’s federal return. The only outside basis difference in B relates to $1,000 of unremitted earnings, which A expects to be remitted as dividends. For federal income tax purposes, since A holds more than 80 percent of B, A can deduct 100 percent of the dividends it receives from 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 B to A would not create a temporary difference on which A should record a DTL.

Example 3-29
Assume the same facts as in Example 3-28 above 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 exists for federal tax purposes. However, because C adjusts federal income for the dividends received deduction, a temporary difference exists for state income tax purposes on which 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.
3.5 Other Considerations and Exceptions

There are other exceptions and special situations that result in additional considerations when an entity is determining the appropriate amounts of DTAs and DTLs to present in the financial statements. See Section 3.4 for a discussion of exceptions to recording deferred taxes for outside basis differences.

3.5.1 Changes in Tax Laws and Rates

<table>
<thead>
<tr>
<th>ASC 740-10-25-47</th>
<th>The effect of a change in tax laws or rates shall be recognized at the date of enactment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-48</td>
<td>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.</td>
</tr>
</tbody>
</table>

Under ASC 740-10-25-47 and ASC 740-10-35-4, the effect of a change in tax laws or rates on DTAs and DTLs should be recognized on the date of enactment of the change. A change in tax rate may affect the measurement of DTAs and DTLs. Those DTAs and DTLs that exist as of the enactment date and are expected to reverse after the effective date of the change in tax rate should be adjusted on the basis of the new statutory tax rate. Any DTAs and DTLs expected to reverse before the effective date should not be adjusted to the new statutory tax rate.

To determine the DTAs and DTLs that exist as of the enactment date, a reporting entity should calculate temporary differences by comparing the relevant book and tax basis amounts as of the enactment date. To determine book basis amounts as of the enactment date, the reporting entity should apply U.S. GAAP on a year-to-date (YTD) basis up to the enactment date. For example:

- Any book basis accounts that must be remeasured at fair value under U.S. GAAP would be adjusted to fair value as of the enactment date (e.g., certain investments in securities or derivative assets or liabilities).
- Book balances that are subject to depreciation or amortization would be adjusted to reflect current period-to-date depreciation or amortization up to the enactment date.
- Book basis account balances such as pension and other postretirement assets and obligations for which remeasurement is required as of a particular date (and for which no events have occurred that otherwise would require an interim remeasurement) would not be remeasured as of the enactment date if the enactment date does not coincide with the remeasurement date of the account balances (i.e., no separate valuation of the benefit obligation is required as of the enactment date) for purposes of adjusting the temporary difference that will be measured to the new statutory tax rate as of the enactment date. For example, assume a calendar-year reporting entity has a pension plan with an annual measurement date of December 31 and a tax law change is enacted on December 22. The entity would adjust its balance sheet accounts for the effects of current-year net periodic pension cost and other contribution and benefit payment activity through the date of enactment.
- Any book basis balances associated with share-based payment awards that are classified as liabilities would be remeasured (on the basis of fair value, calculated value, or intrinsic value, as applicable) as of the enactment date. In addition, for those share-based payment awards that ordinarily would result in future tax deductions, compensation cost would be determined on the basis of the YTD requisite service rendered up to the enactment date.
3.5.1.1 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.

3.5.1.2 Enacted Changes in Tax Laws or Rates That Affect Items Recognized in Equity

Changes in tax law may also affect DTAs and DTLs attributable to items recognized in equity, including (1) foreign currency translation adjustments under ASC 830, (2) actuarial gains and losses and prior service cost or credit recognized under ASC 715, (3) unrealized holding gains and losses on certain available-for-sale (AFS) debt securities under the investment guidance in ASC 320, (4) tax benefits recognized in a taxable business combination accounted for as a common-control merger, and (5) certain tax benefits recognized after a quasi-reorganization.

The FASB concluded that the effect of changes in tax law related to items recorded directly in shareholders’ equity must always be recorded in continuing operations in the period of enactment (see Chapter 6 for intraperiod allocation guidance). This requirement could produce unusual relationships between pretax income from continuing operations and income tax expense or benefit, as illustrated in Example 3-30.
Example 3-30

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 $105 DTL.
- The applicable tax rate at the end of 20X1 and 20X2 is 21 percent. A tax law change is enacted at the beginning of year 20X3 that changes the applicable tax rate to 25 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)

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income from continuing operations</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>210</td>
<td>250</td>
</tr>
<tr>
<td>Deferred</td>
<td>—</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>210</td>
<td>270</td>
</tr>
<tr>
<td>Net income</td>
<td>$790</td>
<td>$730</td>
</tr>
<tr>
<td>ETR</td>
<td>21%</td>
<td>27%</td>
</tr>
</tbody>
</table>

### December 31

<table>
<thead>
<tr>
<th>Balance Sheet (Select Accounts)</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>$105</td>
<td>$125</td>
</tr>
<tr>
<td>Equity CTA</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Deferred tax thereon</td>
<td>(105)</td>
<td>(105)</td>
</tr>
<tr>
<td>Net balance</td>
<td>$395</td>
<td>$395</td>
</tr>
</tbody>
</table>
Example 3-30 (continued)

The following is an analysis of the facts in this example:

- Changes in tax laws affect the DTAs and DTLs of items originally recorded directly in shareholders’ equity. The effect of the change is recognized as an increase or decrease to a DTL or DTA and a corresponding increase or decrease in income tax expense or benefit from continuing operations in the period of enactment.

- Tax law changes can significantly affect an entity’s ETR because the effect of the change is computed on the basis of all cumulative temporary differences and carryforwards on the measurement date. In this case, the 4 percent tax rate increase related to the CTA amounts to $20 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 25 percent after being initially recorded in equity at 21 percent, a 4 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 Section 6.2.6.1), 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.

3.5.1.3 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 prior 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 a change in tax law that affects the measurement of DTAs and DTLs and realization of DTAs:

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.

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.

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 Section 7.3.2 for further guidance on accounting for changes in tax laws or rates in an interim period.
See Section 2.7 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.

For a discussion of the intraperiod tax allocation rules with respect to changes in tax laws or rates, see Chapter 6.

3.5.2 Changes in Tax Status of an Entity

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-32</strong> 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.</td>
</tr>
<tr>
<td><strong>25-33</strong> 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.</td>
</tr>
<tr>
<td><strong>25-34</strong> 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.</td>
</tr>
</tbody>
</table>

Cessation of an Entity’s Taxable Status

<table>
<thead>
<tr>
<th>ASC 740-10-40-6</th>
</tr>
</thead>
<tbody>
<tr>
<td>A deferred tax liability or asset shall be eliminated at the date an entity ceases to be a taxable entity. 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.</td>
</tr>
</tbody>
</table>

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. This section provides an overview of considerations when an entity has a change in tax status.

For a discussion of the intraperiod tax allocation rules with respect to a change in tax status, see Chapter 6.

3.5.2.1 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 Section 14.7.1 for a discussion of the potential disclosure impact when an entity changes its tax status from nontaxable to taxable.

### 3.5.2.2 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 3-33.

### 3.5.2.3 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.

### 3.5.2.4 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 Section 3.5.4.2.
3.5.3 Tax Effects of a Check-the-Box Election

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

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

Example 3-31

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

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

However, if the check-the-box election affects only 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 expected to result in only the avoidance of a reversal of either a taxable or deductible temporary difference with respect to the outside basis difference in a subsidiary,

14 While check-the-box elections are most commonly considered in a foreign context, the same elections can be made for domestic entities.
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 3-32**

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, that 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).

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).

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 DTL 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 deferred or current tax liability would be recognized).

### 3.5.4 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.

#### 3.5.4.1 Recognition Date for Conversion to a REIT

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 E&P of the corporation to the shareholders before election of REIT status.
- Adopt a calendar tax year.
- File its tax return as a REIT (Form 1120-REIT) by the normal due date.

---

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

Alternatively, some entities have analogized an election of REIT status to a change in tax status (i.e., taxable to nontaxable) in accordance with ASC 740-10-25-32 (see Section 3.5.4). 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).

3.5.4.2 Change in Tax Status to Nontaxable: 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.

3.5.4.2.1 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.
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.

### 3.5.4.2.2 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 annual effective tax rate (AETR)).

Further, 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.
Example 3-33

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 an 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 basis 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.

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 a nontaxable S corporation.

3.5.5 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 1** — 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 2** — 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.

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**Example 3-34**

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 use of future percentage of taxable income (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 is 8 percent.
- The association has no temporary differences other than those arising from loan losses.
- The enacted tax rate for all years is 25 percent.

<table>
<thead>
<tr>
<th>Activity in Book — Bad-Debt Reserve</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$ 500</td>
<td>$ 500</td>
<td>$ 300</td>
<td>$ 600</td>
</tr>
<tr>
<td>Loan loss provision</td>
<td>100</td>
<td>100</td>
<td>400</td>
<td>300</td>
</tr>
<tr>
<td>Charge-offs</td>
<td>(100)</td>
<td>(300)</td>
<td>(100)</td>
<td>(320)</td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td>$ 500</td>
<td>$ 300</td>
<td>$ 600</td>
<td>$ 580</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Activity in Tax — Bad-Debt Reserve</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base year (1987)</td>
<td>$ 850</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning balance (current)</td>
<td>$ 850</td>
<td>$ 910</td>
<td>$ 850</td>
<td>$ 910</td>
</tr>
<tr>
<td>PTI deductions</td>
<td>160</td>
<td>160</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Charge-offs</td>
<td>(100)</td>
<td>(300)</td>
<td>(100)</td>
<td>(320)</td>
</tr>
<tr>
<td>Experience method deductions</td>
<td></td>
<td>240</td>
<td>260</td>
<td></td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td>$ 910</td>
<td>$ 850</td>
<td>$ 910</td>
<td>$ 850</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Tax Liability</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax accounting income before loan loss provision</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Tax bad-debt deduction</td>
<td>(160)</td>
<td>(240)</td>
<td>(160)</td>
<td>(260)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 1,840</td>
<td>$ 1,760</td>
<td>$ 1,840</td>
<td>$ 2,740</td>
</tr>
<tr>
<td>Current liability</td>
<td>$ 460</td>
<td>$ 440</td>
<td>$ 460</td>
<td>$ 685</td>
</tr>
</tbody>
</table>
### Example 3-34 (continued)

Deferred tax amounts are shown below.

<table>
<thead>
<tr>
<th></th>
<th>20X0</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deferred Tax Balance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deductible temporary difference*</td>
<td>$ 500</td>
<td>$ 500</td>
<td>$ 300</td>
<td>$ 600</td>
<td>$ 580</td>
</tr>
<tr>
<td>Taxable temporary difference**</td>
<td></td>
<td>(60)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net temporary difference</td>
<td>$ 500</td>
<td>$ 440</td>
<td>$ 300</td>
<td>$ 540</td>
<td>$ 580</td>
</tr>
<tr>
<td>DTA — net</td>
<td>$ 125</td>
<td>$ 110</td>
<td>$ 75</td>
<td>$ 135</td>
<td>$ 145</td>
</tr>
</tbody>
</table>

* The book bad-debt reserve.

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

Income statement amounts are shown below (select accounts).

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income before taxes</strong></td>
<td>$ 1,900</td>
<td>$ 1,900</td>
<td>$ 1,600</td>
<td>$ 2,700</td>
</tr>
<tr>
<td>Provision (benefit) for income taxes:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>460</td>
<td>440</td>
<td>460</td>
<td>685</td>
</tr>
<tr>
<td>Deferred</td>
<td>15</td>
<td>35</td>
<td>(60)</td>
<td>(10)</td>
</tr>
<tr>
<td></td>
<td>475</td>
<td>475</td>
<td>400</td>
<td>675</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$ 1,425</td>
<td>$ 1,425</td>
<td>$ 1,200</td>
<td>$ 2,025</td>
</tr>
<tr>
<td><strong>ETR</strong></td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
</tbody>
</table>

As indicated above, ASC 942-740-25-1 concludes that 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 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 3-35

Assume that Entity B, a bank holding company, acquires a 100 percent interest in a stock savings and loan association, Entity T, in a 20X0 business combination. In 20X1, B directs 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.

3.5.6 Tax Effects of Intra-Entity Profits on Inventory

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. A DTA is recorded for the excess of the tax basis over the financial reporting carrying value of assets other than inventory that results from the intra-entity sale.

However, ASC 740-10-25-3(e) requires that income taxes paid on intra-entity profits on inventory 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 inventory in the buyer's tax jurisdiction and its cost as reported in the consolidated financial statements (i.e., after elimination of intra-entity profit). Specifically, ASC 810-10-45-8 states, “[i]f income taxes have been paid on intra-entity profits on inventory 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 of inventory 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. 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 3-36 illustrates these conclusions for a situation involving the transfer of inventory.
Example 3-36

Assume the following:

- A parent entity, P, operates in a jurisdiction, A, where the tax rate is 25 percent. Parent P’s wholly owned subsidiary, S, operates in a jurisdiction, B, where the tax rate is 35 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**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid income tax</td>
<td>25</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>25</td>
</tr>
</tbody>
</table>

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**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash for sales</td>
<td>300</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>200</td>
</tr>
<tr>
<td>Sales</td>
<td>300</td>
</tr>
<tr>
<td>Inventory</td>
<td>200</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>25</td>
</tr>
<tr>
<td>Prepaid income tax</td>
<td>25</td>
</tr>
</tbody>
</table>

In October 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). Before the adoption of ASU 2016-16, the guidance discussed above applied to intra-entity transfers of all assets. In addition, in situations involving the transfer of assets intended for internal use, the prepaid taxes were 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).
3.5.6.1 Subsequent Changes in Tax Rates Involving Intra-Entity Transactions

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.

3.5.7 Income Tax Consequences of 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 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 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 3-37 below, 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 3-37

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 25 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**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Derivative liability</td>
<td>40,000,000</td>
</tr>
<tr>
<td><strong>To record the issuance of the convertible debt.</strong></td>
<td></td>
</tr>
<tr>
<td>Income tax provision</td>
<td>10,000,000</td>
</tr>
<tr>
<td>DTL</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>

To record the DTL for the temporary difference between the financial reporting basis of the debt ($60 million) and the tax basis of the debt ($100 million).
Example 3-37 (continued)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>

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**

**DTA**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax provision</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>

**DTL**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>786,147</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>500,000</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>1,286,147</td>
</tr>
</tbody>
</table>

To record the tax effects of the interest expense, consisting of $500,000 of current tax benefits and $1,286,147 of deferred tax benefits.

**Income tax provision**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax provision</td>
<td>1,250,000</td>
</tr>
<tr>
<td>DTA</td>
<td>1,250,000</td>
</tr>
</tbody>
</table>

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.
3.5.8 Leases

A lease's classification for accounting purposes does not affect its classification for tax purposes. An entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences between tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements ASU 2016-02, it will need to establish a process (or leverage its existing processes) to account for these differences.

Connecting the Dots

ASC 842 does not significantly affect the accounting for income taxes under ASC 740. In a manner consistent with ASC 840, differences between accounting and tax guidance will result in book/tax differences. Because the lessee will recognize a new right-of-use (ROU) asset and lease liability for operating leases as a result of adopting ASC 842, there are likely to be more book/tax differences under ASC 842 than under ASC 840. If there is no tax basis in the ROU asset, a taxable temporary difference may arise. Similarly, if there is no tax basis in the lease liability, a deductible temporary difference may arise. The taxable and deductible temporary differences are separate and give rise to separate and distinct deferreds. Generally, the deferreds should not be netted in the income tax disclosures. Entities should carefully consider the disclosure requirements in both ASC 740-10-50-2 and ASC 740-10-50-6 (see Chapter 8 for details regarding the disclosure requirement of ASC 740).

Because ASC 842 requires entities to reevaluate their leases, they may have the opportunity to reassess the tax treatment of such leases as well as their data collection and processes. Since the IRS considers a taxpayer's tax treatment of leases to be a method of accounting, an entity may need to obtain IRS consent if it makes any changes to its existing methods. Entities should also consider the potential state tax issues that may arise as a result of ASC 842, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable and state DTAs and DTLs.

3.5.8.1 Deferred Tax Consequences of Synthetic Leases

Entities (lessees) may 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 while, for income tax purposes, the entity is treated as the owner of the property. Therefore, the entity recognizes lease cost in its financial statements but capitalizes the property and the related debt obligation in its income tax return.

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.

Note that if the special-purpose entity is required to be consolidated by the lessee, there is effectively no synthetic lease arrangement because the entity is also treated as the owner of the property for financial reporting purposes.
Upon the adoption of ASC 842, the entity (lessee) will recognize on its statement of financial position an ROU asset and a lease liability for most operating leases (including those related to synthetic lease arrangements). For income tax purposes, the entity is still treated as the owner of the property. The tax bases of the property and related debt for income tax purposes may differ from the ROU asset and lease liability and cause separate temporary differences for each item. Therefore, the entity may need to record and track the deferred taxes on each temporary difference separately. For example, if there is no tax basis in the ROU asset, a taxable temporary difference may arise. Similarly, if there is no tax basis in the lease liability, a deductible temporary difference may arise. The taxable and deductible temporary differences are separate and give rise to separate and distinct deferreds. Generally, the deferreds should not be netted in the income tax disclosures.

Before the adoption of ASC 842, an entity does not recognize on its statement of financial position an asset and liability for operating leases, although 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 usually 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. Regardless of whether the DTA and DTL offset each other, it is generally expected that entities will disclose their respective DTAs and DTLs gross within the income tax disclosures. Entities should carefully consider the disclosure requirements in both ASC 740-10-50-2 and ASC 740-10-50-6 (see Chapter 8 for details regarding the disclosure requirement of ASC 740).

### 3.5.9 Accounting for Temporary Differences Related to ITCs

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-45</strong> 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.</td>
</tr>
<tr>
<td><strong>25-46</strong> 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.</td>
</tr>
</tbody>
</table>

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

Under the deferral method, the ITC would result in a reduction to income taxes payable (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) that is recognized as either a reduction to the carrying value of the related asset or as a deferred credit (i.e., credit is treated as deferred income). The benefit of the ITC is either reflected in net income as a reduction to depreciation expense or recognized as deferred income over the productive life of the related property (rather than as a reduction to income tax expense).\(^\text{16}\) Under this method, temporary differences may be created when either the financial statement carrying amount of the acquired property is reduced or when a deferred credit is recorded. In some cases, receipt of the credit results in a statutory reduction in the tax basis of the related asset, which may affect the temporary basis difference.

\(^{16}\) We are also aware of an alternative view under which the deferred credit would be reversed through the income tax provision in accordance with paragraph 3 of Opinion 4.
Under the flow-through method, the ITC would result in (1) a reduction to income taxes payable for the
year in which the credit arises (or an increase in a DTA if the credit is carried forward to future years,
subject to assessment for realization) and (2) an immediate reduction to income tax expense. Under this
method, temporary differences are generally created only if a statutory reduction in tax basis occurs.

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

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

• **Income statement approach** — Under this approach, the DTA or DTL is recorded with an offset to
  income tax expense.

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

### Example 3-38

**ITC With No Statutory Reduction to Tax Basis**

Assume the following:

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

  **Entry 1A**

  \[
  \begin{align*}
  \text{PP&E} & \quad 1,000 \\
  \text{Cash} & \quad 1,000 \\
  \end{align*}
  \]

  To record the initial purchase.

- In accordance with the tax law, there is no associated reduction in the tax basis of the related asset.
- Entity A’s applicable tax rate is 21 percent.

**Deferral Method**

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

**Entry 1B**

\[
\begin{align*}
\text{Income taxes payable} & \quad 250 \\
\text{PP&E} & \quad 250 \\
\end{align*}
\]

To record the reduction of income taxes payable and the related reduction in the carrying value of the qualifying asset under the
deferral method.\(^1\)

---

\(^1\) Instead of reducing the carrying value of the qualifying asset, A could record a “deferred credit,” which would result in the same deferred tax
accounting treatment (i.e., there would be a book-to-tax difference related to the deferred credit that is recorded for book purposes but not for
tax purposes).
**Example 3-38 (continued)**

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

**Gross-Up Approach**

Under the gross-up approach, A's application of a simultaneous equation yields a DTA of $66 (rounded) and a reduction to the recorded amount of the qualifying asset of $66 (rounded). Thus, the qualifying asset should be recorded at $684 ($1,000 purchase price less the $250 ITC less the $66 DTA). Entity A will record all of the entries above as well as the following entry to account for the qualifying asset, the ITC, and the initial basis difference in the qualifying asset:

<table>
<thead>
<tr>
<th>Entry 1C</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>66</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>66</td>
</tr>
</tbody>
</table>

To record the DTA determined by using the gross-up approach:

\[
\text{initial deductible temporary difference} \times 21\% \text{ tax rate} \div (1-21\% \text{ tax rate}) = $66 \text{ DTA}.
\]

**Income Statement Approach**

Under the income statement approach, A records a DTA of $53 as a component of income tax expense. Entity A will record Entry 1B above and the following entry to account for the initial basis difference in the qualifying asset:

<table>
<thead>
<tr>
<th>Entry 1D</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>53</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>53</td>
</tr>
</tbody>
</table>

To record the DTA under the income statement approach ($250 deductible temporary difference \times 21\% tax rate = $53 DTA).

**Flow-Through Method**

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

<table>
<thead>
<tr>
<th>Entry 1E</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes payable</td>
<td>250</td>
</tr>
<tr>
<td>Current income tax expense</td>
<td>250</td>
</tr>
</tbody>
</table>

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

Because there is no adjustment to the book basis of the qualifying asset and it is assumed that there is no adjustment to the tax basis of the qualifying asset (per the tax law), no deductible temporary difference arises. Therefore, the gross-up and income statement approaches are not applicable.
Example 3-39

ITC With Statutory Reduction to Tax Basis

Assume the same facts as in Example 3-38, except that in accordance with the tax law, there is an associated reduction in the tax basis of the related property equal to 50 percent of the ITC (i.e., $125). Entity A records the same initial entry as follows:

**Entry 2A**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>PP&amp;E</td>
<td>1,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To record the initial purchase.

**Deferral Method**

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

**Entry 2B**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes payable</td>
<td>250</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>250</td>
</tr>
</tbody>
</table>

To record the reduction of income taxes payable and the related reduction in the carrying value of the qualifying asset under the deferral method.\(^\text{18}\)

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

**Gross-Up Approach**

Under the gross-up approach, A's application of a simultaneous equation yields a DTA of $33 (rounded) and a reduction to the recorded amount of the qualifying asset of $33 (rounded). Thus, the qualifying asset should be recorded at $717 ($1,000 purchase price less the $250 ITC less the $33 DTA determined herein). Entity A will record the entries above and the following entry to account for the initial basis difference in the qualifying asset:

**Entry 2C**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>33</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>33</td>
</tr>
</tbody>
</table>

To record the DTA determined under the simultaneous equations method (initial deductible temporary difference of $125 × 21% tax rate ÷ [1–21% tax rate] = $33 DTA).

\(^{18}\) See footnote 17.
## Example 3-39 (continued)

### Income Statement Approach
Under the income statement approach, A records a $26 DTA as a component of tax expense. Entity A will record Entry 2B and the following entry to account for the qualifying asset, the ITC, and the initial basis difference in the qualifying asset:

**Entry 2D**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>26</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>26</td>
</tr>
</tbody>
</table>

To record the DTA under the income statement approach ($125 deductible temporary difference × 21% tax rate = $26 DTA).

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

**Entry 2E**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes payable</td>
<td>250</td>
</tr>
<tr>
<td>Current income tax expense</td>
<td>250</td>
</tr>
</tbody>
</table>

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

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

### Gross-Up Approach
Under the gross-up approach, A’s application of a simultaneous equation yields a DTL of $26 (rounded) and an increase to the recorded amount of the qualifying asset of $26 (rounded). Thus, the qualifying asset should be recorded at $1,026 ($1,000 purchase price plus the $26 DTL determined herein). Entity A will record Entry 2E and the following entry to account for the initial basis difference in the qualifying asset:

**Entry 2F**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>PP&amp;E</td>
<td>26</td>
</tr>
<tr>
<td>DTL</td>
<td>26</td>
</tr>
</tbody>
</table>

To record the DTL under the income statement approach ($125 taxable temporary difference × 21% tax rate = $26 DTL).
Example 3-39 (continued)

**Income Statement Approach**

Under the income statement approach, A would not use the simultaneous equations method. Rather, A would apply its tax rate of 21 percent to the taxable temporary difference of $125, resulting in the recognition of a $26 DTL with the offset to deferred tax expense. Entity A will record Entry 2E and the following entry to account for the qualifying asset, the ITC, and the initial basis difference in the qualifying asset:

**Entry 2G**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>26</td>
</tr>
<tr>
<td>DTL</td>
<td>26</td>
</tr>
</tbody>
</table>

To record the DTL under the income statement approach ($125 taxable temporary difference × 21% tax rate = $26 DTL).

### 3.5.10 Tax Consequences of Securities Classified as HTM, Trading, and AFS

**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.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

*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**

45-3 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.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

45-4 Paragraph superseded by Accounting Standards Update No. 2016-01.
ASC 320-10 (continued)

45-5 An entity that recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities may, at the same time, conclude that a valuation allowance is warranted and in a subsequent fiscal year makes a change in judgment about the level of future years’ taxable income such that all or a portion of that valuation allowance is no longer warranted. In that circumstance, the entity shall include any reversals in the valuation allowance due to such a change in judgment in subsequent fiscal years as an item in determining income from continuing operations, even though initial recognition of the valuation allowance affected the component of other comprehensive income classified as unrealized gains and losses on certain investments in debt and equity securities. If, rather than a change in judgment about future years’ taxable income, the entity generates taxable income in the current year (subsequent to the year the related deferred tax asset was recognized) that can use the benefit of the deferred tax asset, the elimination (or reduction) of the valuation allowance is allocated to that taxable income. Paragraph 740-10-45-20 provides additional information.

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.

Pending Content (Transition Guidance: ASC 825-10-65-2)

45-6 Paragraph superseded by Accounting Standards Update No. 2016-01.

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance 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 LLCs, at fair value through net income. The guidance in this section reflects U.S. GAAP before the adoption of ASU 2016-01.

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.
3.5.10.1 **HTM 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 straightforward 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 in OCI.

3.5.10.2 **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.

3.5.10.3 **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 3-40 below illustrates this concept.

For details on intraperiod tax allocations related to AFS securities, see Section 6.2.4.

### Example 3-40

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 25 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 $250 DTA and a $125 valuation allowance. Accordingly, the carrying amount of the AFS portfolio is reduced by $1,000, OCI is reduced by $875, and a $125 net DTA (a DTA of $250 less a valuation allowance of $125) is recognized at the end of 20X1.
Chapter 4 — Uncertainty in Income Taxes

4.1 Overview and Scope

As discussed in Chapter 1, an entity’s overall objectives in the accounting for income taxes 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.” The total tax provision consists of current tax expense (benefit) (i.e., 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 the excess of deductions over revenues for that year) and deferred tax expense (or benefit) (i.e., change in DTAs and DTLs during the year). The total tax expense reported in the financial statements should reflect the income tax effects of tax positions on the basis of the two-step process in ASC 740-10, recognition (step 1) and measurement (step 2). The recognition and measurement requirements should be applied only to uncertainties in income taxes and do not apply to non-income taxes such as sales tax, value-added tax, and payroll tax.

See Section 11.4 for a discussion of the accounting for uncertainty in income taxes in business combinations.
4.1.1 UTB Decision Tree and Assumptions in Recognition and Measurement

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

Identify material tax position at appropriate unit of account.

- Measure associated tax benefit to be recorded at the largest amount greater than 50 percent likely to be realized upon settlement with tax authority.
- Is tax position "more likely to be sustained than not" on the basis of its technical merits?
  - Yes
    - Is tax position related to current-year ordinary income?
      - Yes
        - Measure associated tax benefit to be recorded at the largest amount greater than 50 percent likely to be realized upon settlement with tax authority.
        - Calculate interest and penalties if necessary.
        - Provide financial statement disclosures.
      - No
        - Record UTB for the full amount.
  - No
    - Record UTB for the full amount.

- Incorporate into interim AETR.
  - Yes
    - Is tax position related to current-year ordinary income?
      - Yes
        - Measure associated tax benefit to be recorded at the largest amount greater than 50 percent likely to be realized upon settlement with tax authority.
        - Calculate interest and penalties if necessary.
        - Provide financial statement disclosures.
      - No
        - Record discretely in the current period.
  - No
    - Record discretely in the current period.

Subsequent Periods

- Has the tax position been effectively settled or has the statute of limitations expired?
  - Yes
    - Account for the resolution of the tax position and provide financial statement disclosures.
  - No
    - Did the tax position meet the more-likely-than-not recognition threshold in the prior period?
      - Yes
        - Account for the resolution of the tax position and provide financial statement disclosures.
      - No
        - Is new information available regarding the sustainability of the tax position?
          - Yes
            - Account for the resolution of the tax position and provide financial statement disclosures.
          - No
            - Is new information available related to measurement of the associated tax benefit?
              - Yes
                - Is the new information available related to measurement of the associated tax benefit?
                  - Yes
                    - Account for the resolution of the tax position and provide financial statement disclosures.
                  - No
                    - There is no change to the tax benefit previously recorded. Calculate interest and penalties if necessary and provide financial statement disclosures.
              - No
                - There is no change to the tax benefit previously recorded. Calculate interest and penalties if necessary and provide financial statement disclosures.
The following table summarizes the assumptions an entity uses when applying the two-step process of recognition and measurement under ASC 740-10:

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

**4.1.2 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:

- “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).
- “An allocation or a shift of income between jurisdictions” (e.g., transfer pricing).
- “The characterization of income or a decision to exclude reporting taxable income in a tax return” (e.g., interest income earned on municipal bonds).
- “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).
- “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).

**4.1.2.1 Tax Positions Related to Entity Classification**

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 or as a pass-through 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 a tax authority’s widely understood administrative practices and precedents. Sometimes, however, these administrative practices and precedents are available only 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.

4.1.2.2 Unit of Account

Each individual tax position must be analyzed separately under ASC 740. ASC 740-10-25-13 states that an entity’s determination of what constitutes a unit of account for its individual tax position “is a matter of judgment based on the individual facts and circumstances.” To determine the unit of account, the 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 history of the entity (or reliable information about others’ history) with the relevant tax authority on similar positions.

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.

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. Further, if a change in unit of account is caused by
Chapter 4 — Uncertainty in Income Taxes

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.

### 4.2 Recognition

<table>
<thead>
<tr>
<th>ASC 740-10</th>
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<tbody>
<tr>
<td><strong>25-5</strong> 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. See paragraph 740-10-55-3 for guidance related to this two-step process.</td>
</tr>
<tr>
<td><strong>25-6</strong> 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 <em>more likely than not</em> means a likelihood of more than 50 percent; the terms <em>examined</em> and <em>upon examination</em> also include resolution of the related appeals or litigation processes, if any. 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. 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. 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.</td>
</tr>
<tr>
<td><strong>25-7</strong> In making the required assessment of the more-likely-than-not criterion:</td>
</tr>
<tr>
<td>a. It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.</td>
</tr>
<tr>
<td>b. Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners and auditors, those practices and precedents shall be taken into account.</td>
</tr>
<tr>
<td>c. Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with other positions.</td>
</tr>
<tr>
<td><strong>25-8</strong> 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:</td>
</tr>
<tr>
<td>a. The more-likely-than-not recognition threshold is met by the reporting date.</td>
</tr>
<tr>
<td>b. The tax position is effectively settled through examination, negotiation or litigation.</td>
</tr>
<tr>
<td>c. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.</td>
</tr>
</tbody>
</table>

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.
ASC 740-10 (continued)

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.

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.

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.

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. 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.

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. 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. Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.
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.

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. See paragraph 740-10-30-7 for measurement requirements.

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 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].

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. If that threshold is not met, no benefit can be recognized in the financial statements for that tax position.

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

4.2.1 Meaning of the Court of Last Resort and Its Impact on Recognition

As part of the technical merit assessment, an entity 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 laws 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. Many more cases are filed with the U.S. Supreme Court than are heard; the justices exercise discretion in deciding which cases to hear.

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, the entity should assume that the case will be heard by the court of last resort.

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.

4.2.2 Legal Tax Opinions Not Required

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, the 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.

4.2.3 Consideration of Widely Understood Administrative Practices and Precedents

When assessing whether a tax position meets the more-likely-than-not recognition threshold, an entity is allowed under ASC 740 to consider 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), the entity must also presume that the tax position will be examined by a tax authority that has knowledge of all relevant information.
4.3 Measurement

ASC 740-10

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).

4.3.1 Information Affecting Measurement of Tax Positions

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 give more weight to information that is objectively verifiable than to information that 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.

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.

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. The 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 in which the entity lacks expertise.
- The tax position arises in connection with an unusual, nonrecurring transaction or event.
4.3.2 Cumulative-Probability Table

It is expected that an entity will prepare a cumulative-probability table 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.

4.3.3 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 4-1 below illustrates this difference by showing the measurement of the benefit of an uncertain tax position. 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.

**Example 4-1**

In its 20X7 tax return, an entity takes a $100 tax deduction, which reduces its current tax liability by $25. 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 that 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:

<table>
<thead>
<tr>
<th>Possible Estimated Outcome</th>
<th>Individual Probability of Occurring</th>
<th>Cumulative Probability of Occurring</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 25</td>
<td>31%</td>
<td>31%</td>
</tr>
<tr>
<td>$ 20</td>
<td>20%</td>
<td>51%</td>
</tr>
<tr>
<td>$ 15</td>
<td>20%</td>
<td>71%</td>
</tr>
<tr>
<td>$ 10</td>
<td>20%</td>
<td>91%</td>
</tr>
<tr>
<td>$ 0</td>
<td>9%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Accordingly, the entity should (1) recognize a tax benefit of $20 because this is the largest benefit that has a cumulative probability of greater than 50 percent and (2) record a $5 liability for UTBs (provided that the tax position does not affect a DTA or DTL).
4.3.4 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.

4.3.5 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).

Connecting the Dots
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, the 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).

Connecting the Dots
When a full tax benefit is recognized for a tax position that is considered binary and no UTB is presented in the tabular UTB reconciliation, the 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.
4.4 Interest (Expense and Income) and Penalties

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-29</strong> 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.</td>
</tr>
<tr>
<td><strong>30-30</strong> 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.</td>
</tr>
</tbody>
</table>

4.4.1 Interest Expense

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.

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.

4.4.2 Interest Income

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.

4.4.3 Penalties

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.

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 4-2
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.

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 the 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, the 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 the 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 4-3
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 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 4-4
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.

See Section 13.3.1 for a discussion related to presentation of interest (expense and income) and penalties in the financial statements.
4.5 **Subsequent Changes in Recognition and Measurement**

### 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.

**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. Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

**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. 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.

**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.

**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. Paragraph 740-270-35-6 addresses the different accounting required for such changes in a prior interim period within the same fiscal year.

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.” ASC 740-10-25-8 states, in part:

- If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:
  - The more-likely-than-not recognition threshold is met by the reporting date.
  - The tax position is effectively settled through examination, negotiation or litigation.
  - The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.
An entity that has taken a tax position that previously did not meet the more-likely-than-not recognition threshold can subsequently recognize the benefit associated with that tax position only if new information changes the technical merits of the position or the tax position is effectively settled through examination or expiration of the statute of limitations.

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.

See Section 11.4 for a discussion of subsequent changes in recognition and measurement of uncertainty in income taxes in a business combination.
4.5.1 Decision Tree for the Subsequent Recognition, Derecognition, and Measurement of Benefits of a Tax Position

- **Did the uncertain tax position originally meet the recognition threshold?**
  - Yes: Wait until new information becomes available, the tax position is effectively settled, or the statute of limitations expires before remeasuring the associated tax benefit.
  - No: Go to next decision.

- **Has the statute of limitations expired?**
  - Yes: Recognize the full tax benefit.
  - No: Go to next decision.

- **Was the tax position in a tax return subject to an examination?**
  - Yes: Wait until the statute of limitations expires or new information becomes available that changes the technical merits of the tax position, permitting recognition and measurement of the tax benefit.
  - No: Go to next decision.

- **Are the three conditions in ASC 740-10-25-10 met?**
  - Yes: The tax position is effectively settled. Recognize the full tax benefit. The tax position is effectively settled. Recognize the full tax benefit.
  - No: Go to next decision.

- **Was the tax position specifically examined by the tax authority?**
  - Yes: If the new information indicates that the recognition threshold is met, recognize and measure the associated tax benefit on the basis of the new information obtained during the examination.
  - No: Go to next decision.

- **Has new information about the technical merits of the tax position been obtained during the examination?**
  - Yes: If the new information indicates that the recognition threshold is met, recognize and measure the associated tax benefit on the basis of the new information obtained during the examination.
  - No: Go to next decision.
4.5.2 New Information

New information (e.g., from a recently completed examination by the tax authority of a tax year that includes a similar type of tax position) may result in a change to the recognition or measurement of a tax position. Such 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 not meet the more-likely-than-not recognition threshold can subsequently recognize a benefit associated with the tax position if new information changes the technical merits of the position. The examination of a tax year by the relevant authority in a jurisdiction (e.g., the 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.

An entity that has taken a tax position that previously met 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.

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.

Example 4-5 (below) and Example 4-6 illustrate the consideration of new information concerning an uncertain tax position that is received after the balance sheet date.

**Example 4-5**

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; however, the entity should consider whether the court ruling and an estimate of its impact should be disclosed in accordance with ASC 855.
Example 4-6

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.

4.5.3 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 be considered effectively settled only 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 that 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 all relevant information available to it. 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.

ASC 740-10-25-12 acknowledges that an entity may obtain information in an examination that leads it to change its evaluation of the 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 Section 7.3.3 for a discussion related to the interim accounting for subsequent change in recognition and measurement.

4.6 Other Topics

4.6.1 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

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

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

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

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

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

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

b. A deferred tax liability or asset shall be recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

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

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

Affirmative adjustments should be accounted for similarly to tax positions that will be taken on a tax return (i.e., similarly to an amended return or refund claim). That is, the entity should account for the tax positions associated with affirmative adjustments in the period in which the entity concludes that it intends to present the positions to an examiner in a future tax examination. Generally, we would expect 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 Section 12.6.1 for guidance on those considerations.
4.6.2 State Tax Positions

Certain operational activities may be taxable in multiple jurisdictions (e.g., federal and state) 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). It is not always certain how these rules should be applied and therefore, management routinely makes judgments 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). In addition to being subject to federal income taxes, an entity could also be subject to income tax imposed by a state or states. While there are similarities between the federal and state income tax rules, there are also differences that give rise to unique state tax positions.

4.6.2.1 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, the 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. Conversely, an entity that has a reasonable basis for not filing a state income tax return in a particular state but concluded that it is more likely than not that it has economic nexus in that state has not met the recognition threshold.

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, and the state tax liability is 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 be derecognized only 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 requires only 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.

4.6.2.2 Due Process

In addition to considering the application of relevant tax rules in accounting for state tax positions, an entity should also consider the “due process clause” and the “commerce clause” of the U.S. Constitution, which 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 may need to assess whether the U.S. Supreme Court would overturn that tax law. This analysis is required for recognition even though the court issues certiorari for tax matters involving the constitutionality of state income taxes only in rare circumstances. Generally, the entity will conclude that the court would uphold the tax law. However, in certain situations, the 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 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.

4.6.3 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 apply the two-step process (i.e., recognition and measurement) under ASC 740-10 to all uncertain tax positions within its scope. The requirements of ASC 740 in the context of transfer pricing arrangements, including related considerations and examples, are outlined below.

4.6.3.1 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. Intra-entity and related-party transactions under transfer pricing arrangements are within the scope of ASC 740 since they encompass “[a]n allocation or a shift of income between jurisdictions.”
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. Typically, 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. In addition, some transfer pricing arrangements could be made up of multiple components that could be challenged individually or in aggregate by a taxing authority. Therefore, there could be multiple of units of account associated with a particular transfer pricing arrangement. See Section 4.1.2.2 for more information about determining the unit of account.

4.6.3.2 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.” An entity should apply the recognition threshold and guidance in ASC 740 to each unit of account in a transfer pricing arrangement. In some cases, a tax position will be determined to have met 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) may typically meet 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 generally be considered during the recognition 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.

4.6.3.3 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, Organisation for Economic Co-operation and Development 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 may serve 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 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 may not strictly follow the arm’s-length principle. In those situations, it may be inappropriate for an entity to assume symmetry of positions when measuring such positions.

**Example 4-7** illustrates the above considerations. See Section 13.2.4 for a discussion of balance sheet presentation in transfer pricing arrangements under ASC 740.
### Example 4-7

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 more likely than not 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 revenue and taxable income) that would require a consistent transfer pricing adjustment (i.e., increasing deduction and reducing 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 (i.e., greatest benefit) that is more than 50 percent likely to be accepted by the two tax jurisdictions under such a treaty on the basis of its 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.

### 4.6.4 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 4-8

Assume the following:

- An entity purchases equipment for $1,000 in 20X7.
- The entity's earnings before interest, depreciation, and taxes are $1,200 each year 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 25 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 profit and loss (P&L).

The 20X7 tax return reflects a $250 reduction in the current tax liability for the $1,000 deduction claimed. For book purposes, the entity will recognize a balance sheet credit of $200 ([$1,000 – $200] × 25%) for UTBs associated with the deduction claimed in year 1. The liability for UTBs will be extinguished over the succeeding
Example 4-8 (continued)

Four years at $50 ($200 × 25 percent) per year. The entity would record the following journal entries, excluding interest and penalties, for the tax effects of the purchased equipment:

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X8</th>
<th>20X9</th>
<th>20Y0</th>
<th>20Y1</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax book and taxable income before depreciation and interest</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(200)</td>
<td>(200)</td>
<td>(200)</td>
<td>(200)</td>
<td>(200)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Interest</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Pretax book and taxable income on ASC 740-10 basis</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Adjust for tax depreciation as filed</td>
<td>(800)</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>—</td>
</tr>
<tr>
<td>Taxable income on as-filed basis</td>
<td>$ 200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Current tax provision</td>
<td>50</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>1,250</td>
</tr>
<tr>
<td>Current tax provision — adjusted for uncertainty</td>
<td>200</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>—</td>
</tr>
<tr>
<td>Deferred tax provision</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Interest and penalties</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total tax provision</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>1,250</td>
</tr>
<tr>
<td>Book income (after tax)</td>
<td>$ 750</td>
<td>$ 750</td>
<td>$ 750</td>
<td>$ 750</td>
<td>$ 750</td>
<td>$ 3,750</td>
</tr>
<tr>
<td>Taxable income — as filed</td>
<td>$ 200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 1,200</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Taxable income — adjusted for uncertainty</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Current tax liability — as filed</td>
<td>50</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Current tax liability — adjusted for uncertainty</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Underpayment (repayment) of tax</td>
<td>200</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>—</td>
</tr>
</tbody>
</table>

**Journal Entries**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X8</th>
<th>20X9</th>
<th>20Y0</th>
<th>20Y1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax provision</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Cash or current tax liability</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>ASC 740 tax provision</td>
<td>200</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Current UTB liability</td>
<td>(50)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Long-term UTB liability</td>
<td>(150)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Current UTB liability</td>
<td>—</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Cash or increase in current tax liability</td>
<td>—</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
</tr>
<tr>
<td>Cash or reduction in current tax liability</td>
<td>—</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>ASC 740 provision</td>
<td>—</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
</tr>
<tr>
<td>Long-term UTB liability</td>
<td>—</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>—</td>
</tr>
<tr>
<td>Current UTB liability</td>
<td>—</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
<td>—</td>
</tr>
</tbody>
</table>
Example 4-8 (continued)

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X8</th>
<th>20X9</th>
<th>20Y0</th>
<th>20Y1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes paid</td>
<td>$ 50</td>
<td>$ 300</td>
<td>$ 300</td>
<td>$ 300</td>
<td>$ 300</td>
</tr>
<tr>
<td>Beginning of the year</td>
<td>—</td>
<td>(200)</td>
<td>(150)</td>
<td>(100)</td>
<td>(50)</td>
</tr>
<tr>
<td>Gross increases — prior-year positions</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Gross decreases — prior-year positions</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Increases in UTBs — current-year positions</td>
<td>(200)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Settlements with tax authorities</td>
<td>—</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Reductions that are due to statute lapse</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>End of year</td>
<td>$ (200)</td>
<td>$ (150)</td>
<td>$ (100)</td>
<td>$ (50)</td>
<td>$ —</td>
</tr>
</tbody>
</table>

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 ($50 per year for the next four years in the above example).

See Section 3.3.5 for a discussion related to the accounting for tax method changes.

4.6.5 Deferred Tax Consequences of UTBs

Recording a liability for a UTB may result in a corresponding temporary difference and DTA. Example 4-9 (below) and Example 4-10 illustrate how a DTA can arise from the accounting for a UTB.

Example 4-9

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 25 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 2,500
- Deferred income tax expense 2,500

Like other DTAs, the DTA created as a result of recording the liability for the UTB should be evaluated for realizability.
Example 4-10

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 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 B for the current and prior years.

However, if A were to file a return in 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 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:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current income tax expense</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Liability for unrecognized state tax benefits</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>DTA for indirect tax benefit</td>
<td></td>
<td>8,000</td>
</tr>
<tr>
<td>Deferred income tax expense</td>
<td></td>
<td>8,000</td>
</tr>
</tbody>
</table>

Note that in this scenario, A may have other tax consequences to consider as a result of recording a liability for taxes payable in B (e.g., an additional federal deduction, as referred to in Example 4-9).

See Section 14.4.1.7 for further discussion of the presentation of deferred taxes resulting from UTBs.

4.6.6 UTBs 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. Example 4-11 below illustrates the accounting for UTBs in a spin-off transaction.

Example 4-11

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 Section 8.3.1.1). 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.
Example 4-11 (continued)

**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 liable only 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 Section 11.3.6.6 for additional guidance on indemnification agreements.
5.1 Introduction
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 in accordance with ASC 740. Specifically, this chapter focuses on 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 related to measuring tax assets and liabilities. However, the guidance in this chapter applies equally to highly complex organizations as well as to simple entities that operate in a single jurisdiction.

A valuation allowance may be required to be recorded against DTAs so the financial statements reflect the amount of the net DTA that is expected to be used in the future (i.e., realized). Expected realization of DTAs must meet the more-likely-than-not standard to be recorded in the financial statements without a valuation allowance. The more-likely-than-not concept is discussed below.

5.2 Basic Principles of Valuation Allowances

<table>
<thead>
<tr>
<th>ASC 740-10</th>
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<tr>
<td>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.</td>
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<th>Pending Content (Transition Guidance: ASC 825-10-65-2)</th>
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<tr>
<td>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.</td>
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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.
30-18 Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

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

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

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. Implementation of the tax-planning strategy shall be primarily within the control of management but need not be within the unilateral control of management.

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.

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.
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.

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. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome.

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.

30-25 See paragraphs 740-10-55-34 through 55-38 for additional guidance related to carrybacks and carryforwards.

5.2.1 The More-Likely-Than-Not Standard

A key concept underlying the measurement of a DTA is that the amount to be recognized is the amount 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 Codification. 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.

### 5.3 Sources of Taxable Income

To assess whether DTAs meet the more-likely-than-not threshold for realization, an entity needs to consider its sources of future taxable income. Taxable income of the appropriate character (e.g., capital or ordinary), within the appropriate time frame, is necessary for the future realization of DTAs.

When determining whether a valuation allowance is needed, an entity must (1) evaluate each of the four sources of taxable income discussed below in accordance with how objectively verifiable it is and (2) consider that each may represent positive evidence that future taxable income will be generated. In addition, the entity may also have to consider negative evidence in its analysis.

ASC 740-10-30-18 lists four sources of taxable income 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.
The possible sources listed in ASC 740-10-30-18(a) and (c) above can often be objectively verified. Because the sources listed in ASC 740-10-30-18(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.

Objectively verifiable positive evidence is required to offset any objectively verifiable negative evidence (e.g., cumulative losses in recent periods; see the discussion in Section 5.3.2.1) in the assessment of whether a valuation allowance is required. Subjectively verifiable positive evidence (e.g., management’s future income projections, which incorporate future earnings growth) may be sufficient to overcome certain types of subjective negative evidence (e.g., negative trends in the entity’s industry outlook that may not be specific to the entity itself). As discussed throughout this chapter, the entity should evaluate both the positive and negative evidence to determine whether a valuation allowance is required.

The implementation guidance in 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 devise a qualifying tax-planning strategy (the source listed in ASC 740-10-30-18(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 (the source listed in ASC 740-10-30-18(b) above), since it constitutes more objectively verifiable evidence of realizability. To help illustrate how to weigh the four sources of future taxable income, we will discuss each source in more detail below.

5.3.1 Future Reversals of Existing Taxable Temporary Differences

The possible source of future taxable income listed in ASC 740-10-30-18(a) above is “[f]uture reversals of existing taxable temporary differences.” When evaluating whether an existing taxable temporary difference is a source of future taxable income, an entity must have a general understanding of the reversal patterns of temporary differences because such an understanding is relevant to the measurement of DTAs when the entity is assessing the need for a valuation allowance under ASC 740-10-30-18. Example 5-1 below illustrates the future reversals of existing taxable temporary differences as a source of taxable income.

**Example 5-1**

**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 (which represents objectively verifiable positive evidence) 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 and no valuation allowance would be necessary even if future losses are expected or a cumulative loss exists as of the measurement date (the latter of which would represent objectively verifiable negative evidence; see the discussion in Section 5.3.2.1). Because the reversing future taxable temporary differences are objectively verifiable positive evidence, they may be used to outweigh the objectively verifiable negative evidence of cumulative losses.

Another simple example is the temporary difference that is often created by recording of 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.
5.3.1.1 Determining the Pattern of Reversals of Existing Taxable Temporary Differences

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:

- 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 “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 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 are related 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 are related to another category of temporary differences.

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.

See Section 5.8 for additional examples of existing temporary differences and some common methods for determining the pattern of their reversal.

5.3.1.2 Realization of a DTA Related to an Investment in a Subsidiary: Deferred Income Tax Exceptions Not a Source of Income

The future reversal of an existing taxable temporary difference for which a DTL has not been recognized under the indefinite reversal criteria of ASC 740-30-25-17 should not be considered a source of taxable income in accordance with the source listed in ASC 740-10-30-18(a) discussed above. ASC 740-30-25-13 indicates that an entity should not consider future distributions of future earnings of a subsidiary or corporate joint venture in assessing the need for a valuation allowance unless a DTL has been recognized for existing undistributed earnings or earnings have been remitted in the past. Similarly, an entity should not consider future reversals of existing taxable temporary differences as a source of taxable income unless a DTL has been recognized on the related taxable temporary difference (i.e., an unrecognized DTL is not a source of future taxable income). Example 5-2 illustrates this concept.
Example 5-2

An Unrecognized DTL Is Not a Source of Future Taxable Income

Assume that before the enactment of the legislation commonly known as the Tax Cuts and Jobs Act (the “Act”) in December 2017, Entity X, a U.S. domestic parent entity, has a wholly owned foreign subsidiary, FS1. The amounts for financial reporting and the tax basis of X’s investment in FS1 are $2,000 and $1,000, respectively, on December 31, 20X1 (i.e., X has a taxable outside basis difference related to its investment in FS1). Further assume that X has an NOL DTA of $1,000, with a 20-year carryforward period.¹

Entity X has not recorded a DTL related to its investment in FS1 because X asserts that the indefinite reinvestment criteria have been met for the $1,000 taxable temporary difference, which is attributable to undistributed earnings. In addition, FS1 has not previously remitted earnings.

Ordinarily, before the enactment of the Act, an existing taxable temporary difference (e.g., from the undistributed earnings of FS1) would have been a potential source of taxable income for consideration in the assessment of the need for a valuation allowance. However, X has not previously accrued a DTL on the earnings of FS1, and FS1 has not remitted earnings in the past; therefore, X cannot consider the reversal of the outside basis taxable temporary difference associated with its investment in FS1 as a source of taxable income when determining whether it is more likely than not that the NOL DTA is realizable.

5.3.1.3 Using the Reversal of a DTL for an Indefinite-Lived Asset as a Source of Taxable Income After Enactment of the Act

Enactment of the Act modified aspects of U.S. federal tax law regarding NOL carryforwards. Under previous U.S. federal tax law, NOLs generally had a carryback period of 2 years and a carryforward period of 20 years. For NOLs incurred in years subject to the new federal tax rules, the Act eliminates, with certain exceptions, the NOL carryback period and permits an indefinite carryforward period, with some limitations as discussed below.

After implementation of the Act, in accordance with the source listed in ASC 740-10-30-18(a), one of the four sources of future taxable income discussed above, a taxable temporary difference associated with an indefinite-lived asset is generally considered to be a source of taxable income to support realization of either NOLs with an unlimited carryforward period or disallowed interest carryforwards with unlimited carryforward periods. This would also generally be true for a deductible temporary difference that is scheduled to reverse into an NOL with an unlimited carryforward period. However, because the Act includes restrictions on the ability to use NOLs and disallowed interest carryforwards with unlimited carryforward periods (i.e., NOLs arising in years subject to the new rules are limited in use to 80 percent of taxable income and the amount of net business interest an entity can deduct is limited to 30 percent of modified taxable income), no more than 80 percent or 30 percent of the indefinite-lived taxable temporary difference would serve as a source of taxable income with respect to the NOL or disallowed interest carryforward, respectively.

However, an entity may sometimes have both NOLs with an unlimited carryforward period and disallowed interest carryforwards with an unlimited carryforward period, meaning that portions of the indefinite-lived taxable temporary difference might serve as a source of taxable income for both because of the limitations provided in the Act. For example, because the annual interest limitation is calculated before NOLs are taken into account, the taxable temporary difference associated with an indefinite-lived asset would first be a source of taxable income for the disallowed interest carryforward (limited to 30 percent of the taxable temporary difference, as discussed above), but then any remaining taxable temporary difference on the indefinite lived asset might also be a source of taxable income for NOLs with an unlimited carryforward period (limited to 80 percent of the remaining taxable temporary difference, as discussed above).

¹ The conclusion reached in this example would have been the same even if the NOL’s carryforward period had been indefinite.
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For existing U.S. federal jurisdiction NOLs created before the effective date of the Act and in jurisdictions that have finite-lived NOLs, the reversal of a DTL related to an indefinite-lived asset generally cannot be used as a source of taxable income to support the realization of such finite-lived DTAs. This is because 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, other than for indefinite-lived DTAs. However, there are 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 for a finite-lived NOL:

- 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.

5.3.1.4 Deemed Repatriation Transition Tax as a Source of Future Taxable Income

See Chapter 3 for a discussion of outside basis differences and the deemed repatriation transition tax. Under certain circumstances, an entity would record a liability for the transition tax in the financial statements for the year that included the enactment date but would not include the deemed repatriation and corresponding tax in that year's tax return. We believe that it would be appropriate in these circumstances for the entity to consider the corresponding one-time deemed repatriation income inclusion to be a source of taxable income when analyzing the realization of DTAs recorded in the financial statements in the period in which the transition tax liability is recorded. The entity should verify that the one-time deemed repatriation income inclusion coincides with the timing of the deductions and other benefits associated with the DTAs.

However, if the entity elects to defer payment of the transition tax liability over a period of up to eight years, the transition tax liability itself does not represent a source of taxable income in future periods when analyzing the realization of DTAs that remain after the deemed repatriation has been included in the entity's income tax return. This is because settlement of the transition tax liability in a future year or years will not result in taxable income.

5.3.2 Future Taxable Income

As discussed above, ASC 740-10-30-18 lists four sources of future income that may enable realization of a DTA, including the source listed in ASC 740-10-30-18(b), “[f]uture taxable income exclusive of reversing temporary differences and carryforwards.” Management projections are inherently subjective. Therefore, future taxable income from the source listed in ASC 740-10-30-18(b) is generally considered to be subjectively determined as opposed to objectively determined.

2 The projections referred to here are management's estimates of future income based on metrics and qualitative information used by the entity, which might include future growth assumptions and other subjective management assertions.
An entity will consider a number of factors in preparing subjective projections of 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 Section 5.4 for further considerations related to future events.

In determining whether a valuation allowance is needed, an entity must use judgment and consider the relative weight of the available negative and positive evidence. 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.” 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.

In addition, if an entity has no objectively verifiable negative evidence, then it need only determine whether it is more likely than not that the DTA will be realized. If the more-likely-than-not assertion can be supported, often by using management’s subjective projections of future income, there is no need for a valuation allowance. However, if the entity is in a cumulative loss position (which is considered a piece of objective and verifiable negative evidence), it requires objective and verifiable positive evidence to overcome this negative evidence, as discussed further below.

5.3.2.1 Cumulative Losses: An Objectively Verifiable Form of Negative Evidence

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. However, 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 recurring permanent differences. Use of a “three-year” convention arose, in part, as a result of proposed guidance in the exposure draft on FASB 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. Paragraph 103 of Statement 109’s

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3 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.
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.” The 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.” 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.

Even though there is no bright-line three-year cumulative loss test, the SEC has consistently questioned registrants that had a three-year cumulative loss about why there was not a valuation allowance and asked for documentation to support such a determination. In very rare circumstances, it may be acceptable for entities that have business cycles longer or shorter than three years to use a period longer or shorter than three years to determine whether they have a cumulative loss. To support this determination, an entity must demonstrate that it operates in a cyclical industry and that a period other than three years is more appropriate. For example, a four-year period or a two-year period may be 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, the entity should consult with its income tax accounting advisers and 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.

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 subjective 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 subjectively determined 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. See Section 5.3.2.3 for further discussion of the development of objectively verifiable future income estimates.

In determining whether a valuation allowance is necessary, an entity must consider all available positive and negative evidence. 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.

Examples 5-3 through 5-7 illustrate different types of negative evidence that an entity should consider in determining whether a valuation allowance is required.
Example 5-3

**Cumulative Losses in Recent Years**

- An entity has incurred operating losses for financial reporting and tax purposes over the past two years. The losses for financial reporting purposes exceed operating income for financial reporting purposes, as measured cumulatively for the current year and two preceding years.
- A currently profitable entity has a majority ownership interest in a newly formed subsidiary that has incurred operating and tax losses since its inception. The subsidiary is consolidated for financial reporting purposes. The tax jurisdiction in which the subsidiary operates prohibits it from filing a consolidated tax return with its parent. This would be negative evidence for the DTA of the subsidiary in that jurisdiction.

Example 5-4

**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 5-5

**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 5-6

**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.
Chapter 5 — Valuation Allowances

Example 5-7

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.

5.3.2.2 Positive Evidence Considered in the Determination of Whether a Valuation Allowance Is Required

When an entity has negative evidence, such as a cumulative loss position, it should also evaluate what positive evidence exists. ASC 740-10-30-22 gives the following examples of positive evidence that, when present, may overcome negative evidence in the assessment of whether a valuation allowance is needed to reduce a DTA to an amount more likely than not to be realized:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual or infrequent item) is an aberration rather than a continuing condition.

Example 5-8 below illustrates situations in which entities have positive evidence that may indicate that a valuation allowance would not be necessary.

Example 5-8

Examples of the Source Listed in ASC 740-10-30-22(a)

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 merges with Company L, which operates in a different industry that is characterized by stable profit margins. The tax law does not restrict use of preacquisition NOL carryforwards. Company L's existing contracts will produce sufficient taxable income to enable use of the loss carryforwards.

Example of the Source Listed in ASC 740-10-30-22(b)

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 considering its tax-planning strategy, the entity determines that the fair value of the entity's remaining net assets exceeds its tax and financial reporting basis.

Example of the Source Listed in ASC 740-10-30-22(c)

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.
Examples 5-9 through 5-12 below illustrate additional situations in which entities that have had negative evidence have concluded that no valuation allowance is required (or that only a small valuation allowance is necessary) as a result of available positive evidence.

**Example 5-9**

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 5-10**

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 5-11**

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 5-12**

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.

5.3.2.3 **Effect of Nonrecurring Items on Estimates of Future Income and Development of Objectively Verifiable Future Income Estimates**

When objective and verifiable negative evidence is present (e.g., cumulative losses), an entity may 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. Management’s projections of future income are inherently not objectively verifiable, and therefore, such projections alone would not be enough to outweigh objectively verifiable negative evidence such as cumulative losses. However, to the extent that management’s future income projections are adjusted to be based solely 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.

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4 Note that similar examples may not result in a similar conclusion. An entity must use judgment in determining whether a valuation allowance is necessary.
That is, 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). An entity with objective negative evidence may 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 and adjusts for certain items as discussed below.

When preparing an objectively verifiable estimate of 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 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 when preparing such estimates of future income 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).
In addition, an entity should consider the effects of the IRC Section 163(j)\(^5\) limitation in a manner similar to nonrecurring items for which the entity makes an adjustment in its historical results. However, the ability to adjust historical operating results to obtain an objectively verifiable estimate of future taxable income does not change the fact that the entity would still need to consider such losses as part of its prior earnings history (i.e., the entity may not exclude such losses in determining whether it has cumulative losses in recent years) in a manner similar to the nonrecurring items discussed above.

Once the objectively verifiable estimate of future income has been developed, this estimate may be used to support the realizability of DTAs. Entities often use an average of the current and two prior years of adjusted historical results as a basis from which to estimate an objective and verifiable annual taxable income for future periods.

Example 5-13 below 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 objectively verifiable negative evidence in the form of cumulative losses exists:

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**Example 5-13**

**Estimation of Future Taxable Income When Negative Evidence in the Form of Cumulative Losses Exists**

Assume the following:

- Entity X, a calendar-year entity, operates in a single tax jurisdiction in which the tax rate is 25 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 $850 ($1,000 × 25% + $600) at the end of 20X3, X must generate $3,400 ($850 ÷ 25%) 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.

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\(^5\) IRC Section 163(j) limits the ability of certain corporations to deduct interest paid or accrued on indebtedness. In general, this limit applies to interest paid or accrued by certain corporations (when no U.S. federal income tax is imposed on the interest income) whose debt-to-equity ratio exceeds 1.5 to 1.0 and when net interest expense exceeds 50 percent of the adjusted taxable income. The Act removed the debt-to-equity safe harbor, expanded interest deductibility limitations, and generally limited the interest deduction on business interest to (1) business interest income plus (2) 30 percent of the taxpayer’s adjusted taxable income.
Example 5-13 (continued)

- 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:

<table>
<thead>
<tr>
<th>Adjusted Historical Results</th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
<th>Three-Year Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income (loss) — as stated</td>
<td>$ 100</td>
<td>$ (500)</td>
<td>$ (1,000)</td>
<td>$ (1,400)</td>
</tr>
<tr>
<td>Nonrecurring items not indicative of future operations:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Litigation settlement</td>
<td></td>
<td>1,600</td>
<td></td>
<td>1,600</td>
</tr>
<tr>
<td>Interest expense on debt that has been extinguished in 20X3</td>
<td>100</td>
<td>200</td>
<td>200</td>
<td>500</td>
</tr>
<tr>
<td>Fixed cost reduction as a result of a completed restructuring</td>
<td>200</td>
<td>300</td>
<td>300</td>
<td>800</td>
</tr>
<tr>
<td>Annual adjusted pretax income (loss)</td>
<td>$ 400</td>
<td>$ 1,600</td>
<td>$ (500)</td>
<td>$ 1,500</td>
</tr>
<tr>
<td>Average annual adjusted pretax income</td>
<td></td>
<td></td>
<td></td>
<td>$ 500</td>
</tr>
</tbody>
</table>

Because X has positive average annual adjusted pretax income (i.e., historical earnings when adjusted for nonrecurring items), it may consider its average annual adjusted pretax income as a starting point for objectively 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 annual adjusted pretax income by the number of years remaining in the loss or credit carryforward period. Rather, X should consider adjusting its average annual pretax income for certain additional 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 [20X3’s] earnings are less than the prior year’s [20X2’s] and the three-year average annual adjusted pretax income, which might suggest that the use of average annual adjusted pretax 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.
5.3.2.3.1 **Time Frame for Projection of Future Taxable Income**

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 usually not be appropriate for an entity to limit the number of years it uses to estimate future taxable income, whether such estimates represent management's inherently subjective projections of future income or objectively verifiable estimates of future income based on adjusted historical results as determined by using the method discussed above. In either case, 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 by using the method discussed above. 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.

5.3.3 **Taxable Income in Prior Carryback Year(s) if Carryback Is Permitted Under the Tax Law**

As discussed above, ASC 740-10-30-18 lists four sources of future income that may enable realization of a DTA, including the source listed in ASC 740-10-30-22(c), “[t]axable income in prior carryback year(s) if carryback is permitted under the tax law.”

The ability to recover taxes paid in the carryback period (the source listed in ASC 740-10-30-22(c)) is considered to be an objectively verifiable form of positive evidence that can 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, discussed earlier.

Some tax laws (e.g., those in certain U.S. state, local, or foreign tax jurisdictions) 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.

Example 5-14 illustrates taxable income in prior carryback year(s) if carryback is permitted under the tax law as a source of taxable income listed in ASC 740-10-30-18(c).

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**Example 5-14**

**Refunds Available by Carryback of Losses to Offset Taxable Income in Prior Years**

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.
5.3.4 Tax-Planning Strategies

As discussed above, ASC 740-10-30-18 lists four sources of future income that may enable realization of a DTA, including the source listed in ASC 740-10-30-22(d), “[t]ax-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.”

Because future taxable income from the source listed in ASC 740-10-30-22(d) may be based on future events, it may be more subjective than that from the sources listed in ASC 740-10-30-22(a) and (c).

The ASC master glossary defines a tax-planning strategy as follows:

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.

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 “[w]ould result in realization of [DTAs].” 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 FASB 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.
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.

5.3.4.1 Examples of Qualifying Tax-Planning Strategies

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 5-15 (below) and Example 5-16 illustrate additional situations in which entities use tax-planning strategies to provide evidence of future taxable income to support the conclusion that no valuation allowance is required or that a valuation allowance is necessary for only a portion of the entity's DTAs.

### Example 5-15

**Acceleration of Taxable Amounts to Use Carryforward**

In 20X2, Entity A generates, for tax purposes, a $2,000 operating loss that cannot be used in the current tax return. Tax law allows for a one-year carryforward. However, after considering (1) future reversals of existing taxable temporary differences, (2) future taxable income exclusive of reversing taxable temporary differences and carryforwards, and (3) taxable income in the prior carryback years, A must record a valuation allowance for the tax consequences of $1,000 of future deductions that are not expected to be realized.

However, A has identified a tax-planning strategy that involves selling at book value, and leasing back, plant and equipment. This strategy would accelerate $600 of taxable amounts (the excess depreciation in prior years) that would otherwise reverse in years beyond the carryforward period. For tax purposes, the sale would accelerate the reversal of the taxable difference (the excess-book-over-tax basis on the date of the sale-leaseback) into taxable income in the year of the sale. After considering the strategy, A must record a valuation allowance at the end of 20X2 only for the $400 of the operating loss whose realization is not more likely than not.
Example 5-15 (continued)

When A is 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. Further, 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 Section 5.3.4.3 for more information about measuring the tax benefits of tax-planning strategies.)

Example 5-16

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 determine 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).

5.3.4.2 Examples of Nonqualifying Tax-Planning Strategies

The following actions would generally not qualify as tax-planning strategies because they would not meet one or more of the criteria in ASC 740-10-30-19 (as discussed above):

- Actions that are inconsistent with financial statement assertions. For example, to classify an investment in a debt security as HTM, 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 HTM to realize a DTA.

However, 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.

- 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 5-17 below illustrates a situation in which an entity would not be able to use the proposed tax-planning strategy as positive evidence to support the conclusion that no valuation allowance is necessary because the tax-planning strategy does not align with positions taken elsewhere within the financial statements.

### Example 5-17

**Tax-Planning Strategy That Is Inconsistent With Financial Statement Assertions**

Assume the following:

- An entity is measuring its DTAs and DTLs at the end of 20X2.
- Capital losses of $2 million were incurred in 20X2.
- Capital losses can be used only to offset capital gains; no capital gains occurred in 20X2.
- The capital gains tax rate is 50 percent.
- The entity has an investment portfolio of debt securities that it has classified as HTM in accordance with ASC 320. The portfolio has the following attributes:

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value</td>
<td>$2,000,000*</td>
</tr>
<tr>
<td>Tax basis</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Book basis</td>
<td>2,500,000</td>
</tr>
</tbody>
</table>

* Decline because of interest rate increase, not a credit adjustment.

- An assumption inherent in the preparation of the financial statements is that an other-than-temporary impairment (OTTI) has not occurred in accordance with ASC 320-10-35-33A though 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.

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6 **ASU 2016-13** was issued in June 2016 and significantly amends the guidance in U.S. GAAP on the measurement of financial instruments. For public business entities (PBEs) that meet the U.S. GAAP definition of an SEC filer, ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods therein. For PBEs that do not meet the U.S. GAAP definition of an SEC filer, the ASU is deferred to a later period. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.
Example 5-17 (continued)

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 × 50%), such a strategy would conflict with ASC 320's HTM 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 Section 5.7.4.1.1, 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.

5.3.4.3 Recognition and Measurement of a Tax-Planning Strategy

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.

Examples 5-18 through 5-20 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 Section 5.3.2.1, do not exist.

Example 5-18

No Tax-Planning Strategy Is Available

Assume the following:

- The entity operates in a single tax jurisdiction where the applicable tax rate is 25 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.
Example 5-18 (continued)

- 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated taxable income in 20X2</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Existing taxable temporary differences that will reverse in 20X2</td>
<td>1,000</td>
</tr>
<tr>
<td>Estimated taxable income exclusive of reversing temporary differences and carryforwards</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

The following table shows the computation of the DTL, DTA, and valuation allowance at the end of 20X1:

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL ($2,000 × 25%)</td>
<td>(500)</td>
</tr>
<tr>
<td>DTA ($10,000 × 25%)</td>
<td>2,500</td>
</tr>
<tr>
<td>Valuation allowance ([($10,000 – $6,000) × 25%])</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

A valuation allowance of $1,000 is necessary because $4,000 of the $10,000 of operating loss carryforward will expire in 20X2.

Example 5-19

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 25 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated taxable income in 20X2</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Reversal of existing taxable temporary differences</td>
<td>2,000</td>
</tr>
<tr>
<td>Estimate of taxable income exclusive of reversing temporary differences</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>

- 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.
Example 5-19 (continued)

The following table illustrates the computation of the DTAs and valuation allowance at the end of 20X1:

<table>
<thead>
<tr>
<th>Computation of Anticipated Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating loss carryforward               $ (9,000)</td>
</tr>
<tr>
<td>Estimated taxable income (excluding legal costs from tax-planning strategy) 4,000</td>
</tr>
<tr>
<td>Income from tax-planning strategy         8,000</td>
</tr>
<tr>
<td>Anticipated taxable income in excess of loss carryforward $ 3,000</td>
</tr>
<tr>
<td>Legal and other estimated costs to implement the tax-planning strategy (1,000)</td>
</tr>
<tr>
<td>Future tax benefit of those legal and other expenses ($1,000 × 25%) 250</td>
</tr>
<tr>
<td>Total valuation allowance $ (750)</td>
</tr>
<tr>
<td>DTA ($9,000 × 25%) $ 2,250</td>
</tr>
<tr>
<td>Less: valuation allowance (750)</td>
</tr>
<tr>
<td>Net DTA $ 1,500</td>
</tr>
</tbody>
</table>

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 $750 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 5-20

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 25 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.
Example 5-20 (continued)

- The following table illustrates, before any qualifying tax-planning strategies are considered and on the basis of historical results and other available evidence, the estimated taxable income exclusive of reversing temporary differences and carryforwards expected to be generated during 20X2:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimate of taxable income in 20X2</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Reversal of existing taxable temporary differences</td>
<td>1,000</td>
</tr>
<tr>
<td>Estimate of taxable income exclusive of reversing temporary differences</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

- 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**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating loss carryforward</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Estimated taxable income</td>
<td>6,000</td>
</tr>
<tr>
<td>Income from tax-planning strategy</td>
<td>2,000</td>
</tr>
<tr>
<td>Anticipated taxable income deficit</td>
<td>$(2,000)</td>
</tr>
</tbody>
</table>

Valuation allowance on anticipated taxable income deficit ($2,000 × 25%) $(500)
Legal and other estimated costs to implement the tax-planning strategy* $(500)
Total valuation allowance $(1,000)

DTA ($10,000 × 25%) $2,500
Less: valuation allowance $(1,000)
Net DTA $1,500

* 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).

5.3.5 Determination of the Need for a Valuation Allowance by Using the Four Sources of Taxable Income

Using all the concepts discussed in Section 5.3, Example 5-21 illustrates the determination of the amount of a valuation allowance when the four sources of taxable income are considered in accordance with ASC 740-10-30-18 and available positive and negative evidence is present.
Example 5-21

Assume the following:

- Entity A is measuring its DTAs and DTLs as of year 20X2.
- The enacted tax rate is 21 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:

<table>
<thead>
<tr>
<th>Temporary Difference</th>
<th>Asset at 21%</th>
<th>Temporary Difference</th>
<th>Liability at 21%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciable assets</td>
<td>—</td>
<td>—</td>
<td>$ 35</td>
</tr>
<tr>
<td>Deferred compensation</td>
<td>$ 275</td>
<td>$ 58</td>
<td>—</td>
</tr>
<tr>
<td>Restructuring cost accruals</td>
<td>165</td>
<td>35</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$ 440</td>
<td>$ 93</td>
<td>$ 35</td>
</tr>
</tbody>
</table>

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.\(^7\)

**Positive**
1. Tax benefits have never expired unused.\(^8\)
2. Entity A has a strong earnings history at the close of 20X2.\(^9\)

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.

\(^7\) Indicates a source of evidence that can be verified objectively.
\(^8\) See footnote 7.
\(^9\) See footnote 7.
Example 5-21 (continued)

To determine the amount of valuation allowance required, management has considered four sources of taxable income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Estimated future taxable income (during the period in which the deductible temporary differences will reverse) exclusive of reversing taxable temporary differences</td>
<td>$ 125</td>
</tr>
<tr>
<td>2. Taxable income during the carryback period</td>
<td>55</td>
</tr>
<tr>
<td>3. Taxable temporary differences related to depreciation</td>
<td>35</td>
</tr>
<tr>
<td>4. Tax-planning strategy net of implementation cost</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>$ 240</td>
</tr>
</tbody>
</table>

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 $42 ($200 × 21%) on the $200 of deductions that is not expected to be realized.

Entity A would record the following journal entry:

**Journal Entry**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>93</td>
</tr>
<tr>
<td>DTL</td>
<td>7</td>
</tr>
<tr>
<td>Valuation allowance</td>
<td>42</td>
</tr>
<tr>
<td>Benefit for income taxes</td>
<td>44</td>
</tr>
</tbody>
</table>

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.
5.4 Consideration of Future Events When Assessing the Need for a Valuation Allowance

In general, entities should consider all available information about future events when determining whether a valuation allowance is needed for DTAs.

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 Section 5.3.2.3 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 (IPOs).
- Events that are inconsistent with financial reporting assertions as of the balance sheet date. For example, anticipating sales of HTM 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.

5.5 Reduction of a Valuation Allowance When Negative Evidence Is No Longer Present

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, as discussed in Section 5.3.2.3.1, unless the facts and circumstances dictate otherwise, an entity should not limit the estimate of future income to (1) a specific period (e.g., the period over which it measures cumulative losses in recent periods) 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.

See Section 7.3.1 for further discussion of change in valuation allowance in interim periods.
5.6 Going-Concern Opinion as Negative Evidence

PCAOB AS 2415 and AICPA AU-C Section 570 require an explanatory paragraph in the auditor's report when the auditor concludes that “substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.” In addition, ASC 205-40 requires an entity's management to evaluate whether conditions or events raise substantial doubt about the entity's ability to continue as a going concern and, if so, “whether its plans that are intended to mitigate those [relevant] conditions and events, when implemented, will alleviate substantial doubt.” In circumstances in which management has identified conditions or events that raise substantial doubt that has not been alleviated by its plans and an explanatory paragraph that has been added to the auditor's report, a valuation allowance would generally be recorded for all DTAs whose realization is not assured by either offsetting existing taxable temporary differences or carryback to open tax years. However, in very limited circumstances, the immediate cause of the going-concern uncertainty may not be directly related to the entity's operations, in which case a full valuation allowance may not be required.

The fact that (1) management has not identified conditions or events that raise substantial doubt, (2) management has identified conditions or events that raise substantial doubt but has determined its plans alleviate the substantial doubt, or (3) a going-concern explanatory paragraph is not included in the auditor's report does not automatically constitute positive evidence about the realization of DTAs. Similarly, when an entity concludes that it must record a valuation allowance for all or part of its DTAs, a going-concern problem may not necessarily exist. For example, an entity that generates sufficient positive cash flows to service its debt and support the book value of its assets (i.e., the entity's assets are not impaired), but that is experiencing financial reporting losses (i.e., recent cumulative losses), would have negative evidence about the realization of DTAs. In this case, the positive evidence may not be sufficient to overcome the negative evidence; thus, the entity would provide a valuation allowance for all or part of its DTAs. However, the auditor may conclude, on the basis of positive cash flows and other factors, that it is not necessary to provide a going-concern reference in the auditor's report, and management may likewise conclude that conditions or events do not raise substantial doubt about the entity's ability to continue as a going concern.

5.7 Exceptions and Special Situations

5.7.1 AMT Valuation Allowances

The U.S. federal AMT has been repealed for tax years beginning after December 31, 2017. Taxpayers with AMT credit carryforwards that have not yet been used may claim a refund in future years for those credits even though no income tax liability exists. Entities can continue using AMT credits to offset any regular income tax liability in years 2018 through 2020, with 50 percent of remaining AMT credits refunded in each of the 2018, 2019, and 2020 tax years and all remaining credits refunded in tax year 2021.

Because the AMT credit will now be fully refundable regardless of whether there is a future income tax liability before AMT credits, the benefit of the AMT credit will be realized. Therefore, an income tax benefit should be recognized for all AMT credits.

10 Taxpayers should consider whether other limitations (e.g., IRC Section 383) apply to their ability to claim a refund of AMT.
5.7.2 Assessing Realization of a DTA for Regular Tax NOL Carryforwards When Considering Future GILTI Inclusions

Under the GILTI tax regime, foreign taxes paid or accrued in the year of the inclusion may be creditable against U.S. taxes otherwise payable, subject to certain limitations (e.g., foreign source income, expense allocations). If not used in the year of inclusion, however, the FTC would be permanently lost. Further, because IRC Section 250 deductions are limited to 50 percent of taxable income after NOL deductions, use of NOLs could reduce or eliminate the eligibility for an IRC Section 250 deduction. Therefore, as a result of expected future GILTI inclusions, a U.S. entity that has historically experienced cumulative losses may expect that existing NOL carryforwards, for which a valuation allowance has historically been recorded, will now be used. Use of the NOL carryforwards may, however, result in an actual cash tax savings that is less than the DTA (before reduction for any valuation allowance) and, in some cases, may result in no cash tax savings at all because, without the NOL, the entity would have been eligible for an IRC Section 250 deduction that would have reduced the net taxable income inclusion and would have been able to use FTCs.

There are two acceptable views regarding how an entity should consider future GILTI inclusions when assessing the realizability of NOL DTAs. The first is that an entity would consider future GILTI inclusions on the basis of tax law ordering rules when estimating available sources of future taxable income to assess the realizability of DTAs. Under a tax law ordering approach, the future reduction or elimination of the IRC Section 250 deduction and FTCs will not result in the need for a valuation allowance for an entity’s existing NOL DTAs. Use of a tax law ordering approach is consistent with Example 18 in the ASC 740-10 implementation guidance (see ASC 740-10-55-145 through 55-148). The same conclusion would apply to DTAs for other tax attributes and deductible temporary differences.

Alternatively, an entity could assess the realizability of DTAs on the basis of the incremental economic benefit they would produce. In other words, because future GILTI inclusions are an integrated part of the regular tax system, an entity would determine how much, if any, benefit is expected to be realized from an entity’s existing NOL carryforwards on a “with-and-without” basis. That is, a DTA would be recognized for only the amount of incremental tax savings the DTAs are expected to produce after the entity considers all facts and circumstances, elements of the tax law, and other factors that would otherwise limit the availability of the IRC Section 250 deduction and use of the FTCs.

We believe that when measuring U.S. GILTI DTAs and DTLs (more specifically, evaluating whether future IRC Section 250 deductions should affect the measurement of GILTI DTAs and DTLs), an entity should apply an approach that is consistent with its assessment of how future IRC Section 250 deductions affect the realizability of an NOL DTA.

For example, if the entity evaluates the realizability of NOL DTAs on the basis of the incremental economic benefit the NOLs would produce (i.e., the “with-and-without” approach described above), it would be appropriate for the entity to factor in the IRC Section 250 deduction that would be available without the NOL when measuring its GILTI DTAs and DTLs. Alternatively, if the entity evaluates the realizability of NOL DTAs on the basis of tax law ordering rules, the measurement of GILTI DTAs and DTLs should take into account only the impact of the IRC Section 250 deduction that will actually be available after use of the NOL in the year the GILTI DTAs and DTLs reverse, because the ordering rules would suggest that the maximum amount of GILTI deduction will not be obtained in those circumstances.
5.7.3 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, 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.¹²

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 FTC not currently allowed because of various current-year limitations (i.e., an excess FTC) 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.” An exception to this are FTCs related to GILTI. Excess GILTI FTCs may not be carried forward or carried back; therefore, a DTA should not be recorded for any excess GILTI FTCs. See Chapter 3 for additional information about FTCs created by GILTI.

Further, 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.

Although, 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.

¹¹ IRC Section 275(a)(4)(A) and Treas. Reg. 26 CFR Section § 1.901-1(h)(2).
¹² Treas. Reg. 26 CFR Section § 301.6511(d)-3.
**Example 5-22**

**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 $10 of FTC against its 20X9 taxes payable; X is allowed to carry back the remaining $90 for one year and carry it forward for 10 years, which gives rise to a DTA. The U.S. federal income tax rate is 21 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 $90 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 $21 (21% tax rate × $100 of foreign taxes paid). A $10 benefit has already been taken for the FTC through the credit election; therefore, X should at least realize an additional $11 benefit for the carryforward taxes as a result of the option to take a deduction ($21 available deduction less the $10 credit taken in 20X9). Therefore, the maximum valuation allowance that X should consider for the $90 FTC carryforward is $79. Note that the FTC was not created by GILTI.

**Example 5-23**

**Credit Benefit Greater Than Deduction Benefit**

Assume the same facts as in Example 5-22, 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 $21 (as calculated in Example 5-22) 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 5-24**

**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 × 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 $10 of FTC against its 20X9 taxes payable and is allowed to carry back the remaining $90 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 21 percent. Total U.S. federal income tax paid by X in 20X9 would be $74 ($400 dividend × 21% tax rate) – $10 FTC). If X chose to “deduct,” rather than credit, the FTC in 20X9, the tax paid would be $63 ($300 distribution × 21% tax rate).

The gross-up under the credit option effectively results in X’s paying an additional $11 in tax in 20X9 related to the foreign-source income ([$100 deemed-paid taxes × 21% tax rate] – $10 FTC). The remaining $90 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 $90 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 $11 ($74 – $63) because of the removal of the gross-up. Accordingly, the maximum valuation allowance is $79 ($90 – $11 refund).

Alternatively, if, instead of a $10 credit limitation, $75 of FTC could be used in 20X9, the FTC would have given rise to a $54 benefit in 20X9 ([$100 × 21%] – $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 $21 ($100 × 21%), compared with the credit of $75 in 20X9. Accordingly, the maximum valuation allowance in this alternative is $25.
Example 5-24 (continued)

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.

5.7.4 Evaluating a DTA (for Realization) Related to 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 accumulated other comprehensive income (AOCI) over the contractual life of the investment, resulting in no cumulative change in the entity’s comprehensive income or future taxable income. In this respect, the temporary differences associated with unrealized gains and losses on debt securities are unlike other types of temporary differences because they do not affect the income statement or the tax return if held until recovery of the debt securities’ amortized cost.

ASC 320-10-35-1(b) requires an entity to exclude unrealized holding gains and losses for AFS debt securities from earnings and report them as a net amount in OCI. ASC 320-10-35-18 requires that an entity assess debt securities classified as either AFS or HTM to determine whether a decline in fair value below the amortized cost is considered other than temporary. Under ASC 320-10-35-33A through 35-33C, before the adoption of ASU 2016-13, an OTTI is triggered if (1) an entity has the intent to sell the security, (2) it is more likely than not that it will be required to sell the security before recovery, or (3) it does not expect to recover the entire amortized cost basis of the security (referred to as a credit loss).

Under step 3 of the impairment test, if an entity concludes that the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, the impairment is considered an OTTI. In that situation, the entity records only the credit-related portion of the impairment loss in earnings (i.e., the difference between the security’s present value of expected cash flows and amortized cost basis). Accordingly, for AFS and HTM debt securities, the amount recognized in OCI is the difference between the fair value of the debt security and the amortized cost less the credit loss component of the OTTI.

ASC 740-20-45-11(b) requires that the tax effects of gains and losses that occur during the year that are included in comprehensive income but excluded from net income (e.g., unrealized gains and losses on AFS securities) be charged or credited directly to related components of shareholders’ equity.

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13 See footnote 6.
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 would appear to allow for such an assumption under step 3 of the impairment test, providing an additional source of taxable income to demonstrate realization of this specific deductible temporary difference. More specifically, 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) (i.e., any unrealized loss recorded in OCI will reverse over the contractual term of the security without affecting the entity’s cumulative comprehensive income or taxable income).

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance clarifies that, upon the effective date of the ASU, “an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.” For all other entities other than PBEs, including not-for-profit entities and employee benefit plans within the scope of ASC 960 through ASC 965 on plan accounting, the amendments in ASU 2016-01 are effective for fiscal years beginning after December 15, 2018, and interim reporting periods within fiscal years beginning after December 15, 2019.

### 5.7.4.1 Before the Adoption of ASU 2016-01

There are two acceptable approaches (described below) for evaluating a DTA that is recognized as a result of an unrealized loss on a debt security that is recognized in OCI. Approach 1 is based on the view that the entity would exclude the DTA attributed to unrealized holding losses of a debt security recognized in OCI from its other DTAs when evaluating the need for a valuation allowance because this deductible temporary difference will not require future taxable income for realization on the basis of the assumption that the debt security will be held until recovery. Approach 2 is based on the view that the entity must evaluate the reporting entity’s collective DTAs for realization on the basis of all expected future sources of taxable income. The SEC staff has indicated that it would accept either of the two approaches. Selection of either alternative is an accounting policy decision that, once made, must be consistently applied.

#### 5.7.4.1.1 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 Section 5.3.4.1 for additional discussion of examples of qualifying tax-planning strategies.)
Proponents of Approach 1 believe it is inappropriate to recognize, within reported results of operations, tax effects of fair value changes in debt securities when those changes will not be included in earnings. Accordingly, when evaluating whether it is more likely than not that DTAs will be realizable, an entity should exclude debt security DTAs established in OCI from other DTAs (i.e., those requiring a source of future taxable income for realization). Given the unique nature of this temporary difference, it is inappropriate for an entity to apply this approach (by analogy) when evaluating other DTAs, including DTAs recognized as a result of a credit loss or an OTTI recognized in earnings.

The difference between a debt security's new amortized cost and its reporting-date fair value does not require a future source of taxable income to demonstrate realization because the expected manner of recovery of the investment is based on a decision not to dispose of the investment before recovery.

Accordingly, to apply Approach 1 when assessing the realization of a DTA, an entity must still demonstrate its intent and ability to hold the debt security until recovery.

5.7.4.1.2 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 imply a source of future taxable income, these facts 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.

5.7.4.2 After the Adoption of ASU 2016-01

Historically, some entities have evaluated the need for a valuation allowance on DTAs associated with AFS debt securities separately from other DTAs (i.e., Approach 1 above). The revised guidance clarifies that such separate evaluation is not permitted, and upon adoption of ASU 2016-01, Approach 1 will no longer be acceptable, and an entity will be required to apply Approach 2.
Precluding an entity from evaluating the realizability of unrealized losses on AFS debt securities separately from all other DTAs may mean that the entity will recognize a valuation allowance on the unrealized losses on AFS debt securities when other negative evidence in the form of cumulative losses in recent years is present. This recognition is a result of the entity's no longer being permitted to solely rely on the assertion that its intent and ability to hold the debt security until maturity will result in recovery of the unrealized losses given that the recovery of the unrealized losses may only partially offset the entity's potential future losses.

5.7.5 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 use 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.
5.7.6 Application of ASC 740-20-45-7 to Recoveries of Losses in AOCI

A credit or gain may be recognized in OCI on a debt security that is classified as AFS but that remains in an overall loss position.

**Example 5-25**

**Recoveries of Losses in AOCI**

Entity A purchases a debt security on January 1, 20X1, for $1,000. The security is classified as held for sale for financial reporting purposes. During 20X1, the security declines in value so that its carrying amount for financial reporting purposes is $800 on December 31, 20X1. The unrealized loss of $200 is recognized in OCI in accordance with ASC 320. During 20X2, the security increases in value, and an unrealized gain of $150 is recognized in OCI. As a result, the security's financial reporting carrying amount increases to $950.

**Approach 1 — Make No Distinction Between Credits on Securities in a Net Loss Position and Those in a Net Gain Position**

Under this approach, rather than distinguishing between credits on securities in a net loss position and credits on securities in a net gain position, A would look only to the total amount of unrealized gains or losses recorded in OCI during the period when applying ASC 740-20-45-7. This approach is consistent with ASC 740-20-45-7, which states, in part:

> The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.

Note that Section 6.2.15 discusses how a reporting entity should consider credits in OCI that are the result of reclassification adjustments when it applies ASC 740-20-45-7. An entity that applies the alternative approach described in Section 6.2.15 (i.e., an entity that does not distinguish between credits that represent gains and those that represent reclassification adjustments) generally should apply Approach 1 to determine the effects of unrealized gains on AFS debt securities when it is applying ASC 740-20-45-7.

**Approach 2 — Do Not Include Credits on Securities That Represent Recovery of Previous Net Losses**

Under this approach, A would not consider an unrealized gain recognized in OCI in the current year as a potential source of future income when applying the intraperiod allocation exception if the security remains in a net loss position. The guidance in ASC 740-20-45-7 that provides the FASB's rationale for including “all items” supports this premise, stating, in part:

> That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

In other words, when a security remains in a net loss position even after a current-year unrealized gain, there is no taxable income expected in future years that would serve as a source of income for the current-year loss from continuing operations. This is substantiated by the fact that there is a DTA for a deductible temporary difference on the security since the tax basis is greater than the book basis. If the security in the example above is sold at the financial reporting amount of $950, there is a taxable loss and no gain; hence, nothing serves as a source of income that would benefit the current-year continuing operations loss.
Example 5-26

Assume the following:

- **Entity B:**
  - Determined, in 20X0, that a valuation allowance is needed to reduce its DTA to an amount that is more likely than not to be realized, or zero.
  - Has a YTD pretax loss and is anticipating a pretax loss for the year for which no tax benefit can be recognized.
  - Has a portfolio of four equity securities that are classified as AFS for financial reporting purposes and, therefore, the unrealized gains or losses are recognized in OCI in accordance with ASC 320.
  - Purchased each equity security on January 1, 20X1, for $1,000.
- During 20X1, a net unrealized gain of $50 on AFS securities is recognized in OCI.
- During 20X2, a net unrealized gain of $150 is recognized in OCI.

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<th>Year 2 Gain/ (Loss)</th>
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* Security 2 year 2 gain includes $30 recovery of unrealized losses from prior year.
** Security 3 year 2 gain includes $50 recovery of unrealized losses from prior year.

See Section 6.2.15 for additional discussion of the intraperiod tax implications of Examples 5-25 and 5-26.

5.7.7 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.”

See Section 3.5.5 for additional discussion of the guidance in ASC 942-740-25 on a thrift’s bad-debt reserves.

5.7.8 Accounting for Valuation Allowances in Separate or Carve-Out Financial Statements

See Section 8.5 for specific guidance on valuation allowances accounted for in separate or carve-out financial statements.
5.7.9 Accounting for a Change in a Valuation Allowance in an Interim Period

See Section 7.3.1 for guidance on changes in valuation allowances in an interim period. For a discussion of intraperiod tax allocations for valuation allowances, see Section 7.4.

5.7.10 Accounting Considerations for Valuation Allowances Related to Business Combinations

See Section 11.5 for a discussion of (1) recognition of an acquiring entity's tax benefit not considered in acquisition accounting, (2) recording a valuation allowance in a business combination, and (3) issues related to accounting for changes in the acquirer's and acquiree's valuation allowance as of and after the acquisition date.

5.7.11 Accounting Considerations for Valuation Allowances Related to Share-Based Payment DTAs

See Section 10.6 for guidance on the determination of a valuation allowance for deferred taxes associated with share-based payment awards.

5.8 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.

5.8.1 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, in part:

[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.

5.8.2 UTBs

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 (a UTB). 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.

5.8.3 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.

5.8.4 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.
5.8.5 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 reverse at that time and 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.

5.8.6 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.

5.8.7 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.

5.8.8 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.
5.8.9 Nondepreciable Assets
In some jurisdictions, certain office buildings and other real estate cannot be depreciated under local tax law. The tax authority may permit the tax basis of such property to be routinely increased for the approximate loss in purchasing power caused by inflation. The tax basis, as adjusted for indexing, is used to measure the capital gain or loss. For financial reporting purposes, depreciation is recognized on such assets. The effects of indexing for tax purposes and depreciation for financial reporting purposes create deductible temporary differences that reverse upon disposition of the associated assets.

5.8.10 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.

5.8.11 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.

5.8.12 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.

5.8.13 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.

5.8.14 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.
5.8.15 Long-Term Contracts

Before the Tax Reform Act of 1986, 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 of 1986 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.

5.8.16 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.
Chapter 5 — Valuation Allowances

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.

5.8.17 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).

5.8.18 Allowances for Doubtful Accounts
The Tax Reform Act of 1986 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).

5.8.19 PP&E
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 5-27

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:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Cumulative</th>
<th>Financial Reporting</th>
<th>Tax Over (Under) Financial Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$ 350</td>
<td>$ 200</td>
<td>$ 150 $ 150</td>
</tr>
<tr>
<td>20X2</td>
<td>260</td>
<td>200</td>
<td>60 210</td>
</tr>
<tr>
<td>20X3</td>
<td>156</td>
<td>200</td>
<td>(44) 166</td>
</tr>
<tr>
<td>20X4</td>
<td>110</td>
<td>200</td>
<td>(90) 76</td>
</tr>
<tr>
<td>20X5</td>
<td>110</td>
<td>200</td>
<td>(90) (14)</td>
</tr>
<tr>
<td>20X6</td>
<td>14</td>
<td>—</td>
<td>14 —</td>
</tr>
<tr>
<td></td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td></td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Future Years</th>
<th>(Originating) Reversing Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$ (60)</td>
</tr>
<tr>
<td>20X3</td>
<td>44</td>
</tr>
<tr>
<td>20X4</td>
<td>90</td>
</tr>
<tr>
<td>20X5</td>
<td>90</td>
</tr>
<tr>
<td>20X6</td>
<td>(14)</td>
</tr>
<tr>
<td></td>
<td>$ 150</td>
</tr>
</tbody>
</table>

If the entity does not consider future originating differences to minimize the complexity of scheduling reversal patterns, a first-in, first-out pattern would be used and the $150 taxable temporary difference would be scheduled as follows on December 31, 20X1:

<table>
<thead>
<tr>
<th>Future Years</th>
<th>(Originating) Reversing Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$ —</td>
</tr>
<tr>
<td>20X3</td>
<td>44</td>
</tr>
<tr>
<td>20X4</td>
<td>90</td>
</tr>
<tr>
<td>20X5</td>
<td>16</td>
</tr>
<tr>
<td>20X6</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$ 150</td>
</tr>
</tbody>
</table>
Chapter 6 — Intraperiod Allocation

6.1 Background

ASC 740 requires an entity to allocate its total annual income tax provision among continuing operations and the other components of its financial statements (e.g., discontinued operations, OCI, and shareholders’ equity). Although it may appear simple, ASC 740’s model for achieving intraperiod tax allocation, which is often referred to as the “with-and-without” approach, is one of the more challenging aspects of income tax accounting.

6.2 Method for Allocating Income Taxes to Components of Comprehensive Income and Shareholders’ Equity

<table>
<thead>
<tr>
<th>ASC 740-20</th>
</tr>
</thead>
</table>

45-1 This guidance addresses the requirements to allocate total income tax expense or benefit. Subtopic 740-10 defines the requirements for computing total income tax expense or benefit for an entity. As defined by those requirements, total income tax expense or benefit includes current and deferred income taxes. After determining total income tax expense or benefit under those requirements, the intraperiod tax allocation guidance is used to allocate total income tax expense or benefit to different components of comprehensive income and shareholders’ equity.

45-2 Income tax expense or benefit for the year shall be allocated among:
   a. Continuing operations
   b. Discontinued operations
   c. Subparagraph superseded by Accounting Standards Update No. 2015-01
   d. Other comprehensive income
   e. Items charged or credited directly to shareholders’ equity.

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).
   a. Subparagraph not used
   b. Subparagraph not used
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.

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.

Allocation to Continuing Operations

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.

The allocation to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of:

a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (see paragraph 740-10-45-20 for a discussion of exceptions to this allocation for certain items)

b. Changes in tax laws or rates (see paragraph 740-10-35-4)

c. Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)

d. Tax-deductible dividends paid to shareholders.

The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraphs 740-20-45-12 and 740-20-45-14.

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.

Allocations to Items Other Than Continuing Operations

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.
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).

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.

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.

**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.
ASC 740-20 (continued)

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.

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.

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.

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.
Chapter 6 — Intraperiod Allocation

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.

Pending Content (Transition Guidance: ASC 825-10-65-2)

45-3 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.

Pending Content (Transition Guidance: ASC 825-10-65-2)

45-4 Paragraph superseded by Accounting Standards Update No. 2016-01.

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.

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.

Pending Content (Transition Guidance: ASC 825-10-65-2)

45-6 Paragraph superseded by Accounting Standards Update No. 2016-01.

6.2.1 General Rule

6.2.1.1 General “With-and-Without” 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 Section 6.2.11 for an exception to this general rule).

Under a with-and-without approach, total tax expense or benefit for the period (the “with”) 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).

Then, tax expense or benefit related to income from continuing operations (the “without”) is computed as the tax effect of the pretax income or loss from continuing operations (current, deferred, and other tax expense — for example, UTBs) for the period plus or minus the tax effects of the four items identified in ASC 740-20-45-8, as follows:

a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (see paragraph 740-10-45-20 for a discussion of exceptions to this allocation for certain items)

b. Changes in tax laws or rates (see paragraph 740-10-35-4)

c. Changes in tax status (see paragraphs 740-10-25-32 and 740-10-40-6)

d. Tax-deductible dividends paid to shareholders.
The with-and-without approach is illustrated in the example below.

**Example 6-1**

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 FDII deduction under IRC Section 250 (considered a special deduction under ASC 740-10-55-27 through 55-30). The IRC Section 250 deduction is calculated as the lesser of 37.5 percent of FDII or U.S. taxable income. There are no other differences between book and tax income. The tax rate is 25 percent.

When determining the tax attributable to continuing operations, X should include the effects of the Section 250 FDII special deduction without considering the loss from discontinued operations. Accordingly, X would perform the following “with” and “without” calculations:

<table>
<thead>
<tr>
<th>Without Loss From Discontinued Operations</th>
<th>With Loss From Discontinued Operations (in Accordance With the Tax Return)</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$ 3,000</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>FDII deduction</td>
<td>(270)</td>
<td>(180)</td>
</tr>
<tr>
<td>Taxable income</td>
<td><strong>2,730</strong></td>
<td><strong>1,820</strong></td>
</tr>
<tr>
<td>Tax rate</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Income tax per component</td>
<td><strong>$ 683</strong></td>
<td><strong>$ 455</strong></td>
</tr>
<tr>
<td>Tax provision — continuing operations</td>
<td>$ 683</td>
<td></td>
</tr>
<tr>
<td>Tax provision — discontinued operations</td>
<td>(228)</td>
<td></td>
</tr>
<tr>
<td>Total income tax expense</td>
<td><strong>$ 455</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Difference is due to the lost IRC Section 250 tax benefit, calculated as follows:
  - Discontinued operations pretax | $(1,000) |
  - Tax rate | 25% |
  - Expected income tax benefit | $(250) |
  - IRC Section 250 benefit lost | 22 |
  - Tax provision – discontinued operations | $(228) |

While ASC 740-20 does not explicitly state how the intraperiod tax allocation guidance should be applied when there are multiple tax-paying components, 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.

Accordingly, by analogy, entities should apply the intraperiod tax allocation guidance to each tax-paying component; that is, they should apply it at the tax-return level within each taxing jurisdiction.

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1 The percentage of income that can be deducted is reduced in taxable years beginning after December 31, 2025.
2 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.
6.2.2 Changes in Valuation Allowances

As discussed in Section 6.2.1.1, when performing an intraperiod tax allocation, an entity generally must first determine income tax allocated to continuing operations. ASC 740-10-45-20 states, “[t]he 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). Causes of changes in valuation allowances could result from, for example, (1) the expiration of a reserved carryforward (in which the valuation allowance is reduced in a manner similar 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, or (3) the generation of deductible temporary differences and carryforwards in the current year that are not more likely than not to be realized. While a change in valuation allowance that results from the expiration of a reserved carryforward would not affect total tax expense and therefore would not affect intraperiod tax allocation, changes in valuation allowance related to the other categories would.

Though the normal rule would suggest that the effect of changes in valuation allowances should be included in continuing operations, 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) and (f)) should be allocated directly to OCI or related components of shareholders' equity:
  - A “decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock).”
  - “Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization,” with limited exceptions.
- Any other change 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). The exception to this rule exists when there is a loss from continuing operations. See below for further information regarding the exception to the general rule.

Regarding the last bullet point, when it is difficult for an entity to determine whether a change in valuation allowance is solely because of 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.
Chapter 6 — Intraperiod Allocation

Example 6-2

At the beginning of 20X1, Entity X, a company operating in a tax jurisdiction with a 25 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 solely because of that income. Therefore, the release of the valuation allowance would be allocated to discontinued operations.

Example 6-3

At the beginning of 20X3, Entity Y, a company operating in a tax jurisdiction with a 25 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 would not be recognized until the following year).

6.2.3 Special Situations

6.2.3.1 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.

6.2.3.2 Fresh-Start Accounting

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.
6.2.4 AFS Debt 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 debt securities generally are charged or credited to OCI (see Section 3.5.10.3). An entity will sometimes recognize a valuation allowance to reduce a DTA for an unrealized loss on AFS debt 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.

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 debt 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 debt 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 6-4 below illustrates this concept.

Example 6-4

Assume that at the beginning of the current year, 20X1, Entity X has no unrealized gain or loss on an AFS debt security. During 20X1, unrealized losses on AFS debt securities are $1,000 and the tax rate is 25 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 $250 DTA and a $125 valuation allowance. Accordingly, the carrying amount of the AFS debt portfolio is reduced by $1,000, OCI is reduced by $875, and a $125 net DTA (a DTA of $250 less a valuation allowance of $125) is recognized at the end of 20X1.

During 20X2, (1) additional unrealized losses of $2,000 on AFS debt 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 debt portfolio is reduced by a total of $3,000 ($1,000 + $2,000), the DTA is increased to a total of $750 ($250 + $500), the valuation allowance is eliminated, the total unrealized loss (net of tax) on AFS debt securities recorded in AOCI is $2,000 ([$500 + $2,000] – [$2,000 × 25%]), and income tax expense from continuing operations for 20X2 is credited (reduced) for the $125 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 debt 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 $750 related to such items ($3,000 × 25%). This situation creates what are commonly referred to as “stranded taxes” or anomalies, which are discussed in Section 6.2.6. If an entity uses the portfolio approach to account for unrealized gains or losses, any differential caused by this requirement ($125 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.

6.2.5 Out-of-Period Items

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 and therefore some or all of a valuation allowance previously established against that DTA is reversed; or (3) when DTAs or DTLs for preexisting outside basis differences are recognized because they are no longer subject to one of the exceptions in ASC 740-30.

ASC 740-20 and ASC 740-10 provide guidance on the intraperiod tax allocation of certain out-of-period adjustments. Such adjustments 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). 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, however, provide guidance on how to allocate the tax effects of certain other out-of-period adjustments. The following are examples of circumstances that give rise to out-of-period adjustments for which ASC 740 does not contain explicit guidance on how to allocate the tax benefit or expense:

- A change in the expected timing of reversal of a DTA or DTL resulting in a change in the expected benefit or expense (as may be the case when a change in tax rates is phased in over multiple years).
- Recognition of the benefit of a deduction for an incentive stock option (ISO) that becomes deductible only because of a disqualifying disposition.
- Recognition of previously unrecognized DTAs or DTLs that are recognized because they are no longer subject to one of the exceptions in ASC 740-30.

In such cases, it is usually appropriate for an entity to analogize to the guidance in ASC 740-20 on out-of-period adjustments. Thus, the 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.

However, other Codification topics may contain guidance that appears, in some cases, to conflict with an analogy to ASC 740-20. In those situations, it may be acceptable to apply the presentation guidance from that other topic. See Section 6.2.5.1 for further discussion of certain tax effects associated with discontinued operations.
6.2.5.1 Intraperiod Allocation of Out-of-Period items Related to Components Classified as Discontinued Operations

Guidance on the presentation of discontinued operations is contained in ASC 205. Specifically, ASC 205-20-45-3A through 45-5 state the following:

**45-3A** The results of all discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income.

**45-3B** A gain or loss recognized on the disposal (or loss recognized on classification as held for sale) shall be presented separately on the face of the statement where net income is reported or disclosed in the notes to financial statements (see paragraph 205-20-50-1(b)).

**45-3C** A gain or loss recognized on the disposal (or loss recognized on classification as held for sale) of a discontinued operation shall be calculated in accordance with the guidance in other Subtopics. For example, if a discontinued operation is within the scope of Topic 360 on property, plant, and equipment, an entity shall follow the guidance in paragraphs 360-10-35-37 through 35-45 and 360-10-40-5 for calculating the gain or loss recognized on the disposal (or loss on classification as held for sale) of the discontinued operation.

**45-4** 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.

**45-5** 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 205-20 notes that the income statement should include, as a separate component, the results of operations of the discontinued operation for the current and prior periods, less applicable income taxes. Further, ASC 205-20-45-5 does not distinguish between pretax- and income-tax-related effects of adjustments to amounts previously recorded in discontinued operations, but it does require those adjustments to be directly related to the discontinued operations (including the disposal transaction). Accordingly, under ASC 205, an entity may conclude that out-of-period tax effects directly related to the operations of the discontinued operation (including the disposal transaction) should be allocated to discontinued operations.

Further, in connection with the implementation of Interpretation 48 (most of which was 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 would 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.

Accordingly, if an entity concludes that the out-of-period tax benefit (or expense) is directly related to the operations of the component that is presented in discontinued operations (including the disposal
transaction), there are generally two acceptable views regarding the allocation of such tax effects. Under one view, the entity may elect to allocate this tax expense or benefit to discontinued operations by applying ASC 205-20 or, under an alternative view, to income from continuing operations by analogy to the general intraperiod allocation rules for out-of-period adjustments in ASC 740-20. Under the alternative view, if the entity concludes that the tax benefit (or expense) is not directly related to the operations of the component that is presented in discontinued operations (including the disposal transaction), the entity should allocate the entire tax expense or benefit to income from continuing operations (by analogy to ASC 740-20).

Out-of-period adjustments are often related to the operations of the discontinued operations (including the disposal transaction). The following are three situations in which an entity may need to make such adjustments:

- As discussed in Section 3.4.17.2, an out-of-period adjustment may be required when an unrecognized book-versus-tax difference that is related directly to the operations of a discontinued operation is no longer subject to one of the exceptions in ASC 740.3
- A domestic corporation may change its legal structure or make elections for tax purposes that result in a worthless stock deduction that is directly related (either partially or entirely) to the operations of a discontinued operation.4
- 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.

Example 6-5
Change in an Indefinite Reinvestment Assertion

Entity X has a profitable foreign subsidiary, A. Entity 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 and no longer asserts that it intends 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 “backwards 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.

3 As discussed in Section 3.4.17.2, an entity may expect an unrecognized outside basis difference DTL to close through a GILTI inclusion, and the entity may have elected to treat GILTI tax as a current-period expense when it arises. In that case, when the tax effect is ultimately recorded, it will represent a current-period tax expense and be allocated in accordance with the normal intraperiod tax allocation rules (i.e., not those applicable to out-of-period adjustments).

4 IRC Section 163(g)(3) specifies that the worthless stock deduction may be taken against the domestic corporation's ordinary income if the investee is considered an affiliate. If the investee is not an affiliate, the deduction would be against the domestic corporation's capital income. This determination may affect the amount of the deduction the domestic corporation is able to benefit from in the current period.
Example 6-6

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 Section 3.3.4.6.1 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.

Example 6-7

Tax Benefit From a Worthless Stock Deduction

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, H 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 of that deduction is considered out of period from Y’s perspective because it represents the recognition of the tax benefit of a loss in a period after the loss arose.

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.

Example 6-8

Out-of-Period Tax Effects of a UTB That Originated in Discontinued Operations

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.
6.2.6 Stranded Taxes

Certain circumstances may result in taxes' being “stranded” in AOCI. Stranded taxes, or anomalies, may arise on account of:

- Changes in tax rates after the pretax amount was included in OCI.
- Pretax amounts' not being tax effected because of the presence of a valuation allowance and the inapplicability of ASC 740-20-45-7.
- The fact that the exception in ASC 740-20-45-7 is applicable in one annual accounting period, but the pretax amount in OCI reverses in a subsequent annual period.
- A change in tax status.
- A change in indefinite reinvestment assertion.
- Circumstances similar to the above.

For example, assume that an entity has a portfolio of AFS debt securities and that during 20X1, their fair value has declined to the extent 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 to the degree 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, an entity treats a reduction in a prior loss 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.

6.2.6.1 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 debt 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.
6.2.6.2 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 debt securities is sold or otherwise disposed of.

As indicated above, another example of a situation that may leave taxes stranded in AOCI is a change in tax rate after the pretax amount was included in OCI. In February 2018, the FASB issued ASU 2018-02 to address industry concerns related to the application of ASC 740 to certain provisions of the Tax Cuts and Jobs Act (the “Act”). Specifically, some constituents in the banking and insurance industries had expressed concerns about the requirement in ASC 740 that the effect of a change in tax laws or rates on DTAs and DTLs be included in income from continuing operations. That guidance applies even in situations in which the tax effects were initially recognized directly in OCI at the previous rate, resulting in stranded amounts in AOCI related to the income tax rate differential.

ASU 2018-02 does not affect the application of the intraperiod rules in ASC 740-20; however, the ASU allows an entity to elect a one-time reclassification from AOCI to retained earnings of stranded tax effects resulting from the Act. The amount of the reclassification includes (1) the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, on the date of enactment of the Act related to items remaining in AOCI and (2) other income tax effects of the Act on items remaining in AOCI that an entity elects to reclassify. The effects of the change in the U.S. federal corporate income tax rate on gross valuation allowances that were originally charged to income from continuing operations are not included.

For example, assume that before the enactment date of the Act, an entity recognized a $1,000 loss in OCI in connection with a derivative used in cash flow hedging activities. No further changes in the fair value of the hedge occur after that date. The forecasted transactions will not occur until after the enactment date. Because there was no tax basis in the derivative, the entity also recognized a $350 DTA and recorded a corresponding entry to OCI. On the enactment date of the Act, the entity reduced the DTA by $140 and recognized a corresponding increase in income tax expense, equal to the temporary difference of $1,000 multiplied by 14 percent. Upon adopting the ASU and electing to make the reclassification, the entity would then recognize a one-time reclassification to move the effect of the rate reduction from AOCI to retained earnings. The entries are summarized in the table below.

<table>
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<th>Derivative Liability</th>
<th>AOCI</th>
<th>DTA</th>
<th>Net Income</th>
<th>Retained Earnings</th>
</tr>
</thead>
<tbody>
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<td>Derivative loss</td>
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<td>$1,000</td>
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<td></td>
</tr>
<tr>
<td>Related tax effect</td>
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<td>$350</td>
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<tr>
<td>Reduction in statutory rate</td>
<td>(140)</td>
<td>$140</td>
<td>$140</td>
<td></td>
</tr>
<tr>
<td>Reclassification under ASU 2018-02</td>
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<tr>
<td>Final balance</td>
<td>$(1,000)</td>
<td>$790</td>
<td>$210</td>
<td>—</td>
</tr>
</tbody>
</table>
For entities electing to reclassify income tax effects of the Act from AOCI to retained earnings, ASU 2018-02 also addressed “[o]ther income tax effects of the Tax Cuts and Jobs Act.” Items classified as other income tax effects of the Act might include, for example, the effect of certain international tax provisions. In some cases, an entity may not have been indefinitely reinvested in the outside basis difference in its foreign subsidiary and, accordingly, recorded a DTL related to the outside basis difference measured in a manner consistent with laws in effect before the deemed repatriation transition tax. When the DTL was initially recorded, a portion may have been recorded through OCI as the tax effects related to the translation of the underlying assets and liabilities of the foreign subsidiary. Because of tax reform, the measurement of the tax effects related to the outside basis difference may have changed as a result, in whole or in part, of the deemed inclusion of previously untaxed post-1986 foreign E&P, offset by a deduction designed to generally result in an effective U.S. federal income tax rate on such E&P of either 15.5 percent or 8 percent depending on the SFC’s aggregate foreign cash position. The remeasurement of the portion of the DTL that remains in AOCI would be an example of other income tax effects of the Act on items remaining in AOCI that an entity may elect to reclassify in accordance with ASC 220-10-45-12A(b).

ASU 2018-02 must be adopted by all entities; however, certain provisions of the ASU are elective. For example, a company can elect to reclassify the income tax effects of the Act on items in AOCI to retained earnings as described above. Under ASC 220-10-45-12A, as added by ASU 2018-02, if an entity elects to reclassify the income tax effects of the Act, the amount of the reclassification includes:

a. The effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of the Tax Cuts and Jobs Act related to items remaining in accumulated other comprehensive income. . . .

b. Other income tax effects of the Tax Cuts and Jobs Act on items remaining in accumulated other comprehensive income that an entity elects to reclassify, subject to the disclosures in paragraph 220-10-50-2(b).

Accordingly, if a company elects to make a reclassification entry, it would be required to reclassify amounts prescribed in ASC 220-10-45-12A(a) but would not be required to reclassify amounts prescribed in ASC 220-10-45-12A(b).

Regardless of whether an election is made to reclassify income tax effects of the Act, however, all companies are required to disclose the following upon adoption of the ASU:

- The company’s accounting policy related to releasing income tax effects from AOCI (e.g., the portfolio approach or the security-by-security approach), described above. This disclosure requirement, which is contained in ASC 220-10-50-1, is applicable only to stranded taxes.
- Whether the company has elected to reclassify, to retained earnings in the statement of stockholders’ equity, the stranded tax effects in AOCI related to the Act.
- If the company has elected to reclassify to retained earnings the stranded tax effects in AOCI related to the Act, what the reclassification encompasses (whether it includes only the change in the federal corporate tax rate or whether it also includes other changes resulting from the Act that affect AOCI).

The existence of a valuation in current or prior periods may affect the reclassification under ASU 2018-02. For example, if a DTA for which the offsetting amount would otherwise be recorded to AOCI requires a valuation allowance at the time it is recorded, there is no net amount recorded in AOCI because the valuation allowance is also recorded as an entry to AOCI. Consequently, upon enactment there would be no stranded tax effect in AOCI related to the item that gave rise to the DTA. Examples 6-9 and 6-10 illustrate the impact of valuation allowances on the reclassification of stranded tax effects under ASU 2018-02.
### Example 6-9

**Valuation Allowance Recorded Before Tax Effects**

Assume that in year 1, before the enactment date of the Act, an entity with a full valuation allowance against its DTAs recognized a $100 loss in OCI in connection with an AFS security held as a short-term investment. The entity records a DTA equal to $35 (the $100 unrealized loss on the AFS security multiplied by the corporate tax rate of 35 percent). Because the entity has a full valuation allowance against its DTAs, it does not record a net tax benefit in OCI but instead records an increase in the valuation allowance of $35. The entries for year 1 are as follows:

<table>
<thead>
<tr>
<th>Unrealized loss on AFS security</th>
<th>AFS Security</th>
<th>AOCI</th>
<th>DTA</th>
<th>Valuation Allowance</th>
<th>Retained Earnings</th>
<th>Continuing Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>(100)</td>
<td>(100)</td>
<td>35</td>
<td>(35)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

During year 2, the entity determines that the valuation allowance is no longer needed and releases it through continuing operations by debiting the valuation allowance and crediting tax benefit (i.e., continuing operations) in the amount of $35. The Act is enacted in year 3, and the entity remeasures its DTA related to the AFS security by using the new lower corporate tax rate of 21 percent to credit the DTA and debit tax expense (i.e., continuing operations) in the amount of $14 ($100 unrealized loss on the AFS security multiplied by the difference in tax rates of 14 percent [35 percent minus 21 percent]).

The entity adopts ASU 2018-02 as of January 1 of year 4. The amount remaining in AOCI related to the AFS security as of the date of enactment is $0. This is because when the tax effects of the changes in value of the AFS security occurred, the entity had a full valuation allowance recorded. Accordingly, no amount is reclassified from AOCI to retained earnings under ASU 2018-02. The entries for years 2, 3, and 4 are as follows:

<table>
<thead>
<tr>
<th>Release of the valuation allowance</th>
<th>AFS Security</th>
<th>AOCI</th>
<th>DTA</th>
<th>Valuation Allowance</th>
<th>Retained Earnings</th>
<th>Continuing Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>35</td>
<td>(35)</td>
<td></td>
</tr>
</tbody>
</table>

| Enactment                        |              | (14) |     |                      |                   | 14                   |

| ASU 2018-02                      |              | 0    |     |                      |                   | 0                    |

| Total (years 1, 2, 3, and 4)     | (100)        | 100  | 21  | 0                    | 0                 | (21)                 |

### Example 6-10

**Valuation Allowance Recorded After Tax Effects**

Assume the same facts as in Example 6-9 above, except that the valuation allowance is not recorded until the beginning of year 2 and is not released before enactment.

In year 1, the entity records the $35 DTA and corresponding tax benefit in OCI related to the $100 unrealized loss on the AFS security. The entries for year 1 are as follows:

<table>
<thead>
<tr>
<th>Unrealized loss on AFS security</th>
<th>AFS Security</th>
<th>AOCI</th>
<th>DTA</th>
<th>Valuation Allowance</th>
<th>Retained Earnings</th>
<th>Continuing Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>(100)</td>
<td>(100)</td>
<td>100</td>
<td></td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>(35)</td>
<td>(35)</td>
<td>35</td>
<td></td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>
Example 6-10 (continued)

In year 2, the entity determines that a full valuation allowance is needed and accordingly credits the valuation allowance in the amount of $35 with an offsetting entry to tax expense (i.e., the amount is not “backwards traced” to AOCI). In year 3, the Act is enacted, and the entity remeasures its DTA related to the AFS security by using the new lower corporate tax rate of 21 percent to credit the DTA and debit the valuation allowance in the amount of $14. The entity adopts ASU 2018-02 as of January 1 of year 4. In doing so, it determines that upon enactment, the stranded tax effect related to the AFS security is $14. This is because although the entity recorded a valuation allowance against the DTA related to the AFS security in year 2, the tax effect related to the AFS security that was recorded in OCI (and thus remained in AOCI as of enactment) was $35. Consequently, a debit of $14 is made to AOCI, and a credit of $14 is made to retained earnings to reclassify the stranded tax effects remaining in AOCI as of enactment. The entries for years 2, 3, and 4 are as follows:

<table>
<thead>
<tr>
<th>AFS Security</th>
<th>AOCI</th>
<th>DTA</th>
<th>Valuation Allowance</th>
<th>Retained Earnings</th>
<th>Continuing Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full valuation allowance recorded</td>
<td>(35)</td>
<td></td>
<td></td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>Enactment</td>
<td></td>
<td>(14)</td>
<td></td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>ASU 2018-02</td>
<td></td>
<td></td>
<td>14</td>
<td>(14)</td>
<td></td>
</tr>
<tr>
<td>Total (years 1, 2, 3, and 4)</td>
<td>(100)</td>
<td>79</td>
<td>21</td>
<td>(21)</td>
<td>(14)</td>
</tr>
</tbody>
</table>

For entities that adopt ASU 2018-02 prospectively in a period after the enactment date (December 22, 2017), the reclassification adjustment is based on the amount that remains at the time of adoption. For example, assume that before enactment, an entity holds an AFS security for which an unrealized loss of $1,000 has been recorded in AOCI, resulting in a corresponding tax effect of $350 that is also recorded in AOCI. Upon enactment, the entity records an entry in the amount of $140 ($1,000 × [35% – 21%]) to reduce the DTA related to the unrealized loss with a corresponding debit to tax expense to reflect the difference between the pre-enactment corporate tax rate of 35 percent and the new corporate tax rate of 21 percent.

In the first quarter of 2018, after the enactment date, the entity sells the AFS security, resulting in the reversal of the remaining $210 DTA balance and, before application of either the security-by-security approach or the portfolio approach, reversal of $210 of tax benefit recorded in OCI. During the second quarter of 2018 and after the sale of the AFS security, the entity adopts ASU 2018-02 and elects to prospectively reclassify stranded tax effects from AOCI to retained earnings.

If the entity had made an accounting policy election to use the security-by-security approach to account for deferred taxes associated with unrealized gains and losses recorded in OCI, the amount of the reclassification under ASU 2108-02 recorded in the second quarter of 2018 would be $0 because the entire tax effect associated with the AFS security would have been removed from AOCI when the security was sold.

Alternatively, if the entity had made an accounting policy election to use the portfolio approach to account for deferred taxes associated with unrealized gains and losses recorded in OCI, $140 would be reclassified from AOCI to retained earnings upon adoption of ASU 2018-02. This is because under the portfolio approach, tax effects associated with an individual security in a portfolio are not removed from AOCI until the disposal of the last security in the portfolio.
The ASU is effective for all entities for fiscal years beginning after December 15, 2018, including interim periods therein. Earlier application is permitted in financial statements that have not yet been issued or made available for issuance. Upon adoption, an entity would apply this guidance to each period in which the effect of the Act (or portion thereof) is recorded and may apply it either (1) retrospectively as of the date of enactment or (2) as of the beginning of the period of adoption.

Because both ASU 2018-02 and ASU 2016-01 may affect amounts previously recorded in AOCI, the impact that the adoption of one ASU has on the adoption of the other will depend on (1) the order in which the ASUs are adopted, (2) the entity's existing policies for releasing stranded tax effects, and (3) the entity's choice of adoption with respect to ASU 2018-02.

**Changing Lanes**

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. Although the ASU retains many current requirements, it significantly revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The ASU also amends certain disclosure requirements associated with the fair value of financial instruments.

The ASU requires entities to carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and LLCs, with readily determinable fair values (and those without readily determinable fair values upon the occurrence of certain events), to fair value each period through net income. However, AFS debt securities will continue to be recorded through OCI. The ASU is effective for PBEs for fiscal years beginning after December 15, 2017, and interim periods therein. Upon adoption, an entity is required to record a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. Consequently, entities with equity securities that were classified as AFS before adoption will reclassify amounts from AOCI to retained earnings by means of the cumulative-effect adjustment recorded upon adoption.

For example, if ASU 2016-01 is adopted before ASU 2018-02 and the entity elects to adopt ASU 2018-02 prospectively, certain stranded tax effects may have already been reclassified into retained earnings because the entity's existing policy was to release stranded tax effects by using a security-by-security approach (i.e., those specific effects will not remain in AOCI when ASU 2018-02 is adopted and, accordingly, will not be affected by ASU 2018-02). However, an entity may still elect to reclassify other tax effects of the Act in accordance with ASC 220-10-45-12A(a) (e.g., effect of rate change on deferred tax amounts related to debt securities) or ASC 220-10-45-12A(b) *in addition* to those previously reclassified by means of the cumulative-effect adjustment recorded upon adoption of ASU 2016-01.

Alternatively, if ASU 2018-02 is adopted before ASU 2016-01 (or is adopted after ASU 2016-01, but the entity elects to adopt ASU 2018-02 on a retrospective basis) and the entity has elected to reclassify stranded tax effects from AOCI, the tax effects remaining in AOCI that would be reclassified upon adoption of ASU 2016-01 would generally be limited to the tax effect of the pretax gain or loss on the equity security at the new 21 percent statutory tax rate.

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5 If a registrant elects to apply the guidance *retrospectively* after it files its annual financial statements in its Form 10-K (e.g., if it elects retrospective adoption in its Form 10-Q filed for the first quarter of 2019 for a calendar-year entity) and subsequently files a new or amended registration statement that incorporates by reference those interim financial statements, the registrant must consider the need to retrospectively revise its annual financial statements that are incorporated by reference in that new or amended registration statement (i.e., the annual financial statements in its Form 10-K for the year ended December 31, 2018, in this example). This requirement does not apply to a registrant that chooses to (1) apply the new guidance as of the beginning of the period of adoption or (2) early adopt the new guidance in the annual financial statements incorporated by reference into the new or amended registration statement.
Chapter 6 — Intraperiod Allocation

If the two ASUs are adopted simultaneously, the entity should decide which ASU was adopted first since that determination will affect the resulting disclosures.

6.2.7 Transactions Among or With Shareholders

6.2.7.1 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 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.

### 6.2.8 Other Special Considerations

#### 6.2.8.1 Holding Gains and Losses Recognized for Both Financial Reporting and Tax Purposes

Assume that an entity has an AFS portfolio of debt 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 6-11 below illustrates this concept.

#### Example 6-11

Assume the following:

- Company X acquires AFS debt securities for $12 million on January 1, 20X0.
- For financial reporting purposes, unrealized gains and losses on AFS debt 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 debt securities is $5 million, all of which was incurred during the current year.
- The tax rate for 20X1 and 20X2 is 20 percent.
- Pretax income and taxable income, excluding the unrealized loss for 20X1 and 20X2, are $5 million and zero, respectively.
**Example 6-11 (continued)**

- 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 sells the AFS debt securities for $7 million and 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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized loss on investments (OCI)</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Investment portfolio</td>
<td>5,000,000</td>
</tr>
<tr>
<td>To record the unrealized loss on AFS securities in OCI</td>
<td></td>
</tr>
<tr>
<td>Income tax expense — continuing operations</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Taxes currently payable</td>
<td>1,000,000</td>
</tr>
<tr>
<td>To record the taxes payable on $5 million of taxable income exclusive of losses on the security portfolio, which are reported in OCI</td>
<td></td>
</tr>
<tr>
<td>Taxes currently payable</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Income tax benefit — OCI</td>
<td>1,000,000</td>
</tr>
<tr>
<td>To record the tax consequences of losses on securities portfolio in 20X1 — computed on the basis of mark-to-market accounting as elected under tax law</td>
<td></td>
</tr>
</tbody>
</table>

### Journal Entries Year 2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realized loss on sale of investments (P&amp;L)</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Investment portfolio</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Unrealized loss on investment (OCI)</td>
<td>5,000,000</td>
</tr>
<tr>
<td>To record the pretax consequences of the sale of the investment portfolio in 20X2</td>
<td></td>
</tr>
<tr>
<td>Income tax expense — OCI</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Income tax benefit — continuing operations</td>
<td>1,000,000</td>
</tr>
<tr>
<td>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</td>
<td></td>
</tr>
</tbody>
</table>

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

For a discussion of temporary differences, see Chapter 3.

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 Section 6.2.7.1 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.

### 6.2.8.3 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.

**6.2.8.3.1 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.

**6.2.8.3.1.1 Asset Sale**

When the net assets of a subsidiary are sold, the parent will present the gain or loss on the net assets (excluding deferred taxes) in pretax income and will present the reversal of any DTAs or DTLs associated with the assets sold (the inside basis differences\(^6\)) and any tax associated with the gain or loss on sale in income tax expense (or benefit).

**6.2.8.3.1.2 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 deferred taxes effects (the inside basis differences\(^7\)) is to include the elimination of such amounts as part of the overall computation of the pretax gain or loss on the sale of the subsidiary; under this approach, the only amount that would be included in income tax expense (or benefit) would be the tax associated with the gain or loss on the sale of the shares (the outside basis difference\(^8\)). 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 also need to consider the intraperiod guidance on discontinued operations in addition to this guidance. For a discussion of outside basis differences in situations in which the subsidiary is presented as a discontinued operation, see Section 3.4.17.2.

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\(^6\) See Section 3.3.1 for the meaning of “inside” and “outside” basis differences.

\(^7\) See footnote 5.

\(^8\) See footnote 5.
6.2.8.3.2 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 difference9) 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.

6.2.8.3.2.1 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 differences10) being sold should not be presented as held for sale; rather, they should be presented along with the consolidated entity’s other deferred taxes.

6.2.8.3.2.2 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 differences11) being sold should be presented as held for sale and not with the consolidated entity’s other deferred taxes.

6.2.9 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 below.

6.2.10 Treatment of Tax Benefit for Dividends Paid on Shares Held by an ESOP

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes.

After the adoption of ASU 2016-09, the tax benefit of tax-deductible dividends on unallocated shares paid to the employee stock ownership plan (ESOP) that are not recorded in retained earnings should be recorded in the income statement. ASC 718-740-45-7 states, “[t]he tax benefit of tax-deductible dividends on allocated and unallocated employee stock ownership plan shares shall be recognized in the income statement.”

9 See footnote 5.
10 See footnote 5.
11 See footnote 5.
Changing Lanes

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB's Simplification Initiative), including by making minor improvements to the Codification topics on income taxes related to ESOPs. The ASU amends the guidance in ASC 718-740-45-7 to clarify where the tax benefit of tax-deductible dividends should be shown in the income statement. That is, the tax benefit should be recognized in income taxes allocated to continuing operations.

For further information about ASU 2019-12, see Appendix B.

6.2.11 Exception to the General Rule

6.2.11.1 Intraperiod Tax Allocation When There Is a Loss From Continuing Operations in the Current Period

ASC 740-20-45-7 provides an exception to the general intraperiod allocation guidance under ASC 740-20 for an entity that has a current-year loss from continuing operations.

ASC 740-20-45-7 states:

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations. That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

The benefit to be allocated to continuing operations is generally computed as the lesser of (1) the tax expense associated with the income in discontinued operations or (2) the tax benefit associated with the loss in continuing operations.

The exception to the general rule applies to a situation in which (1) an entity has a loss from continuing operations and income related to other items such as discontinued operations and (2) the entity would not have otherwise recognized a benefit for the loss from continuing operations under the with-and-without approach described in ASC 740-20-45 (e.g., because the entity has a valuation allowance against its net DTAs). Below is an illustration of the exception to the general intraperiod tax allocation rule.

**Example 6-12**

Assume the following:

- Company A has a $10,000 NOL DTA at the beginning of the year with a full valuation allowance recorded against it.
- During the current year, A disposes its wholly owned subsidiary, Company B, and has determined that the disposal will be presented as discontinued operations in accordance with ASC 205.
- Company A generated a loss of $6,000 during the year, and B generated income of $5,000 during the year.
- There are no permanent differences.
- Company A concludes that it will still need a full valuation allowance for its DTAs.
Example 6-12 (continued)

As a result of the exception to the general rule above, the pretax income/(loss), tax expense/(benefit), and net income/(loss) would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Continuing Operations</th>
<th>Discontinued Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year income/(loss)</td>
<td>$(6,000)</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Income tax expense/(benefit)</td>
<td>(1,250)*</td>
<td>1,250</td>
</tr>
<tr>
<td>Net income/(loss)</td>
<td>$(4,750)</td>
<td>$ 3,750</td>
</tr>
</tbody>
</table>

* The benefit allocated to continuing operations is limited to the tax expense associated with discontinued operations income of $5,000 × 25% = $1,250.

Note that the table above is for illustrative purposes only, given that discontinued operations are presented net of tax in the financial statements.

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.

6.2.11.1.1 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 income from 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.

6.2.11.1.2 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.
### 6.2.11.1.3 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 Section 6.2.16).
- 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 AOCI or loss into net income or loss (see Section 6.2.14).

An entity should apply its selected approach consistently to all periods and tax-paying components.

#### Example 6-13

Assume the following:

- An entity has incurred losses for financial and income tax reporting purposes in recent years and, accordingly, has recognized significant NOL carryforwards for which the DTA, net of its valuation allowance, is zero at the beginning of the year.
- The entity does not have positive verifiable evidence to support a valuation allowance release at the end of each year presented.
- The entity reflects a zero total income tax provision for the year because of the need to establish a full valuation allowance against all of its DTAs at the end of the year.
- The applicable jurisdiction tax rate for all items is 25 percent.

The scenarios below are based on the above assumptions and illustrate application of the individual-component approach and the net approach.

#### Scenario A

<table>
<thead>
<tr>
<th></th>
<th>Individual-Component Approach</th>
<th>Net Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pretax</td>
<td>Allocated Tax Benefit</td>
</tr>
<tr>
<td>Net loss from continuing operations</td>
<td>$ (1,000)</td>
<td>$ 250</td>
</tr>
<tr>
<td>Net loss from discontinued operations</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>OCI</td>
<td>1,000</td>
<td>(250)</td>
</tr>
<tr>
<td>Comprehensive loss</td>
<td>$ (1,000)</td>
<td>$ —</td>
</tr>
</tbody>
</table>

Scenario A illustrates that under the individual-component approach, even though there is no incremental tax effect from discontinued operations and other comprehensive loss (because of the entity’s NOL and full valuation allowance established against its DTAs), income tax benefit is allocated to continuing operations, income tax expense is correspondingly allocated to OCI (which is the only other “intraperiod allocation” component in the current year), and no income tax expense or benefit is allocated to discontinued operations. There is no incremental tax effect, regardless of whether there are multiple items of income or loss, or there is a single item of income other than a continuing-operations loss, because the financial statement reporting effect of applying the ASC 740-20-45-7 exception is simply a mechanical intraperiod allocation of the entity’s total current-year income tax provision of zero.
Example 6-13 (continued)

Scenario B

<table>
<thead>
<tr>
<th>Individual-Component Approach</th>
<th>Possible Methods of Allocating Income Tax Benefit (Expense) When Applying the Net Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax</td>
<td>Allocated Tax Benefit (Expense)</td>
</tr>
<tr>
<td>Net loss from continuing operations</td>
<td>$ (1,000)</td>
</tr>
<tr>
<td>Net loss from discontinued operations</td>
<td>(400)</td>
</tr>
<tr>
<td>OCI</td>
<td>1,000</td>
</tr>
<tr>
<td>Comprehensive loss</td>
<td>$ (400)</td>
</tr>
</tbody>
</table>

Scenario B illustrates that there may be multiple possible methods of allocating income tax benefit and expense when the net approach is applied.

Changing Lanes

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB’s Simplification Initiative).

Under the Simplification Initiative, stakeholders provided feedback on the difficulty of applying the exception in ASC 740-20-45-7, which they noted (1) is often overlooked, (2) provides little perceived benefit to users of financial statements, and (3) is applied inconsistently in practice. On the basis of this feedback, ASU 2019-12 removes the exception in ASC 740-20-45-7. The FASB notes that removal of this exception “will reduce the cost of applying Topic 740, while not significantly altering the information provided to users of financial statements.” In addition, the ASU provides related amendments to the illustrative example in ASC 740-20-55-10 through 55-14 to conform with the removal of the exception.

These amendments should be applied prospectively. For further information about ASU 2019-12, see Appendix B.

6.2.12 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, 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 Section 6.2.1.1.
However, as discussed in Section 6.2.11, 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 OCI. 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 to the extent 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, OCI, 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 consider only 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.

### 6.2.13 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 (“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.
Foreign currency exchange gains recorded in OCI should not be included in the measure of income outside continuing operations under the intraperiod allocation exception in ASC 740-20-45-7 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 Section 9.4.1, 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.

6.2.14 Consideration of Credit Entries for Reclassification Adjustments That Are Recorded in OCI During the Reporting Period When the Exception to the General Intraperiod Tax Allocation Rule Is Applied

Generally, an entity should exclude credit entries for reclassification adjustments that are recorded in OCI during the reporting period when applying ASC 740-20-45-7 to determine income within OCI. The guidance in ASC 740-20-45-7 supports this premise, stating, in part:

*That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations.* [Emphasis added]

In other words, regarding the determination of the amount of income tax benefit that should be allocated to continuing operations when there is a loss from continuing operations, ASC 740-20-45-7 requires a reporting entity to consider whether there are other sources of taxable income outside of continuing operations in the current year. This approach is consistent with the general approach in ASC 740-10 that an entity would apply to determine whether a valuation allowance is required against DTAs (i.e., the reporting entity would consider the tax consequences of taxable income expected in future years in assessing the realizability of DTAs). A credit in OCI created by the reclassification of a realized loss to continuing operations does not represent potential future taxable income; therefore, the exception is not applicable in such circumstances. Under this premise, an entity should similarly exclude debit entries for reclassification adjustments that are recorded in OCI that would otherwise reduce other gains in OCI that would provide a source of income.

We are aware of an alternative approach in practice under which an entity does not distinguish between credits resulting from reclassification adjustments and other gains in OCI. Using this approach, an entity would look to the total amount of the adjustment recorded in OCI during the period when applying ASC 740-20-45-7, as discussed in Section 6.2.11.1.1.

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.

6.2.15 Application of ASC 740-20-45-7 to Recoveries of Losses in AOCI

A credit or gain may be recognized in OCI on a debt security that is classified as AFS but that remains in an overall loss position.

**Example 6-14**

Entity A purchases a debt security on January 1, 20X1, for $1,000. The security is classified as held for sale for financial reporting purposes. During 20X1, the security declines in value so that its carrying amount for financial reporting purposes is $800 on December 31, 20X1. The unrealized loss of $200 is recognized in OCI in accordance with ASC 320. During 20X2, the security increases in value, and an unrealized gain of $150 is recognized in OCI. As a result, the security's financial reporting carrying amount increases to $950.

If the $150 unrealized gain recognized in OCI in 20X2 is not taxed currently, there are two acceptable approaches on whether A should include it in the measure of income outside of continuing operations when applying the intraperiod allocation exception given that the security is still in a net loss position of $50. The approach an entity selects is an accounting policy election that should be applied consistently.

**Approach 1 — Make No Distinction Between Credits on Securities in a Net Loss Position and Those in a Net Gain Position**

Under this approach, rather than distinguishing between credits on securities in a net loss position and credits on securities in a net gain position, A would look only to the total amount of unrealized gains or losses recorded in OCI during the period when applying ASC 740-20-45-7. This approach is consistent with ASC 740-20-45-7, which states, in part:

> The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.

Note that Section 6.2.15 discusses how a reporting entity should consider credits in OCI that are the result of reclassification adjustments when it applies ASC 740-20-45-7. An entity that applies the alternative approach described in Section 6.2.15 (i.e., an entity that does not distinguish between credits that represent gains and those that represent reclassification adjustments) generally should apply Approach 1 to determine the effects of unrealized gains on AFS debt securities when it is applying ASC 740-20-45-7.

**Approach 2 — Do Not Include Credits on Securities That Represent Recovery of Previous Net Losses**

Under this approach, A would not consider an unrealized gain recognized in OCI in the current year as a potential source of future income when applying the intraperiod allocation exception if the security remains in a net loss position. The guidance in ASC 740-20-45-7 that provides the FASB's rationale for including "all items" supports this premise, stating, in part:

> That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

In other words, when a security remains in a net loss position even after a current-year unrealized gain, there is no taxable income expected in future years that would serve as a source of income for the current-year loss from continuing operations. This is substantiated by the fact that there is a DTA for a deductible temporary difference on the security since the tax basis is greater than the book basis. If the security in the example above is sold at the financial reporting amount of $950, there is a taxable loss and no gain; hence, nothing serves as a source of income that would benefit the current-year continuing operations loss.
**Example 6-15**

Assume the following:

- **Entity B:**
  - Determined, in 20X0, that a valuation allowance is needed to reduce its DTA to an amount that is more likely than not to be realized, or zero.
  - Has a YTD pretax loss and is anticipating a pretax loss for the year for which no tax benefit can be recognized.
  - Has a portfolio of four debt securities that are classified as AFS for financial reporting purposes and, therefore, the unrealized gains or losses are recognized in OCI in accordance with ASC 320.
  - Purchased each debt security on January 1, 20X1, for $1,000.
- During 20X1, a net unrealized gain of $50 on AFS securities is recognized in OCI.
- During 20X2, a net unrealized gain of $150 is recognized in OCI.

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Year 1 Gain/(Loss)</th>
<th>Year 2 Gain/(Loss)</th>
<th>December 31, 20X1</th>
<th>December 31, 20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security 1</td>
<td>$1,000</td>
<td>$100</td>
<td>$100</td>
<td>$1,100</td>
<td>$1,200</td>
</tr>
<tr>
<td>Security 2</td>
<td>$1,000</td>
<td>(30)</td>
<td>970</td>
<td>50*</td>
<td>1,020</td>
</tr>
<tr>
<td>Security 3</td>
<td>$1,000</td>
<td>(100)</td>
<td>900</td>
<td>50**</td>
<td>950</td>
</tr>
<tr>
<td>Security 4</td>
<td>$1,000</td>
<td>80</td>
<td>1,080</td>
<td>(50)</td>
<td>1,030</td>
</tr>
<tr>
<td>Total</td>
<td>$4,000</td>
<td>$50</td>
<td>$4,050</td>
<td>$150</td>
<td>$4,200</td>
</tr>
</tbody>
</table>

* Security 2 year 2 gain includes $30 recovery of unrealized losses from prior year.
** Security 3 year 2 gain includes $50 recovery of unrealized losses from prior year.

If B selects Approach 1, the amount of gain it should include in the measure of income outside of continuing operations when applying the intraperiod allocation exception in ASC 740-20-45-7 for the two years would be determined on the basis of the following amounts:

<table>
<thead>
<tr>
<th>Year 1 Gain/(Loss)</th>
<th>Year 2 Gain/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50</td>
<td>$150</td>
</tr>
</tbody>
</table>

If B selects Approach 2, the amount of gain it should include in the measure of income outside of continuing operations when applying the intraperiod allocation exception in ASC 740-20-45-7 for the two years would be determined on the basis of the following amounts:

<table>
<thead>
<tr>
<th>Year 1 Gain/(Loss)</th>
<th>Year 2 Gain/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50</td>
<td>$70</td>
</tr>
</tbody>
</table>
6.2.16 Implications of the Character of Income (or Loss) When the Exception to the General Intraperiod Tax Allocation Rule Is Applied

Intraperiod allocation is required for each tax-paying component (see Section 6.2.11.1). 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 in which 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 in which 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 6-16

In a tax jurisdiction that has a 25 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 debt securities recorded as a component of OCI. The following table illustrates the separate application of the approaches described above:

<table>
<thead>
<tr>
<th></th>
<th>If Character Is Not Considered</th>
<th>If Character Is Considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$ 300</td>
<td>$ 300</td>
</tr>
<tr>
<td>Tax expense</td>
<td>(250)</td>
<td>(100)*</td>
</tr>
<tr>
<td>Net income</td>
<td>50</td>
<td>200</td>
</tr>
<tr>
<td>Capital gain (AFS securities)</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Tax expense</td>
<td>0</td>
<td>(150)</td>
</tr>
<tr>
<td>OCI (net of tax)</td>
<td>600</td>
<td>450</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>$ 650</td>
<td>$ 650</td>
</tr>
</tbody>
</table>

* (1,000 × 25%) – (600 × 25%).
Chapter 7 — Interim Reporting

7.1 Overview

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 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).

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.

General Recognition Approach

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.
Chapter 7 — Interim Reporting

ASC 740-270 (continued)

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.

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.

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.

Pending Content (Transition Guidance: ASC 740-10-65-8)

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 reflected in the computation of the annual effective tax rate beginning in 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.

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.
### ASC 740-270 (continued)

**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.

**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. 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.

**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.

**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. See Subtopic 740-20 for the requirements to allocate total income tax expense (or benefit).

### 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.

**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 (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).

**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).
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. 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).

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.

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 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, 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.

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.

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 use 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. This chapter discusses considerations and complexities when an entity is accounting for income taxes in interim periods.
7.1.1 The Basic Interim Provision Model

ASC 740-270-25-2 requires entities to compute tax (or benefit) related to ordinary income (or loss) by using an estimated AETR for each interim period. To calculate its estimated AETR, an entity must estimate its ordinary income and the related tax expense or benefit for the full fiscal year. The formula to compute the estimated AETR is as follows:

\[
\text{AETR} = \frac{\text{Estimated Annual Tax on Ordinary Income/Loss}}{\text{Estimated Annual Pretax on Ordinary Income/Loss}}
\]

The estimated AETR is then applied to YTD ordinary income or loss to compute the YTD tax (or benefit) applicable to ordinary income or loss as follows:

\[
\text{YTD Tax Expense/Benefit} = \text{AETR} \times \text{YTD Ordinary Income/Loss}
\]

The interim tax expense (or benefit) is the difference between current YTD tax (or benefit) and prior YTD tax (or benefit):

\[
\text{Interim Tax Expense/Benefit} = \text{YTD Tax Expense/Benefit} - \text{Prior-Period YTD Tax Expense/Benefit}
\]

The AETR should also include anticipated ITCs (see ASC 740-270-30-14 and 30-15 for certain exclusions), FTCs, percentage depletion, capital gains rates, and other available tax-planning alternatives.

Example 7-1 below illustrates a typical computation of the AETR and interim tax expense as determined under ASC 740-270.

**Example 7-1**

Assume the following:

- The entity anticipates ordinary income of $100,000 for the full fiscal year.
- All income is taxable in the United States at a 21 percent rate. The income is not taxable in any other jurisdiction.
- Estimated tax credits for the fiscal year total $4,000.
- 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 AETR is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on estimated annual ordinary income at statutory rate ($100,000 at 21%)</td>
<td>$21,000</td>
</tr>
<tr>
<td>Less estimated tax credits</td>
<td>(4,000)</td>
</tr>
<tr>
<td><strong>Estimated annual tax on ordinary income</strong></td>
<td><strong>$17,000</strong></td>
</tr>
<tr>
<td><strong>Estimated AETR</strong> (17,000 ÷ 100,000)</td>
<td>17%</td>
</tr>
</tbody>
</table>
Example 7-1 (continued)

Assuming that ordinary income before tax is $20,000 in each of the first three quarters and $40,000 in the fourth quarter, the entity computes quarterly taxes as follows:

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>AETR</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$20,000</td>
<td>17%</td>
<td>$3,400</td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>17%</td>
<td>6,800</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>17%</td>
<td>10,200</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>17%</td>
<td>17,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td>17%</td>
<td>$17,000</td>
</tr>
</tbody>
</table>

7.2 Items Accounted for Separately From the AETR

ASC 740-270

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. 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.

Pending Content (Transition Guidance: ASC 740-10-65-8)

30-11 The effects of changes in judgment about beginning-of-year valuation allowances and effects of changes in tax laws or rates on deferred tax assets or liabilities and taxes payable or refundable for prior years (in the case of a retroactive change) shall be excluded from the estimated annual effective tax rate calculation.

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, 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.

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. See Example 3 (paragraph 740-270-55-24) for illustrations of accounting for these items in the interim period which they occur.
ASC 740-270 (continued)

Certain Tax Credits

30-14 Certain investment tax credits may be excluded from the estimated annual effective tax rate. If an entity includes allowable investment tax credits as part of its provision for income taxes over the productive life of acquired property and not entirely in the year the property is placed in service, amortization of deferred investment tax credits need not be taken into account in estimating the annual effective tax rate; however, if the investment tax credits are taken into account in the estimated annual effective tax rate, the amount taken into account shall be the amount of amortization that is anticipated to be included in income in the current year (see paragraphs 740-10-25-46 and 740-10-45-28).

30-15 Further, paragraphs 840-30-30-14 and 840-30-35-34 through 35-35 require that investment tax credits related to leases that are accounted for as leveraged leases shall be deferred and accounted for as return on the net investment in the leveraged leases in the years in which the net investment is positive and explains that the use of the term years is not intended to preclude application of the accounting described to shorter periods. If an entity accounts for investment tax credits related to leveraged leases in accordance with those paragraphs for interim periods, those investment tax credits shall not be taken into account in estimating the annual effective tax rate.

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.

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.

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.
Chapter 7 — Interim Reporting

ASC 740-270 (continued)

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.

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.

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.

30-25 See Example 1, Cases B2 and B3 (paragraphs 740-270-55-7 through 55-8) for illustrations of the application of these requirements.

Year-to-Date Ordinary Income; Anticipated Ordinary Loss for the Year

30-26 If an entity has ordinary income for the year to date at the end of an interim period and anticipates an ordinary loss for the fiscal year, the interim period tax shall be computed in accordance with paragraph 740-270-30-5. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraphs 740-270-30-6 through 30-8, shall not exceed the tax benefit determined in accordance with paragraphs 740-270-30-30 through 30-33. 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.

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.
ASC 740-270 (continued)

Pending Content (Transition Guidance: ASC 740-10-65-8)

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.

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.

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).

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.

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

30-34 See Example 2, Cases A1 and A2; B; and C1 and C2 (paragraphs 740-270-55-15 through 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) for illustrations of special year-to-date limitation computations.

30-35 This guidance addresses possible changes to the general interim period income tax expense methodology when an entity is subject to tax in multiple jurisdictions.

30-36 If an entity that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions, interim period tax (or benefit) related to consolidated ordinary income (or loss) for the year to date shall be computed in accordance with the requirements of this Subtopic using one overall estimated annual effective tax rate with the following exceptions:

a. If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for that jurisdiction and applied to ordinary income (or loss) in that jurisdiction in accordance with the methodology otherwise required by this Subtopic.

b. If an entity is unable to estimate an annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). The tax (or benefit) related to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported. The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth.

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.

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.
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.

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. 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.

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.

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). 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. 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.

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. 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.

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].
- 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].
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]

Further, ASC 740-270-30-4 states:

[F]or 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.

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.[1]

Ordinary income does not include items of comprehensive income outside of continuing operations (discontinued operations and OCI). Therefore, the tax effects of such items are excluded from the AETR. Other tax effects of items reported in equity are also excluded from the AETR.

Certain items or events related to continuing operations are specifically excluded from the estimated AETR, and their related tax effects are recognized discretely (i.e., numerator excludes tax effect and denominator excludes any pretax book income or loss), including:

- Significant unusual or infrequent items (ASC 740-270-30-8).
- Components of pretax income that are not estimable (ASC 740-270-30-17).
- Exclusion of a jurisdiction from the AETR (ASC 740-270-30-36(a) and (b)).
- Excess tax benefits and tax deficiencies from share-based payment awards (ASC 740-270-30-4).
- Tax-exempt interest.
- Interest expense when interest is classified as income tax expense.

### 7.2.1 Significant Unusual or Infrequent Items

In accordance with ASC 740-270-30-8, significant unusual or infrequently occurring items that are separately reported are specifically excluded from the definition of ordinary income and are therefore excluded from the AETR. To qualify for exclusion from the AETR, the item must be:

- Significant.
- Unusual or infrequently occurring:
  - 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” (ASC master glossary).
  - 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” (ASC master glossary).
- Separately reported.

---

1 Although use of the term “unusual or infrequently occurring items” is consistent with the accounting definition of extraordinary items in ASC 225, it is related to items that are not classified as a separate component of the financial statement, as prescribed in that Codification topic.
An entity records the tax effects of significant unusual or infrequently occurring items in the period in which the items occur and excludes those tax effects from the calculation of the estimated AETR. Example 7-2 below illustrates an interim tax provision that includes a significant unusual or infrequently occurring item.

### Example 7-2

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 and AETR in 20X1 is 25 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.

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Ordinance Income</th>
<th>Income Tax — Ordinary Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>YTD</td>
</tr>
<tr>
<td>First</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Second</td>
<td>$20,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Third</td>
<td>$15,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Fourth</td>
<td>$35,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Annual</td>
<td>$80,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Significant Unusual or Infrequent Loss</th>
<th>Income Tax — Significant Unusual or Infrequent Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>YTD</td>
</tr>
<tr>
<td>First</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Second</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Third</td>
<td>$ (15,000)</td>
<td>$ (15,000)</td>
</tr>
<tr>
<td>Fourth</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Annual</td>
<td>$ (15,000)</td>
<td>—</td>
</tr>
</tbody>
</table>

* The $2,500 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.

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Total Income</th>
<th>Total Income Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>YTD</td>
</tr>
<tr>
<td>First</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Second</td>
<td>$20,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Third</td>
<td>—</td>
<td>30,000</td>
</tr>
<tr>
<td>Fourth</td>
<td>$35,000</td>
<td>65,000</td>
</tr>
<tr>
<td>Annual</td>
<td>$65,000</td>
<td></td>
</tr>
</tbody>
</table>

The AETR estimate of 25 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.
7.2.2 Components of Pretax Income That Are Not Estimable

Generally, an entity can reliably estimate ordinary income (or loss); however, there may be instances in which the entity is unable to estimate part of its ordinary income (or loss). In situations in which an entity is unable to estimate a portion of its ordinary income (or loss), the guidance in ASC 740-270-25-3 applies:

If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Accordingly, the pretax amount of ordinary income (or loss) that cannot be reliably estimated and the related tax effects should be excluded from the entity's estimate of its AETR in all periods, and the tax effects of the item that cannot be estimated should be recorded discretely in the interim period in which that item is reported.

Examples of such items may include (but are not limited to) impairment losses and foreign exchange gains or losses that would not already be excluded from the entity's estimate of its AETR (e.g., because they are significant unusual or infrequently occurring items).

7.2.3 Exclusion of a Jurisdiction From the AETR

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 annual effective tax rate.” However, ASC 740-270-30-36 contains exceptions to this general guidance, which can lead to the exclusion of a jurisdiction from the AETR.

7.2.3.1 Loss Jurisdiction for Which No Tax Benefit Can Be Recognized

ASC 740-270-30-36(a) states:

If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with 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.

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, as ASC 740-270-30-32 states, the “reversal of existing taxable temporary differences may be a source of evidence in determining whether a tax benefit requires limitation.”

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 7-3, no amount of tax benefit can be recognized for the forecasted loss; in Example 7-4, however, a tax benefit can be recognized for a portion of the forecasted loss.
Example 7-3

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:

<table>
<thead>
<tr>
<th>Country A</th>
<th>Country B</th>
<th>Country C (Excluding)</th>
<th>Total</th>
<th>Combined — Excluding Country C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecasted income (loss) for the year</td>
<td>80,000</td>
<td>40,000</td>
<td>(20,000)</td>
<td>100,000</td>
</tr>
<tr>
<td>Anticipated tax expense (benefit) for the year</td>
<td>32,000</td>
<td>8,000</td>
<td>—</td>
<td>40,000</td>
</tr>
<tr>
<td>AETR</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Quarterly tax computations are as follows:

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Tax Expense (Benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Country A</td>
<td>Country B</td>
</tr>
<tr>
<td>First quarter</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>80,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

This example is consistent with Example 5, Case B, in ASC 740-270-55-41.
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 YTD, 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).

### Example 7-4

Assume the same facts as in Example 7-3 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:

<table>
<thead>
<tr>
<th>Country A</th>
<th>Country B</th>
<th>Country C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecasted income (loss) for the year</td>
<td>80,000</td>
<td>40,000</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Anticipated tax expense (benefit) for the year</td>
<td>32,000</td>
<td>8,000</td>
<td>(1,000)</td>
</tr>
<tr>
<td>AETR</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Quarterly tax computations are as follows:

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Country A</th>
<th>Country B</th>
<th>Country C</th>
<th>Total</th>
<th>YTD</th>
<th>AETR</th>
<th>YTD</th>
<th>Less Previously Reported</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>20,000</td>
<td>10,000</td>
<td>(15,000)</td>
<td>15,000</td>
<td>15,000</td>
<td>39%</td>
<td>5,850</td>
<td>5,850</td>
<td></td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>10,000</td>
<td>5,000</td>
<td>35,000</td>
<td>50,000</td>
<td>39%</td>
<td>19,500</td>
<td>5,850</td>
<td>13,650</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>10,000</td>
<td>(10,000)</td>
<td>20,000</td>
<td>70,000</td>
<td>39%</td>
<td>27,300</td>
<td>19,500</td>
<td>7,800</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>20,000</td>
<td>10,000</td>
<td>—</td>
<td>30,000</td>
<td>100,000</td>
<td>39%</td>
<td>39,000</td>
<td>27,300</td>
<td>11,700</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>80,000</td>
<td>40,000</td>
<td>(20,000)</td>
<td>100,000</td>
<td></td>
<td></td>
<td>39,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
7.2.3.1.1 Foreign Losses Providing a Tax Benefit by Reducing a GILTI Inclusion

Questions arise about whether an entity should exclude ordinary losses in foreign subsidiaries from the estimation of its AETR under ASC 740-270-30-36(a) if the entity concludes that it is not more likely than not that the entity will realize the tax benefits of losses in those foreign jurisdictions, but those losses will provide tax benefits for U.S. tax purposes by reducing the entity’s GILTI inclusion.

We believe that there are two acceptable views.

Under one view, both the loss from the foreign subsidiary and the corresponding U.S. tax benefit related to the reduction in the GILTI inclusion would be contemplated in the estimation of the AETR. ASC 740-270-30-36(b) states, in part:

The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth.

Accordingly, because there is a benefit in the U.S. jurisdiction, ordinary losses and the related U.S. benefit derived by reduced GILTI inclusion would be included in the overall AETR.

Under the alternative view, however, the U.S. tax benefit related to the reduction in GILTI inclusion would be included in the estimation of the AETR, but the ordinary loss from the foreign subsidiary would not. ASC 740-270-30-36(a) states:

If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-33, 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].

Under this second view, because the guidance in ASC 740-270-30-36 appears to suggest application on a jurisdiction-by-jurisdiction basis, the ordinary loss from the loss jurisdiction and the related tax (or benefit) in that separate jurisdiction would be excluded. However, the U.S. tax benefit related to the reduction in GILTI inclusion would be included in the estimation of the AETR unless the U.S. jurisdiction is also a loss jurisdiction.

7.2.3.1.2 Zero-Tax-Rate Jurisdictions and Nontaxable Entities

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.

The exception in ASC 740-270-30-36(a) 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(a) (discussed in Section 7.2.3.1) 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 7-5

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 25 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 $25, respectively, resulting in an estimated AETR of 2.5 percent. The YTD pretax income of P and S is $370 and $30, respectively. The YTD interim tax expense is $10 ($400 YTD consolidated pretax income multiplied by 2.5 percent).

Example 7-6

Entity P operates in a jurisdiction in which the tax rate is 25 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 $275, respectively, resulting in an annual estimated AETR of 27.5 percent. The YTD pretax income (loss) for P and S is $430 and ($30), respectively. The YTD interim tax expense is $110 ($400 YTD consolidated pretax income multiplied by 27.5 percent).

7.2.3.2 Inability to Estimate AETR in Dollars or Unreliable Estimate of Ordinary Income (or Loss) or Related Tax Expense (or Benefit)

ASC 740-270-30-36(b) states:

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.

ASC 740-270-30-36(b) provides additional exceptions to the general rule that the interim period tax (or benefit) related to consolidated ordinary income (or loss) for the YTD should be computed by using one overall estimated AETR. It indicates that if an entity is (1) unable to estimate an AETR in a foreign jurisdiction in dollars or (2) unable to make a reliable estimate of (a) its ordinary income (or loss) or (b) the related tax (or benefit) for the fiscal year, the entity should exclude that jurisdiction from the overall AETR.

An entity may not be able to reliably estimate an AETR in a foreign jurisdiction in dollars if the relevant foreign exchange rate is highly volatile. The determination of what constitutes a “reliable estimate” is a matter of judgment.

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2 Although the standard refers to “dollars,” we believe that this concept would apply to any reporting entity that has difficulty estimating an AETR in a foreign jurisdiction in its reporting currency.
7.2.4 Excess Tax Benefits and Deficiencies Related to Share-Based Payment Awards

When a share-based payment award is granted to an employee, the fair value of the award is generally recognized over the vesting period, and a corresponding DTA is recognized to the extent that the award is tax deductible. The tax deduction is generally based on the intrinsic value at the time of exercise (for an option) or on the fair value upon vesting of the award (for restricted stock), and it can be either greater (excess tax benefit) or less (tax deficiency) than the compensation cost recognized in the financial statements.

ASC 740-270-30-4, ASC 740-270-30-8, and ASC 740-270-30-12 require entities to account for excess tax benefits and tax deficiencies as discrete items in the period in which they occur (i.e., entities should exclude them from the AETR). Therefore, the effects of expected future excesses and deficiencies should not be anticipated. The tax effects of the expected compensation expense should be included in the AETR.

Example 7-7

If, in the first quarter, an exercise of stock options results in a tax 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 deficiency in the first quarter. In the second quarter, if an excess tax benefit does result, the income tax expense recorded in the first quarter resulting from the deficiency can be reversed as income tax benefit.

7.2.4.1 Interim Tax Effects of Awards Expected to Expire Unexercised During the Year

When estimating the AETR for the current interim period, an entity should not include the estimated effects of the expiration of awards expected to occur in a future interim period. For example, if share-based payment awards are expected to expire unexercised in the second quarter because they are “deep out of the money,” the 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 entity should record the income tax expense related to the write-off of the DTA upon expiration of an award in the period in which the awards expire unexercised. See Chapter 10 for general guidance on the accounting for income taxes associated with share-based payments and Section 10.2.4.2 for guidance related to the accounting for awards that expire unexercised.

7.2.4.2 Measuring the Excess Tax Benefit or Tax Deficiency 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 FDII deduction) that lower the entity's ETR and can affect the determination of the excess tax benefit or tax deficiency that must be (1) accounted for under ASC 718-740-35-2 and (2) treated as a discrete item in the period in which the excess tax benefit or tax deficiency occurs. 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 discretely under ASC 718-740-35-2. One acceptable approach is to consider only 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 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 deficiency.

Use of one of the approaches described above to measure the excess tax benefit or tax deficiency constitutes an accounting policy that should be applied consistently to all awards and related tax effects.

### 7.2.5 Tax-Exempt Interest

It is acceptable for an entity to either include or exclude tax-exempt interest income when computing its estimated AETR. However, if tax-exempt interest income is included in ordinary income, we believe that the resulting tax benefit (permanent difference) should be included in the calculation of the estimated AETR. Whichever method is elected should be consistently applied.

As described in paragraph 80 of Interpretation 18, the FASB did not provide explicit guidance requiring a specific approach and instead stated, “the accounting practice . . . for tax-exempt interest income in interim periods appears to be uniform.” 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.

### 7.2.6 Interest Expense When Interest Is Classified as Income Tax Expense

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.
7.3 Items Excluded in Part From the AETR

Certain items that may affect the AETR can also result in amounts recorded separately from the AETR, such as certain changes in:

- Valuation allowances (ASC 740-270-30-7, ASC 740-270-30-11, and ASC 740-270-25-4).
- Tax laws and rates (ASC 740-270-25-5 and ASC 740-270-30-11).
- Changes in recognition and measurement of UTBs.
- Assertions related to outside basis difference exceptions.

These events often affect both beginning-of-the-year tax balances as well as taxes related to current-year activities.

7.3.1 Valuation Allowances

ASC 740-270-30-7 states that “[t]he tax effect of a valuation allowance expected to be necessary” at the end of the year for a DTA originating in the current year should be included in the AETR.

A valuation allowance on beginning-of-the-year DTAs may increase or decrease during the year. ASC 740-270-30-11 states that “[t]he effects of changes in judgment about beginning-of-year valuation allowances . . . shall be excluded from the estimated annual effective tax rate calculation.” However, ASC 740-270-25-4 indicates that “[t]he 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” (emphasis added).

Examples 7-8 through 7-10 below illustrate this concept.

Example 7-8

Valuation Allowance on Originating DTA

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 tax credit – ($4,000 combined forecasted taxable income of 20X1 and 20X2 × 50%)) will be necessary at the end of 20X1. The estimated pretax book income for the full fiscal year is $10,000. The $9,000 difference between book income and taxable income is attributable to tax-exempt income.

Because the valuation allowance relates to the tax attribute originating during the current year, the tax consequences of the $1,000 valuation allowance on the credits are included in the AETR.
Example 7-8 (continued)

The AETR and first-quarter tax expense are computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated pretax book income for 20X1</td>
<td>$10,000</td>
</tr>
<tr>
<td>Estimated tax-exempt income during 20X1</td>
<td>(9,000)</td>
</tr>
<tr>
<td>Estimated pretax book income subject to tax for 20X1</td>
<td>$1,000</td>
</tr>
<tr>
<td>Statutory tax rate</td>
<td>50%</td>
</tr>
<tr>
<td>Estimated tax before credits</td>
<td>$500</td>
</tr>
<tr>
<td>Generated credits</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Valuation allowance on credits generated in the current year</td>
<td>1,000</td>
</tr>
<tr>
<td>Total estimated annual tax expense/(benefit)</td>
<td>$1,500</td>
</tr>
<tr>
<td>Estimated AETR $1,500 benefit ÷ $10,000 pretax income</td>
<td>-15%</td>
</tr>
<tr>
<td>Income earned in first quarter of 20X1</td>
<td>$5,000</td>
</tr>
<tr>
<td>Tax expense/(benefit) for first quarter of 20X1 ($5,000 × [-15%])</td>
<td>$750</td>
</tr>
</tbody>
</table>

Thus, if pretax accounting income is $5,000 during the first quarter of 20X1, a benefit for income taxes of $750 ($5,000 × [-15%]) would be recognized and net income of $5,750 would be reported for that interim period.

Example 7-9

Decrease in Valuation Allowance on Beginning-of-the-Year DTAs

Assume the following:

- At the beginning of fiscal year 20X1, Entity X has a DTA of $4,000 that relates to $20,000 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.
- Entity X has no other DTAs or DTLs.
- Entity X’s tax rate is 20 percent.
- At the beginning of the year, X estimates that it will earn $1,000 of income before tax in each of the quarters in 20X1.
- 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 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 AETR is 0% ($0 projected tax expense ÷ $4,000 forecasted income).
## Example 7-9 (continued)

The following table illustrates X's tax expense (or benefit) in each of the four quarters of 20X1:

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>Quarter Ended</th>
<th>Quarter Ended</th>
<th>Quarter Ended</th>
<th>Year Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>March 31, 20X1</td>
<td>June 30, 20X1</td>
<td>September 30, 20X1</td>
<td>December 31, 20X1</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000*</td>
<td>$ 1,000*</td>
</tr>
<tr>
<td>Income tax expense (benefit):**</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduction in gross DTAs as a result of application of NOLs to reduce current period's taxable income***</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Reduction in valuation allowance as a result of reduction in gross DTAs†</td>
<td>(200)</td>
<td>(200)</td>
<td>(200)</td>
<td>(200)</td>
</tr>
<tr>
<td>Reduction in valuation allowance as a result of changes in judgment over the future years</td>
<td>—</td>
<td>(3,200)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total income tax expense</td>
<td>—</td>
<td>(3,200)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 1,000</td>
<td>$\ 4,200</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

* 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.

Because X estimated that it will earn income of $1,000 in each quarter in the current year, $800 of valuation allowance will be reduced through the AETR ($4,000 projected annual income × 20% tax rate) in accordance with ASC 740-270-25-4. Also in accordance with ASC 740-270-25-4, the remaining valuation allowance of $3,200 will be reduced discretely in the second quarter because the reduction is resulting from changes in judgment over the realizability of the DTA in future years.

## Example 7-10

### Increase in Valuation Allowance on Beginning-of-the-Year DTAs

Assume that Entity B 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.
Example 7-10 (continued)

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, and B’s estimate of taxable income expected in 20X2 continues to be $3,000. Pretax book 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 reduction in estimated 20X3 taxable income × 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, as computed below, and net income of $500 for the first quarter of 20X2.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>YTD ordinary income</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>AETR</td>
<td>50%</td>
</tr>
<tr>
<td>YTD tax expense on ordinary income</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Increase in valuation allowance as a result of change in judgment about realizability in future years</td>
<td>500</td>
</tr>
<tr>
<td>Total tax expense in first quarter of 20X2</td>
<td>$ 1,500</td>
</tr>
<tr>
<td>ETR in first quarter of 20X2 ($1,500 + $2,000)</td>
<td>75%</td>
</tr>
</tbody>
</table>

7.3.1.1 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 . . . [r]ealized” 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.
7.3.1.2 YTD Pretax Loss Exceeds the Anticipated Pretax Loss for the Full Year

Under current U.S. GAAP and the interim period income tax model, an entity is generally required to calculate its best estimate of the AETR for the full fiscal year at the end of each interim reporting period and to use that rate to calculate income taxes on a YTD basis. ASC 740-270-30-28 provides additional guidance for situations in which an entity incurs a loss on a YTD basis that exceeds the anticipated loss for the year. In these situations, the income tax benefit is limited to the income tax benefit that would exist on the basis of the YTD loss.

**Changing Lanes**

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB's Simplification Initiative). The ASU amends the exception to the general guidance in ASC 740-270-30-28 described above.

Stakeholders provided mixed feedback on the usefulness of the exception and the outcomes it yields. However, stakeholders acknowledged that application of this exception is complex and prone to errors. The FASB decided that removing the exception in ASC 740-270-30-28 would reduce the cost and complexity of applying ASC 740. The FASB also decided that removal of the exception would not significantly affect the information provided to users of financial statements. In paragraph BC42 of the ASU, the Board acknowledges that removal of the exception could result in recognition of tax benefits in an interim period that exceed the tax benefits that would be received on the basis of the actual YTD loss. However, the FASB further notes that the informational benefit to financial statement users of limiting the tax benefits in the interim period would not outweigh the costs to preparers.

These amendments should be applied prospectively. For further information about ASU 2019-12, see Appendix B.

7.3.2 Changes in Tax Laws and Rates Occurring in Interim Periods

Under ASC 740-270-25-5, 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.
Changing Lanes

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB’s Simplification Initiative). The ASU amends the guidance in ASC 740-270-25-5 to address feedback from stakeholders that the guidance on recognizing the income tax effects of an enacted change in tax law in an interim period is unclear. More specifically, ASC 740-10 requires that the tax effect of a change in tax law or rates on deferred tax accounts and taxes payable or refundable for prior years be recognized in the period that includes the enactment date. ASC 740-270-25-5, however, states that the effect of a change in tax law or rates on taxes currently payable or refundable for the current year is recorded after the effective date and no earlier than the enactment date. Because the guidance in ASC 740-270-25-5 appears inconsistent with that in ASC 740-10, diversity in practice has developed.

As a result, to reduce the cost and complexity of applying ASC 740, the FASB amended ASC 740-270-25-5 to require that the effects of an enacted change in tax law be reflected in the computation of the AETR in the first interim period that includes the enactment date of the new legislation. In addition, the example in ASC 740-270-55-44 through 55-49 will also be amended to reflect the change.

These amendments should be applied prospectively. For further information about ASU 2019-12, see Appendix B.

7.3.2.1 Retroactive Changes in Tax Laws

Certain changes in tax laws are applied retroactively. 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 attributable to income recognized in prior annual periods that ended after the effective date of the retroactive legislation. The effect (if any) on the prior annual period is recognized in the interim period (and annual period) that includes the date of enactment. Such an effect might be reflected as a change 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.

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 in the period of enactment for the effect of the retrospective legislation. That updated AETR is then applied to the YTD 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. 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. For further discussion, see Section 7.5.3.

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 Section 7.2.2). In these situations, an entity would be required to determine the actual effect of retrospective legislation on income tax expense (or benefit) and balance sheet income tax accounts.

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 that report; 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 7-11 below illustrates the accounting for a change in tax rate retroactive to interim periods of the current year.

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:

<table>
<thead>
<tr>
<th>Item</th>
<th>January 1</th>
<th>March 31</th>
<th>June 30</th>
<th>September 30</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet liability</td>
<td>$(1,000)</td>
<td>$(950)</td>
<td>$(850)</td>
<td>$(800)</td>
<td>$(200)</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Item</th>
<th>January 1</th>
<th>March 31</th>
<th>June 30</th>
<th>September 30</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated hedging (loss) gain</td>
<td>$(300)</td>
<td>$(600)</td>
<td>$(400)</td>
<td>$(200)</td>
<td>$100</td>
</tr>
</tbody>
</table>

The table below illustrates C’s estimated AETR calculation for fiscal year 20X2 at the end of the first quarter. As discussed in Section 7.2, the changes in OCI are excluded from the AETR calculation.

**Estimated AETR Calculation on March 31, 20X2**

<table>
<thead>
<tr>
<th>Estimated annual ordinary income</th>
<th>$8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary difference</td>
<td>$(800)</td>
</tr>
<tr>
<td>Estimated taxable income</td>
<td>7,200</td>
</tr>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>2,520</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>280</td>
</tr>
<tr>
<td>Estimated annual tax expense</td>
<td>$2,800</td>
</tr>
<tr>
<td>Estimated AETR</td>
<td>35%</td>
</tr>
</tbody>
</table>

**Estimated Change in DTA on March 31, 20X2**

<table>
<thead>
<tr>
<th>Deductible Temporary Difference</th>
<th>Tax Rate</th>
<th>DTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X2</td>
<td>$1,000</td>
<td>35%</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>200</td>
<td>35%</td>
</tr>
<tr>
<td>Change = deferred tax expense</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Example 7-11 (continued)

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 deferred tax expense that is recorded as a discrete amount and the amount that is recognized through the AETR:

### Estimated Change in DTA on June 30, 20X2

<table>
<thead>
<tr>
<th></th>
<th>Deductible Temporary Difference</th>
<th>Tax Rate</th>
<th>DTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X2</td>
<td>$1,000</td>
<td>35%</td>
<td>$350</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>200</td>
<td>40%</td>
<td>80</td>
</tr>
<tr>
<td>Change = deferred tax expense</td>
<td></td>
<td></td>
<td>$270</td>
</tr>
<tr>
<td>Less: discrete tax benefit ($900 liability × 5% rate increase)</td>
<td></td>
<td></td>
<td>(45)</td>
</tr>
<tr>
<td>Deferred tax expense included in AETR</td>
<td></td>
<td></td>
<td>$315</td>
</tr>
</tbody>
</table>

### Estimated AETR Calculation

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated annual ordinary income</td>
<td>$8,000</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>(800)</td>
</tr>
<tr>
<td>Estimated taxable income</td>
<td>7,200</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>2,880</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>315*</td>
</tr>
<tr>
<td>Estimated annual tax expense</td>
<td>$3,195</td>
</tr>
<tr>
<td>Estimated AETR</td>
<td>39.9%</td>
</tr>
</tbody>
</table>

* Computed in table above.

Because of the enacted tax rate increase, the DTA related to the cumulative $500 loss in OCI for hedging activity on the enactment date must also be adjusted. The $25 tax benefit ($500 cumulative loss × 5% change in tax rate) related to the adjustment to the DTA for the tax rate increase is a discrete item that is part of continuing operations and therefore affects the tax expense in the quarter of enactment.
Example 7-11 (continued)

The following table summarizes the quarterly income tax on the basis of the above calculations:

### Quarterly ETR Calculation

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>YTD ordinary income</td>
<td>$2,000</td>
<td>$4,000</td>
<td>$6,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>AETR</td>
<td>35.0%</td>
<td>39.9%</td>
<td>39.9%</td>
<td>39.9%</td>
</tr>
<tr>
<td>YTD income tax expense attributable to ordinary income</td>
<td>700</td>
<td>1,598</td>
<td>2,396</td>
<td>3,195</td>
</tr>
<tr>
<td>YTD discrete income tax expense</td>
<td>—</td>
<td>(70)*</td>
<td>(70)</td>
<td>(70)</td>
</tr>
<tr>
<td>YTD total income tax expense</td>
<td>700</td>
<td>1,528</td>
<td>2,326</td>
<td>3,125</td>
</tr>
<tr>
<td>Previously recorded</td>
<td>—</td>
<td>700</td>
<td>1,528</td>
<td>2,326</td>
</tr>
<tr>
<td>Interim tax expense</td>
<td>$700</td>
<td>$828</td>
<td>$798</td>
<td>$799</td>
</tr>
<tr>
<td>ETR</td>
<td>35.0%</td>
<td>41.4%</td>
<td>39.9%</td>
<td>39.9%</td>
</tr>
</tbody>
</table>

### Quarterly OCI Changes

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI (pretax)</td>
<td>$(300)</td>
<td>$200</td>
<td>$200</td>
<td>$300</td>
</tr>
<tr>
<td>Tax</td>
<td>105</td>
<td>(75)**</td>
<td>(80)</td>
<td>(120)</td>
</tr>
<tr>
<td>OCI (net)</td>
<td>$(195)</td>
<td>$125</td>
<td>$120</td>
<td>$180</td>
</tr>
</tbody>
</table>

* $70 = $45 (balance sheet liability) + $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. For further discussion, see Chapter 14.

### 7.3.2.2 Administratively Effective Date of New Legislation

ASC 740-270-55-49 indicates that “[t]he effect of the new legislation shall not be reflected [in an AETR] until it is effective or administratively effective.” Further, ASC 740-270-55-50 states:

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.

An example is the tax rate change included in the Tax Cuts and Jobs Act (the “Act”), enacted on December 22, 2017. The Act reduced the corporate tax rate to 21 percent, effective January 1, 2018, for all corporations. IRC Section 15 required fiscal year-end taxpayers to determine a blended tax rate on the basis of the applicable rates before and after the change and the number of days in the period within the taxable year before and after the effective date of the change in tax rate. The “blended rate” was applied to taxable income for the entire taxable year. As illustrated in the table below, the domestic
federal statutory tax rate (blended tax rate) for all non-calendar-year-end entities with the same fiscal year-end was the same, regardless of income (or projected income used for interim reporting). It is assumed in the table that the entities' fiscal year-end is March 31, 2018, and the effective date of the new tax rate is January 1, 2018.

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Days Under Tax Rate</th>
<th>Tax Ratio</th>
<th>Tentative Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective rate before enactment</td>
<td>35%</td>
<td>275</td>
<td>75.34%</td>
</tr>
<tr>
<td>(April 1, 2017, to December 31, 2017)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effective rate after enactment</td>
<td>21%</td>
<td>90</td>
<td>24.66%</td>
</tr>
<tr>
<td>(January 1, 2018, to March 31, 2018)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic federal statutory tax rate</td>
<td>21%</td>
<td>90</td>
<td>24.66%</td>
</tr>
<tr>
<td>(blended tax rate)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Given the mechanics of IRC Section 15, we believe that the change in tax rate was administratively effective for a fiscal-year-end entity at the beginning of the entity’s fiscal year that included January 1, 2018 (in this case, April 1, 2017), and that the “blended rate” should have been reflected in the entity’s third-quarter AETR — i.e., as of the later of the enactment date or the administratively effective date.

In addition, because ASC 740-10-25-47 requires the effect of a change in tax laws or rates to be recognized as of the date of enactment, all corporations, regardless of their year-end, were required to adjust their DTAs and DTLs as of December 22, 2017. Accordingly, in a manner consistent with the guidance in ASC 740-270-55-50 and 55-51, the applicable tax rates for deferred tax balances were as follows:

- For balances expected to reverse after the enactment date and within the fiscal year including the effective date, the applicable rate was the “blended tax rate.”
- For balances not expected to reverse in the fiscal year including the effective date, the applicable rate was the new statutory tax rate of 21 percent.

### 7.3.3 Changes in Judgment Related to UTBs

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 measurement of the greatest amount of benefit that is more likely than not 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.
7.3.3.1 Changes in Judgment Regarding a Tax Position Taken in the Current Year

Example 7-12 below demonstrates changes in judgment regarding a tax position taken in the current year.

<table>
<thead>
<tr>
<th>Example 7-12</th>
</tr>
</thead>
<tbody>
<tr>
<td>In the first quarter of 20X7, an entity:</td>
</tr>
<tr>
<td>• Estimates that its ordinary income for fiscal year 20X7 will be $4,000 ($1,000 per quarter). Assume a tax rate of 25 percent.</td>
</tr>
<tr>
<td>• 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 $750 [($4,000 - $1,000) × 25%]. Assume that the transaction meets the recognition threshold and that the full $250 will be recognized under ASC 740.</td>
</tr>
</tbody>
</table>

| Estimated pretax book income for 20X7 | $ 4,000 |
| Estimated income tax expense for 20X7 (includes the $250 tax benefit) | $ 750 |
| Estimated AETR | 18.8% |
| Accordingly, for each quarter in 20X7 (provided that earnings are ratable), ordinary income and income tax expense are expected to be $1,000 and $188, 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 but does meet the minimum threshold required to avoid penalties if the position is taken on the tax return; thus, the company intends to still take the uncertain tax position on the 20X7 tax return. 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 $250 benefit) | $ 1,000 |
| Estimated AETR | 25% |
| 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: |

<table>
<thead>
<tr>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>YTD ordinary income</td>
<td>$ 1,000</td>
<td>$ 2,000</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Estimated AETR</td>
<td>18.8%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>YTD income tax expense</td>
<td>188</td>
<td>500</td>
<td>750</td>
</tr>
<tr>
<td>Less previously recorded</td>
<td>—</td>
<td>188</td>
<td>500</td>
</tr>
<tr>
<td>Interim tax expense</td>
<td>$ 188</td>
<td>$ 312</td>
<td>$ 250</td>
</tr>
<tr>
<td>ETR</td>
<td>18.8%</td>
<td>31.2%</td>
<td>25%</td>
</tr>
</tbody>
</table>

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 25 percent, which does not reflect any benefit for the tax position. Of the $250 total change representing the loss of the tax benefit previously thought to be more likely than not, a $125 UTB is recognized in the second quarter and the remaining UTB of $125 is recognized in the third and fourth quarters.
### 7.3.3.2 Changes in Judgment Regarding a Tax Position Taken in the Prior Year

Example 7-13 below demonstrates changes in judgment regarding a tax position taken in the prior year.

#### Example 7-13

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, the entity determines income tax expense in each of the quarters in 20X7 as follows:

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>YTD ordinary income</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$3,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Estimated AETR</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>YTD income tax expense attributable to ordinary income</td>
<td>300</td>
<td>600</td>
<td>900</td>
<td>1,200</td>
</tr>
<tr>
<td>YTD discrete income tax expense</td>
<td>—</td>
<td>400</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>YTD total income tax</td>
<td>300</td>
<td>1,000</td>
<td>1,300</td>
<td>1,600</td>
</tr>
<tr>
<td>Less previously recorded</td>
<td>—</td>
<td>300</td>
<td>1,000</td>
<td>1,300</td>
</tr>
<tr>
<td>Interim tax expense</td>
<td>$300</td>
<td>$700</td>
<td>$300</td>
<td>$300</td>
</tr>
<tr>
<td>ETR</td>
<td>30%</td>
<td>70%</td>
<td>30%</td>
<td>30%</td>
</tr>
</tbody>
</table>

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 ordinary income.

### 7.3.4 Changes in an Indefinite Reinvestment Assertion

An entity may change its indefinite reinvestment assertion related to an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration. For interim income tax reporting purposes, the DTL related to 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 Section 6.2.5.1, 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.
7.4 Intraperiod Tax Allocation in Interim Periods

ASC 740-270

45-1 Subtopic 740-20 establishes requirements to allocate total income tax expense (or benefit) of an entity for a period to different components of comprehensive income and shareholders’ equity. That process is referred to as intraperiod tax allocation. This Section addresses that required allocation of income tax expense (or benefit) in interim periods.

45-2 Section 740-20-45 describes the method of applying tax allocation within a period. The tax allocation computation shall be made using the estimated fiscal year ordinary income together with unusual items, infrequently occurring items, and discontinued operations for the year-to-date period.

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. See Example 7 (paragraph 740-270-55-52) for an illustration of the income statement display of these items.

45-4 Paragraph 740-20-45-3 requires that the manner of reporting the tax benefit of an operating loss carryforward recognized in a subsequent year generally is determined by the source of the income in that year and not by the source of the operating loss carryforward or the source of expected future income that will result in realization of a deferred tax asset for the operating loss carryforward. The tax benefit is allocated first to reduce tax expense from continuing operations to zero with any excess allocated to the other source(s) of income that provides the means of realization, for example, discontinued operations, other comprehensive income, and so forth. That requirement also pertains to reporting the tax benefit of an operating loss carryforward in interim periods.

45-5 Paragraph 740-270-25-11 establishes the requirement that when the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision shall be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.

Specific Requirements Applicable to Discontinued Operations

45-6 This guidance addresses specific requirements for the intraperiod allocation of income taxes in interim periods when there are discontinued operations.

45-7 When an entity reports discontinued operations, the computations described in paragraphs 740-270-25-12 through 25-14, 740-270-30-11 through 30-13, and 740-270-45-2 through 45-3 shall be the basis for the tax (or benefit) related to the income (or loss) from operations of the discontinued operation before the date on which the criteria in paragraph 205-20-45-1E are met.
Chapter 7 — Interim Reporting

ASC 740-270 (continued)

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.

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.

The requirements within ASC 740-20 to allocate the total income tax expense (or benefit) of an entity to different components of comprehensive income and shareholder's equity are applicable to interim periods (the “with-and-without” intraperiod allocation model; see Chapter 6). ASC 740-270-45-2 states that “[t]he 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.”

The intraperiod allocation of tax effects in an earlier quarter may be revised in a later quarter. For example, a tax effect may be allocated to an item other than income from continuing operations during the first quarter of the fiscal year. However, as a result of the occurrence of unanticipated events in a later quarter of the same fiscal year, the allocation of the tax effect to that item could change (e.g., a component classified as a discontinued operation might be sold in the current year, whereas the entity's initial expectation was that it would not be sold until the subsequent year). 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 intraperiod 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 7-14

In the first and second quarters of 20X1, an entity generates tax benefits from unrealized losses on an AFS debt security, which results in the recognition of a DTA. In accordance with ASC 740-20-45-11(b), the expense related to the unrealized losses is recorded net of tax through OCI. On the basis of the entity's expected future earnings, no valuation allowance on the DTA is deemed necessary. No further tax benefits are generated in the third and fourth quarters.
Example 7-14 (continued)

Beginning in the third quarter and through the end of the fiscal year, unanticipated events result in continued operating losses for the entity; by year-end, a full valuation allowance on the DTA is necessary. Although the recognition of the benefit of the DTA in OCI was appropriate in the first and second quarters, the application of the intraperiod allocation approach to the YTD income in the third quarter would result in there being no tax benefit allocated to OCI, and 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 7-15

In the first quarter of 20X0, an entity is evaluating whether to release a valuation allowance against an NOL DTA on the basis of an expected gain on a sale of a discontinued operation (assume that the income from the sale is of the appropriate character for the entity to realize the DTA and is the only source of income during the year).

When there is uncertainty about the timing of the sale, the entity should determine, by using its best estimate, the period in which the sale will be finalized. If management expects to sell the component in the current year, the entity should follow Approach 1 below. If management does not expect to sell the component in the current year, the entity should follow Approach 2 below. Whichever approach is applied on the basis of an entity’s facts and circumstances, the objective to properly reflect the intraperiod allocation of tax expense for the annual period should be met.

- **Approach 1** — Allocate the anticipated benefit to discontinued operations in the quarter and YTD period in which income is available to offset the DTA (which would generally be the period in which the sale occurs in this example). If management’s expectation regarding the timing of the sale of the component changes in a subsequent interim period such that the sale is now expected to occur in the subsequent year, any benefit previously recognized in discontinued operations during the year and any benefit not yet recognized during a previous interim period should be recognized in continuing operations in the quarter in which it becomes apparent, on the basis of the entity’s best estimate, that the transaction will not occur in the current year.

- **Approach 2** — Allocate the anticipated benefit to income from continuing operations in the first quarter and, if income from discontinued operations becomes available in a subsequent quarter and YTD period and is sufficient to offset the DTA (which would generally be the period in which the sale occurs in this example), reclassify the benefit to income from discontinued operations.

See Section 6.2.2 for further guidance on accounting for changes in valuation allowances resulting from items other than continuing operations.

7.4.1 Recognition of the Tax Benefit of an Operating Loss Carryforward in an Interim Period

The method of intraperiod tax allocation for annual periods also applies to reporting the tax benefit of an operating loss carryforward 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. The tax benefit is allocated first to reduce income tax expense from continuing operations to zero with any excess benefit allocated to other sources of income that provide a means of realization (e.g., gains from extraordinary items and from discontinued operations).
7.4.2 Intraperiod Tax Allocation When There Is a Loss From Continuing Operations and Income in Discontinued Operations

The tax effect of discontinued operations should be recognized in the period in which the pretax amounts are recognized. Such amounts should be consistent with the intraperiod tax allocation (i.e., the tax related to the discontinued operations is the incremental tax effect of those pretax amounts).

ASC 740-20-45-7 contains the following exception to the income tax accounting treatment of a loss from continuing operations:

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, discontinued operations, other comprehensive income, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations. That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider a gain on discontinued operations in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. [Emphasis added]

There are three acceptable alternatives related to how an entity should record an interim tax provision containing discontinued operations (or other items recorded separately from continuing operations) in interim periods when there is a loss from continuing operations. Each alternative is illustrated in Example 7-16 below.

**Example 7-16**

Assume the following:

- Entity T has an NOL carryforward of $1 million. The DTA of $250,000 (at a 25 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 in discontinued operations.
- 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 the gain on discontinued operations) is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain from discontinued operations</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Statutory tax rate</td>
<td>25%</td>
</tr>
<tr>
<td>Income tax expense allocated to discontinued operations</td>
<td>$ 75,000</td>
</tr>
<tr>
<td>Income tax (benefit) allocated to continuing operations</td>
<td>$(75,000)</td>
</tr>
</tbody>
</table>
Example 7-16 (continued)

On the basis of the above computation, the estimated AETR for continuing operations is 18.8 percent, calculated as follows:

Estimated annual tax benefit $ (75,000)  
Estimated annual pretax loss $ (400,000) 

= 18.8%

Given the above facts, the paragraphs below illustrate 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**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Income/ (Loss)</th>
<th>AETR</th>
<th>Tax</th>
<th>Income/ (Loss)</th>
<th>Tax Rate</th>
<th>Tax</th>
<th>Tax Receivable (Payable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>$ (100,000)</td>
<td>18.8%</td>
<td>$ 18,750</td>
<td>$300,000</td>
<td>25%</td>
<td>$(75,000)</td>
<td>$(56,250)</td>
</tr>
<tr>
<td>Second</td>
<td>(100,000)</td>
<td>18.8%</td>
<td>18,750</td>
<td>(37,500)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Third</td>
<td>(100,000)</td>
<td>18.8%</td>
<td>18,750</td>
<td>(18,750)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fourth</td>
<td>(100,000)</td>
<td>18.8%</td>
<td>18,750</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(400,000)</td>
<td>18.8%</td>
<td>$ 75,000</td>
<td>$300,000</td>
<td>—</td>
<td>$(75,000)</td>
<td>—</td>
</tr>
</tbody>
</table>

In this alternative, T would apply the concepts of the AETR during each period for continuing operations and would recognize discontinued operations as a discrete item in the period in which it occurs. However, ASC 740-20-45-7 requires an equal amount of continuing operations tax benefit and “other component” tax expense (i.e., financial statement component neutral). While the above approach complies with the requirements of an AETR for continuing operations and a discrete item for other components by year-end, the resulting effect does not maintain the financial statement component neutrality (i.e., equal amounts of tax expense and benefit that are not related to changes in the tax balance sheet accounts).

**Alternative 2**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Income/ (Loss)</th>
<th>AETR</th>
<th>Tax</th>
<th>Income/ (Loss)</th>
<th>Tax</th>
<th>Tax Receivable (Payable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>$(100,000)</td>
<td>75,000</td>
<td>300,000</td>
<td>$(75,000)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Second</td>
<td>(100,000)</td>
<td>—</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Third</td>
<td>(100,000)</td>
<td>—</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fourth</td>
<td>(100,000)</td>
<td>—</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(400,000)</td>
<td>75,000</td>
<td>300,000</td>
<td>$(75,000)</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

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 met only if the entity does not comply with the requirement to use an AETR for continuing operations.
Example 7-16 (continued)

Alternative 3

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Income/ (Loss)</th>
<th>AETR</th>
<th>Tax</th>
<th>Income/ (Loss)</th>
<th>Tax</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>$(100,000)</td>
<td>18.8%</td>
<td>$ 18,750</td>
<td>$300,000</td>
<td>$ (18,750)</td>
<td>—</td>
</tr>
<tr>
<td>Second</td>
<td>(100,000)</td>
<td>18.8%</td>
<td>$ 18,750</td>
<td>(18,750)</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Third</td>
<td>(100,000)</td>
<td>18.8%</td>
<td>$ 18,750</td>
<td>(18,750)</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Fourth</td>
<td>(100,000)</td>
<td>18.8%</td>
<td>$ 18,750</td>
<td>(18,750)</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$(400,000)</td>
<td></td>
<td>$ 75,000</td>
<td>$300,000</td>
<td>$ (75,000)</td>
<td>—</td>
</tr>
</tbody>
</table>

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.

7.5 Other Considerations

Other complexities can arise when entities are determining the appropriate amount of income tax to recognize in an interim period. ASC 740-270 addresses some of these complexities.

7.5.1 Inability to Make a Reliable Estimate of the AETR

ASC 740-270-30-18 states:

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.

If a company’s AETR is highly sensitive to changes in estimates of total ordinary income (or loss), the AETR may not be considered reliable. This may occur when, for example, an entity is expecting marginal ordinary income (or loss) and relatively significant permanent differences or tax credits.

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. If a reliable estimate of the AETR cannot be made, the best estimate of the AETR may be the actual ETR for the YTD.

7.5.2 Nonrecognized Subsequent Events

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 UTBs, changes in tax laws or rates, a change in tax status, an IPO, or a business combination). Entities should consult with their accounting advisers before applying this alternative approach.

7.5.3 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 YTD income tax expense or benefit by applying an estimated AETR to YTD 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 YTD expense or benefit on the balance sheet. That is, the YTD 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 YTD tax expense (or benefit) 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.

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 7-17

Company A is preparing interim financial statements and calculates an estimated AETR of 25 percent that, when applied to YTD ordinary income of $100, results in an interim expense 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:

- *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.

- *Calculate current taxes* — Company A calculates its current taxes payable in accordance with tax law applied to YTD 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).

- *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.

<table>
<thead>
<tr>
<th>Debits (Credits)</th>
<th>Current Taxes</th>
<th>Deferred Taxes</th>
<th>Income Statement Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Split AETR</td>
<td>20</td>
<td>5</td>
<td>25</td>
</tr>
<tr>
<td>2. Calculate current taxes</td>
<td>40</td>
<td>(15)</td>
<td>25</td>
</tr>
<tr>
<td>3. Calculate deferred taxes</td>
<td>15</td>
<td>10</td>
<td>25</td>
</tr>
</tbody>
</table>

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.
Chapter 8 — Accounting for Income Taxes in Separate Financial Statements

8.1 Introduction

Financial statements often need to be prepared that are composed of the assets and operations of some subcomponent of a larger consolidated reporting entity. Such financial statements are commonly referred to as “separate” or “carve-out” financial statements and are routinely required in connection with an IPO, a spin-off, or a sale, or to comply with debt covenants.

When used broadly, “separate” and “carve-out” describe financial statements that are derived from the financial statements of a larger parent company. In this context, the words are often used interchangeably. A narrower use of the term “carve-out financial statements” refers specifically to financial statements that are not the separate financial statements of a legal entity subsidiary but rather of certain operations (e.g., unincorporated divisions, branches, disregarded entities, or lesser components of the parent reporting entity) that have been “carved out” of the parent entity or one or more legal entity subsidiaries. In this chapter, we use “separate financial statements” to refer to financial statements of one or more legal entity subsidiaries and “carve-out financial statements” to refer to financial statements that are composed of the assets and operations of divisions, branches, disregarded entities, or lesser components of the parent entity or one of its subsidiaries.

Even though carve-out financial statements are not those of a legal entity (i.e., they are composed of portions of a legal entity or entities that have been “carved out”), they are commonly referred to as the financial statements of the carve-out “entity.” See Deloitte’s A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions for further discussion of carve-out financial statements.

8.2 Determining Whether an Allocation of Income Taxes Is Required in Separate or Carve-Out Financial Statements

**ASC 740-10**

<table>
<thead>
<tr>
<th>Allocation of Consolidated Tax Expense to Separate Financial Statements of Members</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-27</strong> 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.</td>
</tr>
</tbody>
</table>
ASC 740-10 (continued)

Pending Content (Transition Guidance: ASC 740-10-65-8)

30-27A An entity is not required to allocate the consolidated amount of current and deferred tax expense to legal entities that are not subject to tax. However, an entity may elect to allocate the consolidated amount of current and deferred tax expense to legal entities that are both not subject to tax and disregarded by the taxing authority (for example, disregarded entities such as single-member limited liability companies). The election is not required for all members of a group that files a consolidated tax return; that is, the election may be made for individual members of the group that files a consolidated tax return. An entity shall not make the election to allocate the consolidated amount of current and deferred tax expense for legal entities that are partnerships or are other pass-through entities that are not wholly owned.

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.

Question 3 of SAB Topic 1.B.1 (codified in ASC 220-10-S99-3) states:

SEC Staff Accounting Bulletins

SAB Topic 1.B. Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity

S99-3 The following is the text of SAB Topic 1.B.1, Costs Reflected in Historical Income Statements . . .

Question 3: What are the staff’s views with respect to the accounting for and disclosure of the subsidiary’s income tax expense?

Interpretive Response: Recently, a number of parent companies have sold interests in subsidiaries, but have retained sufficient ownership interests to permit continued inclusion of the subsidiaries in their consolidated tax returns. The staff 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.

Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. Others, however, have used different allocation methods.

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.¹

¹ Paragraph 40 of Statement 109 [paragraph 740-10-30-27] states: “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. . . . The method adopted . . . shall be systematic, rational, and consistent with the broad principles established by [Statement 109] [Subtopic 740-10]. A method that allocates current and deferred taxes to members of the group by applying [Statement 109] [Subtopic 740-10] to each member as if it were a separate taxpayer meets those criteria.”
To understand the accounting for income taxes in separate or carve-out financial statements, management and practitioners must understand the legal structure of the operations to be included in such statements. The remainder of this section discusses some of the considerations related to whether separate or carve-out financial statements would require an allocation of income taxes.

8.2.1 Separate Financial Statements Composed of One or More Taxable Legal Entities

The primary source of guidance applicable to the accounting for income taxes in separate financial statements is ASC 740-10-30-27, which 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.” For income tax accounting purposes, a “member” is generally a taxable legal entity (i.e., a corporation or an LLC that has elected to be taxed as a corporation) that is included in the parent's consolidated tax return. Thus, if separate financial statements are being prepared that are composed of one or more taxable legal entities that are included in the parent's consolidated tax return (as might be the case if the separate financial statements are being prepared in connection with a spin-off of a subsidiary), an allocation of current and deferred income tax expense is explicitly required under ASC 740-10-30-27.

8.2.2 Separate Financial Statements of Nontaxable Legal Entities or “Pass-Through” Entities

Separate financial statements may be composed of one or more nontaxable entities (e.g., “pass-through” entities such as partnerships and multiple member LLCs that have elected to be taxed as pass-throughs). Such nontaxable or pass-through entities are not members of their parent's consolidated income tax return. Therefore, allocation of income tax expense is not required in the separate financial statements of a pass-through entity. This is true irrespective of whether the separate financial statements will be included in a filing with the SEC.

8.2.3 Carve-Out Financial Statements (i.e., Statements Composed of One or More Unincorporated Divisions, Branches, Disregarded Entities, or Lesser Components of the Parent Reporting Entity)

Because ASC 740-10-30-27 discusses only the allocation of current and deferred income taxes to the separate financial statements of a member (i.e., a taxable legal entity subsidiary that is included in a parent's consolidated income tax return), it does not explicitly address the allocation of income taxes in carve-out financial statements. Whether an allocation of the consolidated amounts of current and deferred income taxes is required in carve-out financial statements depends on the ultimate use of the financial statements.

If the carve-out financial statements will be included in a filing with the SEC, an allocation of taxes is generally required under the guidance in SAB Topic 1.B.1 (codified in ASC 220-10-S99-3). Question 3 of SAB Topic 1.B.1 specifically addresses income taxes and states, in part:

The staff 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.

In this context, “the registrant” has been interpreted in practice to include a carve-out “entity,” either because the carve-out entity will ultimately become a registrant or because the carve-out entity represents the predecessor of the registrant.
The allocation of income taxes in carve-out financial statements that will be included in a filing with the SEC is required regardless of whether the carved-out operations will be subsumed into a taxable or nontaxable entity upon consummation of the transaction for which the carve-out financial statements are being prepared. Only in limited circumstances has the SEC allowed the omission of a tax provision (e.g., if the carve-out entity prepares abbreviated financial statements — see Section 8.2.5).

If the carve-out financial statements will not be included in a filing with the SEC, the parent entity is generally not required to allocate income taxes to the carve-out financial statements, although doing so is usually preferable because it yields more useful information.

### 8.2.4 Separate Financial Statements of Single Member LLCs

An LLC with only one member (a “single member LLC”) is a unique legal entity structure that can, under certain circumstances, be classified for U.S. federal income tax purposes as a regarded entity (i.e., similar to a corporation) or can be disregarded (i.e., not respected as an entity separate from its owner but rather treated like a division of a corporation). However, unlike a division of a corporation, a disregarded single member LLC generally is not severally liable for the current and deferred income taxes of its taxable owner provided that it maintains its separate and distinct legal existence. An entity’s determination of whether an allocation of current and deferred income taxes is required in the separate financial statements of a single member LLC therefore depends, in part, on how the single member elects to treat itself for U.S. federal income tax purposes.

A regarded single member LLC that is subject to federal, foreign, state, or local taxes based on income should account for such taxes in its separate financial statements in accordance with ASC 740 (see Section 8.2.1).

A disregarded single member LLC would follow the guidance discussed in Section 8.2.3 to allocate current and deferred taxes in its financial statements. Accordingly, while it would certainly be acceptable by analogy to ASC 740-10-30-27 (and would generally be preferable) for the disregarded single member LLC to recognize an allocation of current and deferred income taxes in its separate financial statements, we do not believe that it is required unless the disregarded single member LLC (1) will include the separate financial statements in a filing with the SEC or (2) is in the situation described in the paragraph below.

Because a single member LLC is a legal entity and not a division, it is possible for the single member LLC to enter into a tax-sharing agreement with its owner. 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. The allocation method used must be appropriate for financial reporting purposes regardless of the manner in which the contractual tax-sharing agreement allocates taxes to the single member LLC. See Section 8.3.1 for further discussion of acceptable allocation methods and Section 8.3.4 for further discussion of tax-sharing arrangements that are inconsistent with the broad principles established by ASC 740.

If income taxes are not allocated, practitioners should ensure that they have a complete understanding of the business purpose of the structure and of the user(s) of the financial statements. See Section 8.7.2 for disclosure considerations for financial statements of a single member LLC that do not include an allocation of income taxes.
Changing Lanes

Because stakeholders indicated that the previous guidance was unclear, the FASB issued ASU 2019-12 in December 2019. The ASU added the guidance in ASC 740-10-30-27A to clarify that legal entities that are not subject to tax (e.g., certain partnerships and disregarded single member LLCs) are not required to have an allocation of consolidated current and deferred taxes in their separate financial statements. An allocation of current and deferred income tax expense is permitted, however, in the separate financial statements of legal entities that are not subject to tax and are disregarded by the taxing authority. In addition, ASC 740-10-50-17A requires an entity that is not subject to tax and is disregarded by the taxing authority to disclose that it has elected to allocate amounts of consolidated current and deferred taxes in its separate financial statements.

The policy election to allocate taxes to legal entities that are not subject to tax and are disregarded by the taxing authority allows the inclusion of a tax provision in the separate financial statements of a single member LLC (a disregarded entity for tax purposes) but not in the financial statements of a partnership (a regarded entity for tax purposes).

These amendments should be applied retrospectively.

The addition of ASC 740-10-30-27A means that current and deferred income tax expense are no longer required to be allocated to the financial statements of a single member LLC being prepared for inclusion in an SEC filing (regardless of whether a tax-sharing agreement exists between the single member LLC and its taxable parent). That is, such financial statements are treated the same as those of a partnership in the accounting for income taxes in the separate financial statements.

For more information on ASU 2019-12, see Appendix B.

An entity’s conclusion about whether to allocate income taxes to the separate financial statements of a single member LLC is not an assessment of whether income taxes are attributable to that single member LLC in accordance with ASC 740-10-55-226 through 55-229. Rather, such a conclusion constitutes the application of the presentation guidance in ASC 740-10-30-27.

8.2.5 Abbreviated Financial Statements

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 separate 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 (e.g., if the carve-out financial statements are composed of parts of a number of different legal entities).
8.3 Allocating Current and Deferred Income Tax Expense in the Income Statement of Separate and Carve-Out Financial Statements

The allocation of current and deferred income tax expense required by ASC 740-10-30-27 to separate financial statements is necessary because, in a consolidated income tax return, the results of operations of the members are combined to determine income tax expense of the consolidated group. Therefore, taxable income of one member of the consolidated return may be offset by losses and credits of another member and vice versa. Because income tax obligations are not determined at a level below the consolidated filing group, it is necessary to make an allocation of the amount of consolidated current and deferred income tax expense into separate or carve-out financial statements.

8.3.1 Acceptable Methods of Allocating Tax to Separate and Carve-Out Financial Statements

ASC 740-10-30-27 does not prescribe a particular method for allocating current and deferred income tax expense to separate financial statements of a member; rather, it requires only 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 separate-return and parent-company-down approaches, both of which are discussed below. Choosing an income tax allocation method is an accounting policy decision, and the method should be consistently applied. See Section 8.3.2 for considerations specific to public companies.

8.3.1.1 Separate-Return Method

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 or carve-out 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 8-1

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Separate-Return Approach</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P (Stand-Alone)</td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 300</td>
<td>$(100)</td>
</tr>
<tr>
<td>Tax rate</td>
<td>21%</td>
<td>21%</td>
</tr>
<tr>
<td>Current tax expense (benefit)</td>
<td>63</td>
<td>0</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total tax expense (benefit)</td>
<td>$ 63</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

Note that in this example, as a result of the different conclusions related to realizability of the benefit for S1's loss, the $147 of tax expense representing the “sum of the parts” of income tax expense allocated in the separate financial statements does not equal the $126 of tax expense reflected in P’s consolidated financial statements.

8.3.1.1.1 Modifications to the Separate-Return Method

Depending on the facts and circumstances, certain modifications to the separate-return method may also be considered systematic, rational, and consistent with the broad principles of ASC 740. For example, entities often modify the separate-return method to eliminate the effects of inconsistent conclusions related to realizability.
Example 8-2

Assume the same facts as in Example 8-1. Under this modified method, 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 $21 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>P</th>
<th>S1</th>
<th>S2</th>
<th>Sum of Separate-Return Tax Expense</th>
<th>P</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$ 300</td>
<td>$(100)</td>
<td>$ 400</td>
<td>$ 600</td>
<td>$ 300</td>
<td>0</td>
</tr>
<tr>
<td>Tax rate</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td></td>
<td>21%</td>
<td>0</td>
</tr>
<tr>
<td>Current tax expense (benefit)*</td>
<td>63</td>
<td>(21)</td>
<td>84</td>
<td>$ 126</td>
<td>126</td>
<td>0</td>
</tr>
<tr>
<td>Total tax expense (benefit)</td>
<td>$ 63</td>
<td>$(21)</td>
<td>$ 84</td>
<td>$ 126</td>
<td>$ 126</td>
<td>0</td>
</tr>
</tbody>
</table>

* 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 $21 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 a deferred tax benefit (rather than a current tax benefit) of $21 in the current year), 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 operations of the separate or carve-out entity 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.

8.3.1.1.2 Application of the Separate-Return Method in Separate or Carve-Out Financial Statements That Combine Multiple Legal Entities, Multiple Divisions, or Both

When multiple members are presented in separate financial statements on a combined basis, questions have arisen regarding the application of the separate-return method 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 members that is combined in the separate financial statements can be viewed collectively as a single member, in which case a single tax provision would be allocated to the combined members as a whole.
In these circumstances, 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 separate financial statements of the combined members.

The first approach is to calculate the tax provision as if all the members combined in the separate financial statements had been combined in such statements in all periods presented and had historically filed a consolidated tax return. 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, calculation of an income tax provision under the separate-return method as if all of the members were part of a consolidated return during all periods presented (in accordance with the same principles) would appear to be an acceptable interpretation of this guidance.

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 separate, combined financial statements, we believe that a second acceptable approach is to calculate the tax provision by applying the separate-return method to each member separately. In other words, application of the tax law to the individual members appearing in the separate financial statements would result in a separate tax provision calculation for each member that lacks a common parent in the separate financial statements. These individual tax provisions would then be combined to determine the total amount of taxes to be allocated to the combined, separate financial statements. This approach is 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 purpose for the separate financial statements. For example, if they are being prepared in connection with a spin-off or sale transaction and will be part of a consolidated tax return prospectively, 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., certain 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 for the application of a single-return approach. We recommend that entities consult their professional accounting advisers in these circumstances. See Section 8.2.3 for additional discussion of single member LLCs.

### 8.3.1.1.3 Application of the Separate-Return Method in Separate or Carve-Out Financial Statements When Tax Amounts Are Calculated on a Consolidated Tax Return Basis (e.g., the Deemed Repatriation Transition Tax, GILTI, BEAT)

The member should record income taxes as if it had not been a member of the U.S. consolidated tax return group. However, depending on the facts and circumstances, it may be appropriate for an entity to apply related-party and affiliated group tax rules that are relevant regardless of whether it makes an election to file a consolidated tax return.

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1 Under this approach, if a division or group of divisions is included in the separate or carve-out financial statements, the separate-return method would generally be applied to those divisions in aggregate and then combined with the tax provisions of the members.
8.3.1.2 Parent-Company-Down Method

Under the parent-company-down method, total current and deferred income tax expense, as determined at the consolidated level, is allocated to separate or carve-out financial statements by using a pro rata allocation. The pro rata portion of consolidated tax expense allocated to the separate or carve-out financial statements might be determined by, for example:

- Calculating the member’s or carve-out entity’s pretax income as a percentage of the total consolidated pretax income.
- Calculating the member’s or carve-out entity’s pretax income adjusted for permanent items as a percentage of the total consolidated pretax income adjusted for permanent items.

**Example 8-3**

This example illustrates how the parent-company-down method 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 20 percent tax rate. On a consolidated basis, P has current and deferred tax expense of $110 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:

<table>
<thead>
<tr>
<th></th>
<th>Parent</th>
<th>S1</th>
<th>S2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pretax income (loss)</td>
<td>$300</td>
<td>$(100)</td>
<td>$400</td>
</tr>
<tr>
<td>Permanent items</td>
<td>$100</td>
<td>$50</td>
<td>$(200)</td>
</tr>
<tr>
<td>Pretax income (loss) adjusted for permanent items</td>
<td>$400</td>
<td>$(50)</td>
<td>$200</td>
</tr>
<tr>
<td>Tax rate</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Consolidated tax</td>
<td>$110</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Parent</th>
<th>S1</th>
<th>S2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax allocated on the basis of pretax income (loss)</td>
<td>$55</td>
<td>$(18.7)</td>
<td>$73.7</td>
</tr>
<tr>
<td>Tax allocated on the basis of pretax income (loss) adjusted for permanent items</td>
<td>$80.3</td>
<td>$(9.9)</td>
<td>$39.6</td>
</tr>
</tbody>
</table>
Example 8-3 (continued)

As depicted above, 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 ($110 in this example).

8.3.2 Preferable Allocation Method for Public Companies

Question 3 of SAB Topic 1.B.1 (codified in ASC 220-10-599-3) 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.

For public entities, the separate-return method for allocating taxes among members of a group that file a consolidated tax return is preferable to other methods and, if the separate-return method is not used (including, as discussed in Section 8.3.1.1.1, when the separate-return method is modified), a pro forma income statement is required for the most recent annual and interim periods, including a tax provision determined by using the separate-return method. The acceptable methods for allocating current and deferred income taxes in carve-out financial statements are generally the same as those for allocating income taxes in separate financial statements of a member. It would also, therefore, be considered preferable to allocate income taxes to carve-out financial statements by using the separate-return method if such an allocation is required (e.g., because the carve-out financial statements will be included in a public filing).

Most entities preparing separate and carve-out financial statements to which an allocation of current and deferred income taxes is required will use the separate-return method because to use a different method would require entities to maintain a separate set of financial statements to meet the SEC's expectation of a pro forma income statement when the allocation is not determined on the separate-return basis.

8.3.3 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 permitted only 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 a 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 or carve-out financial statements. 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.
8.3.4 Tax-Sharing Agreements

8.3.4.1 General

A tax-sharing agreement is a legal agreement between the members of a consolidated group (e.g., a parent and corporate subsidiary) that typically governs the cash payment responsibility of each party related to income taxes of the consolidated filing group. Tax-sharing agreements should be formally documented, and the documentation should indicate how a member of a consolidated filing group will pay or be compensated for income tax expense or benefit attributed to its operations. This would generally include documentation of, for example, (1) whether a member’s cash payment responsibility will be calculated on a consolidated or separate-return basis and (2) how the member will be compensated for the benefit to the consolidated group of NOLs and tax credits attributable to its operations.

Such documentation is important for several reasons. First, it provides information about the risks and rewards of the parties to a legally enforceable contract. Second, even a documented tax-sharing agreement can be difficult to apply because of the complexities of the tax law. Third, a documented tax-sharing agreement serves as the basis for the preparation of separate or carve-out financial statements.

8.3.4.2 Tax-Sharing Agreements That Are Not Acceptable for Financial Reporting Purposes

When the legal tax-sharing agreement that governs the cash payments and receipts between a parent entity and the members of its consolidated filing group 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 member of the consolidated filing group that prepares separate financial statements. Any difference between (1) the income-tax-related cash flows that are to be paid or received by a member under the legal tax-sharing agreement and (2) the income-tax-related cash flows of the member implied by the allocation of current and deferred income taxes by using a systematic and rational method of allocation for financial reporting purposes is reported in the separate financial statements of the group member as either a charge to retained earnings (i.e., in a manner consistent with accounting for dividends generally) or a credit to paid-in capital (i.e., in a manner consistent with accounting for contributions from shareholders generally).

Example 8-4

Assume that a parent company, Entity P, a holding company operating in a tax jurisdiction with a 21 percent tax rate, has two operating subsidiaries, S1 and S2, and that the legal tax-sharing agreement states that S1 and S2 will not make a payment to or receive a payment from P with regard to the subsidiaries’ taxable income or loss for a given year when the consolidated group has no tax liability (expense) or refund (benefit) for that 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. An allocation of income tax expense in a manner consistent with the cash obligations of P, S1, and S2 under the tax-sharing agreement generally would not conform with the “systematic, rational, and consistent” requirements of ASC 740-10-30-27. Therefore, assume that for financial reporting purposes, the group has chosen to allocate income taxes to the separate financial statements of S1 and S2 by using the separate-return method and that the NOL resulting from the $1,000 loss incurred by S2 in 20X1 does not require a valuation allowance. Entity P records the following journal entries in the separate financial statements of S1 and S2 for 20X1:

**Journal Entry — Consolidated Group Member S1**

Income tax expense — income from continuing operations 210
Income taxes payable 210
Paid-in capital 210

To record income tax expense and payable in the separate financial statements of S1 on a separate-return basis and then reclassify the payable to paid-in capital to reflect the fact that S1 will not have to make a payment with regard to such taxes under the tax-sharing agreement. In effect, the taxes were paid on its behalf by P, representing a contribution by S1’s shareholders to S1’s capital ($1,000 × 21%).

**Journal Entry — Consolidated Group Member S2**

NOL carryforward* 210
Income tax benefit — loss from continuing operations 210
Retained earnings* 210
NOL carryforward 210

To record income tax benefit in the separate financial statements of S2 on a separate-return basis and reflect the fact that S2 will not receive a payment with regard to the reduction in taxes resulting from its loss. In effect, S2 distributed the benefit of the loss to P as a dividend against retained earnings ($1,000 × 21%).

* See the discussion in Section 8.4.3 of alternative approaches for accounting for hypothetical DTAs in separate financial statements prepared by using the separate-return method. This example assumes that S2 has elected not to record the hypothetical DTA (it is hypothetical because no NOL exists on a consolidated basis; P had no taxable income, and S2’s loss was offset by S1’s income). Under this approach, if S2 did not have retained earnings, the amount could also be recorded as a return of capital.
8.3.5 Allocating Benefits to a Subsidiary for Parent’s Interest Expense

Example 8-5

Assume that Entity P is the parent of a wholly owned subsidiary, Company S, and that S is a member of P’s consolidated tax return. Further assume that P issued term debt upon acquiring S and that P deducts the interest paid on the debt for income tax purposes. The legal tax-sharing agreement between P and S specifies that S will receive payments from P to the extent of the benefit to P of the interest deductions taken by P in the consolidated tax return related to the term debt.

Company S prepares separate financial statements, and P does not allocate the debt and corresponding interest expense to S for financial reporting purposes. Company S does pay dividends to P, in part to provide cash flows for P’s debt service obligation.

The FASB staff has informally indicated that in circumstances such as those in Example 8-5 above, the tax benefit of the interest expense determined in accordance with the legal tax-sharing agreement and paid by P to S should be allocated to equity in the separate financial statements of S. 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 has been recognized in S’s financial statements, is inconsistent with the broad principles established by ASC 740.

8.3.6 “Return-to-Provision” Adjustments in Separate or Carve-Out Financial Statements

When preparing an income tax provision for financial reporting purposes, an entity will often find it necessary to make estimates of amounts that will ultimately be included in the filed income tax return because the financial statements must be issued before the date on which the income tax return is due. This can result in “return-to-provision” adjustments (also known as return-to-accrual adjustments), which occur when estimates used for the provision in the consolidated financial statements differ from the amounts reported on the consolidated income tax return. Any resulting differences between the consolidated tax return and consolidated tax provision should be carefully evaluated to determine whether such variances represent changes in estimates or a correction of an error.

The income tax effects of return-to-provision adjustments that are considered changes in estimates in the consolidated financial statements are generally recorded in separate or carve-out financial statements in the same period in which the changes in estimates were identified in the consolidated financial statements. The income tax effects of return-to-provision adjustments that are not considered changes in estimates in the consolidated financial statements, however, generally should be recorded in the historical separate or carve-out financial statements in the periods to which they relate and not in the period identified (i.e., irrespective of the period in which they were accounted for in the parent’s consolidated financial statements). Differences between the periods in which return-to-provision adjustments are recorded in consolidated financial statements versus when they are recorded in separate or carve-out statements could stem, for example, from differences in materiality between the separate or carve-out financial statements and the consolidated financial statements.
8.4 Current and Deferred Income Taxes in the Balance Sheet of Separate and Carve-Out Financial Statements

As discussed in detail above, an allocation of current and deferred income tax expense to separate and carve-out financial statements is often necessary. However, there is no authoritative guidance in ASC 740-10-30-27 or elsewhere that specifically addresses how current and deferred taxes should be reflected in the balance sheet of the separate or carve-out financial statements.

8.4.1 Requirement to Record DTAs and DTLs in Separate or Carve-Out Financial Statements

The recording of DTAs and DTLs in the balance sheet of carve-out financial statements was discussed at the June 12, 2001, AICPA SEC Regulations Committee joint meeting with the SEC staff. The following is an excerpt from those meeting minutes that expresses the SEC staff's view:

**Question:** Should carveout financial statements (i.e., financial statements of a business that is not a legal entity, e.g., a division) reflect income tax expense and deferred tax assets/liabilities if the reporting entity is a component of a taxable entity?

**Background:** The accounting literature does not clearly address the issue of accounting for income taxes by a reporting entity that is not a legal entity.

Paragraph 1 of SFAS 109 states that it “addresses financial accounting and reporting for the effects of income taxes that result from an enterprise’s activities . . . .” Paragraph 40 provides standards for accounting for income taxes in the “separate financial statements of a subsidiary.” It states that tax expense “shall be allocated among the members of the group when those members issue separate financial statements.” (Emphasis added.) SFAS 109 does not define the term “enterprise.” However, paragraph 40 seems to apply only to legal entities.

SAB Topic 1-B is entitled Allocation of Expenses and Related Disclosures in Financial Statements of Subsidiaries, Divisions, or Lesser Business Components of Another Entity. In its text, it seems to use the word “subsidiary” as a surrogate for the larger collection of reporting entities listed in its title. The response to Question 1 states that “the historical income statements of a registrant should reflect all of its costs of doing business.” However, the response then states that “income taxes . . . are discussed separately below.” Question 3 addresses income tax expense. Although the SAB seems to use the term “subsidiary” broadly, the discussion of subsidiary income taxes in the response to Question 3 seems to be written in the context of legal entities, referring to issues of whether the entity can be included in a consolidated tax return (this is not an issue for a component of a legal entity) with its “parent.” The response states the need to provide a pro forma tax provision if the financial statements do not reflect income taxes on a separate return basis. Guidance in the Staff Training Manual (at Topic Three.IVA.1. and Topic Seven.IVA.4.) also focuses on the need for pro forma tax provision information.

Although an allocation of deferred tax assets and liabilities needs to be made to apply the separate return method, none of this guidance specifically addresses balance sheet presentation or footnote disclosure issues. The guidance calling for pro forma information focuses on the need for tax provision information.

**Discussion:** Many accountants focus on the concept stated in SAB Topic 1-B that income statements should reflect all costs of doing business. They present income tax provisions as part of the historical accounts reflected in carveout financial statements. Others believe that since reporting entities that are not legal entities do not have legal tax status, they do not have tax liabilities or expenses. Therefore, they present income tax information in carveout financial statements only on a pro forma basis. Although practice does not appear to be uniform, it appears that registrants present income taxes in carveout financial statements as part of the historical accounts more frequently than they present them as pro forma information. This observation is based in part on comments made by the Big 5 accounting firms in communications discussing the question of whether a single member LLC should present a tax provision in its financial statements. A single member LLC is treated as a "disregarded entity" for tax purposes. In other words, it is treated no differently than a division of a taxpayer. The majority of the firms felt that a single member LLC should present a tax provision. The other firms did not have strong views.

**Staff Comment:** As stated in SAB Topic 1B, the staff believes that financial statements are more useful to investors if they reflect all costs of doing business. As the transactions reported in the carveout financial statements have income tax implications to the taxable entity of which the reporting entity is a part, the staff believes that carveout financial statements should reflect income tax expense and deferred tax assets/liabilities attributable to the reporting entity.
As indicated in the minutes above, the SEC staff believes that financial statements “are more useful to investors if they reflect all costs of doing business” and that carve-out financial statements “should reflect income tax expense and deferred tax assets/liabilities attributable to the reporting entity.” While the staff's views were expressed specifically in the context of carve-out financial statements, we believe that such views would also apply to separate financial statements of members (i.e., taxable legal entities that are included in a parent's consolidated tax return).

Therefore, we generally believe that the balance sheet of separate and carve-out financial statements should include DTAs and DTLs for temporary differences related to the separate entity's operations when such financial statements will be included in a filing with the SEC. In addition, although it is not clear from the minutes above, we believe that it is generally appropriate to record DTAs and DTLs in separate and carve-out financial statements regardless of the method (e.g., the separate-return method or the parent-company-down method) used to allocate current and deferred income tax expense to the separate or carve-out financial statements.

8.4.2 Method for Recording DTAs and DTLs in the Balance Sheet of Separate or Carve-Out Financial Statements

We believe that it is generally appropriate for an entity to begin its allocation of DTAs and DTLs in the balance sheet of separate or carve-out financial statements by identifying stand-alone temporary differences and attributes of the separate or carve-out entity. Those differences and attributes would be based on the financial statement carrying amount of the assets and liabilities included in the separate or carve-out financial statements as if the entity were required to file its own tax return. However, because there is no available guidance on how DTAs should be reflected in separate and carve-out financial statements, many issues arise in practice. We discuss some of those issues in Section 8.4.3 (below) and Section 8.4.4.

8.4.3 Recognition of DTAs Related to Temporary Differences for Which the Separate or Carve-Out Entity Has Been Paid by Another Member of the Consolidated Filing Group

Under some tax-sharing arrangements, one member of the consolidated filing group, typically a parent, will pay a separate or carve-out entity for temporary difference DTAs each period as they arise. Once the separate or carve-out entity has been paid for the DTAs, questions arise about whether such DTAs should be removed from the separate or carve-out entity's balance sheet.

Careful consideration should be given to the facts and circumstances of each individual tax-sharing agreement. We believe that it would generally not be appropriate for an entity to remove DTAs related to temporary differences from the separate or carve-out financial statements when a parent pays a separate or carve-out entity for temporary difference DTAs each period as they arise. Temporary difference DTAs are tied to the financial reporting and tax bases of specific assets and liabilities of the separate or carve-out entity. The fact that the entity receives payment for associated DTAs does not change whether a basis difference exists or whether a future benefit would result from settlement of the asset or recovery of the liability at its financial reporting carrying amount. Therefore, derecognition of DTAs related to temporary differences would generally not be consistent with the broad principles of ASC 740.
8.4.4  Recording Deferred Income Taxes in the Balance Sheet Under the Separate-Return Method

8.4.4.1  Taxable Temporary Differences Resulting From Investments in Foreign Subsidiaries and Foreign Corporate Joint Ventures in Separate Financial Statements Prepared by Using the Separate-Return Method

ASC 740-30-25-18 indicates that a DTL should not be recognized for an “excess of the amount for financial reporting over the tax basis [i.e., ‘outside basis difference’] of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration” unless “it becomes apparent that those temporary differences will reverse in the foreseeable future” (emphasis added). There is, however, also a rebuttable presumption under ASC 740-30-25-3 that all undistributed earnings will be transferred by a subsidiary to its parent. This rebuttable presumption may be overcome if the criteria of ASC 740-30-25-17 are met (i.e., sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely).

The determination of whether a DTL should be recognized (e.g., whether the rebuttable presumption is or is not overcome) for an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration is first made at the parent’s level on a consolidated basis and takes into account all of the consolidated entity’s relevant facts and circumstances.

When the investment in the foreign subsidiary or corporate joint venture is owned by the separate reporting entity and is included in the separate financial statements of that entity, the separate financial statements prepared by using the separate-return method must also include an assertion with respect to whether the temporary difference will reverse in the foreseeable future. Questions often arise about whether the assertion in the separate financial statements prepared by using the separate-return method should be the same as the assertion made in the consolidated financial statements related to that same investment or whether, instead, the separate reporting entity must perform an independent analysis that takes into account only the separate reporting entity’s operations, facts, and circumstances.

Preparing an independent analysis that takes into account only the facts and circumstances of the separate reporting entity is consistent with the separate-return method. However, we believe that because the separate reporting entity is controlled by its parent, if the parent considers the separate reporting entity’s facts and circumstances, the parent is inherently required to also consider the consolidated filing group’s plans for reinvestment, cash needs, and so forth when determining whether the outside basis taxable temporary difference will reverse in the foreseeable future. Therefore, in most cases, if a separate analysis is performed, the separate reporting entity would reach the same conclusion in both the current and historical periods presented in the separate financial statements as that reached by the parent regarding the corresponding periods in the consolidated financial statements. Thus it would generally be unnecessary for the separate reporting entity to perform a separate analysis. Example 8-6 illustrates this concept.

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2 It may be appropriate in some circumstances to modify the separate-return method (see Section 8.3.1.1.1). We would not generally expect the types of modifications to the separate-return method that are described in Section 8.3.1.1.1 to affect the applicability of the guidance in this section to separate financial statements.
Example 8-6

Assume that U.S. Parent (USP) owns 100 percent of U.S. Subsidiary (USS, a member of USP's consolidated U.S. tax return), and USS is preparing separate financial statements by using the separate-return method. Assume further that USS owns an investment in Foreign Corporation A and A has undistributed earnings. USP has significant cash needs on a consolidated basis and therefore cannot assert that the undistributed earnings of A will be indefinitely reinvested, so it records a DTL in its consolidated financial statements. Even if USS could demonstrate that, on its own, it did not (and does not) have significant cash needs in the United States, it would record a DTL in its separate financial statements because a decision by USP to repatriate A's undistributed earnings to meet USP's consolidated cash needs would result in USS's incurring U.S. income tax (i.e., it would be difficult to support a conclusion that USS's outside basis taxable temporary difference on its investment in A will not reverse in the foreseeable future given USP's cash needs and its control over USS's operations).

Alternatively, assume that USP has demonstrated (and continues to demonstrate) on a consolidated basis that it does not have significant cash needs and therefore has asserted that the undistributed earnings of A will be indefinitely reinvested. USS, on its own, did not and does not generate sufficient cash flows to meet its debt obligations without contributions from USP. USP has historically provided and has the ability and intent to continue providing the necessary contributions for the foreseeable future. Because USP had (and continues to have) the ability and intent to provide funding to USS, USS would not have to record a DTL related to its investment in A in its separate financial statements. However, USS must carefully consider the facts and circumstances and use significant professional judgment to determine the appropriate period, if any, in which to record the DTL in the separate financial statements.

If management believes that the facts and circumstances suggest that it is appropriate for the separate or carve-out financial statements and the consolidated financial statements to contain different conclusions, consultation with the company's accounting advisers is strongly encouraged.

Regardless of the conclusions reached, disclosure would be required in the separate or carve-out financial statements of the company's accounting for outside basis deferred taxes on investments in foreign corporations and joint ventures.

8.4.4.2 Current Taxes Payable or Receivable and UTBs Liability Under the Separate-Return Method

When income tax expense is allocated to the separate reporting entity under the separate-return method and (1) such allocation results in a current income tax payable or receivable or (2) the allocation includes an expense related to a UTB, questions can arise about whether and, if so, how such a current payable or receivable and the UTB liability should be reflected in the balance sheet.\(^3\)

A separate reporting entity to which income tax expense was allocated under the separate-return method should initially reflect current income taxes payable and UTB liabilities in the balance sheet in the same manner as if it had prepared a separate return. This view is premised on the facts that (1) under U.S. federal tax law, members (corporate subsidiaries) of a consolidated filing group are severally liable for all tax positions taken in the consolidated return and (2) while nonmembers (unincorporated divisions, branches, or disregarded entities included in the entity's consolidated income tax return) are not severally liable for the current tax liability or tax positions taken in the consolidated return because they are not regarded as separate entities for income tax purposes, the presentation of current tax payables and UTB liabilities in the separate financial statements of nonmembers is consistent with the separate-return method. The separate reporting entity would then derecognize the payable or UTB liability (1) once it makes a payment (presumably to its parent under the terms of the tax-sharing arrangement) to settle the current tax payable or UTB liability or (2) once the current

\(^3\) The concepts in this section are equally applicable to income taxes payable and receivable. However, for ease of discussion throughout the remainder of this section, we refer only to income taxes payable.
tax payable or UTB liability is settled by the parent directly with the taxing authority. If the current tax payable or UTB liability is settled by the parent directly with the taxing authority, the separate reporting entity would derecognize the liability with a corresponding entry to equity. Adjustments to the current tax payable or UTB liability because of changes in facts and circumstances (i.e., unrelated to payment of the obligations) would generally be accounted for in the income tax provision.

However, in circumstances in which a tax-sharing agreement exists between the separate reporting entity and its parent or other members of the consolidated filing group (or both), we believe that it would also be acceptable for the separate reporting entity to immediately adjust, through equity, the recorded amount of current income taxes payable or UTB liabilities to reflect only the amount the separate reporting entity would be required to pay (presumably to its parent). For example, a tax-sharing agreement between a parent and a separate reporting entity that is a member (corporate subsidiary) of the consolidated return group may specify that the member is not liable for the tax consequences of tax positions taken in the consolidated return related to its business. The tax-sharing agreement might also specify that the separate reporting member must reimburse the parent for income taxes paid for an amount different from that determined by using the separate-return method. We believe that in each scenario it would be acceptable to adjust the UTB and current taxes payable to an amount consistent with what the separate reporting entity would ultimately have to pay (presumably to its parent) under the tax-sharing agreement. Any such adjustment would be recorded through equity.

### 8.4.4.3 DTAs Related to Tax Attributes Under the Separate-Return Method

The operations of a separate or carve-out entity may result in tax credits or NOLs in a particular year. Had the separate or carve-out entity filed its own tax return, it may not have been able to use the tax credits in the year in which they were generated. In these circumstances, NOL and tax credit carryforwards (tax attributes) could result.

Under the separate-return method, the separate or carve-out entity would recognize DTAs associated with the tax attributes (carryforwards) and evaluate them for realizability. The DTA would be assessed for realizability on the basis of positive and negative evidence related to the operations of only the separate or carve-out entity.

These tax attributes may be realized in the income tax return of the consolidated filing group (to offset taxable income from other operations included in the consolidated filing group) in a period before they would have been used by the separate or carve-out entity solely on the basis of the separate or carve-out entity’s operations. Therefore, the tax attributes generated by the separate or carve-out entity would no longer be available to reduce future taxable income of either the consolidated filing group or the separate or carve-out entity. In these situations, the tax attribute carryforwards represent “hypothetical DTAs” in the separate or carve-out financial statements because they no longer legally exist within the consolidated filing group; however, if the separate or carve-out entity had filed its own tax return, the tax attributes would be available.

Generally, two approaches exist for accounting for hypothetical DTAs related to tax attribute carryforwards, but an entity should choose and apply one consistently.
Under the first approach, the balance sheet of the separate or carve-out 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, in effect, distributed to and used by the parent and, accordingly, should be reversed through equity). Under this approach, the deferred tax benefit associated with the tax attributes would still be recognized in the income statement of the separate or carve-out financial statements (as long as no valuation allowance was needed in the separate or carve-out financial statements).

In subsequent years, the entity must continue assessing its ability to realize the benefit of the hypothetical DTA on the basis of the positive and negative evidence associated with its stand-alone operations (even though it does not continue to record the hypothetical DTA in the balance sheet). Changes in the measurement of the hypothetical DTA would be effected through an entry to deferred tax expense (or benefit) in the income statement of the separate or carve-out financial statements with an offsetting entry in APIC. Subsequent accounting is also an accounting policy election that should be applied consistently.

In addition, the separate company would be required to disclose the following:

- The reasons why the hypothetical DTA was not recorded.
- The possible effects on future tax provisions related to future changes in the realizability of the unrecorded hypothetical DTA.

Under the second approach, we believe that it would be acceptable to present the 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 financial statements in accordance withASC 740 as if the separate reporting entity had filed a separate tax return. If it had, the hypothetical DTA could not have been used by any other entity and thus would be presumed to continue to exist.

However, this second approach would not be appropriate if the separate or carve-out entity (1) would not have been more likely than not to realize the benefit of the tax attribute on a separate-return basis when it initially arose but (2) modified the separate-return method to take into consideration realizability of the attribute within the consolidated filing group and, as a result, recorded a DTA and corresponding benefit in the separate or carve-out financial statements (see Section 8.3.1.1.1 for further discussion of modifying the separate-return method for realizability). In that situation, once the parent has used the tax attribute, realization has occurred in a manner consistent with the initial conclusion about the recognition of the attribute in the separate financial statements (i.e., it was recognized only because it could be used by the consolidated filing group), and it should be derecognized. In other words, that DTA was recognized (with a corresponding benefit) only because the separate-return method was modified for realizability by the consolidated filing group. Once it has been realized by the consolidated filing group, it cannot be realized again in the separate financial statements as if the modified separate-return method had not been applied.

If a hypothetical DTA is recorded in the separate or carve-out financial statements, the separate or carve-out entity should disclose the fact that the DTA does not legally exist and would be derecognized if the entity were to leave the consolidated tax return filing group.
Example 8-7

Technology Co., an SEC registrant, is a U.S. software company with a March 31 year-end. Technology 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 Technology Co. Technology 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 because of accelerated depreciation. The loss was used by Technology 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 Technology 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, Technology Co. may choose whether to record the hypothetical DTA in the Division’s separate balance sheet. If Technology Co. elects to record the hypothetical DTA, it would record the following entry in the Division’s separate financial statements:

\[
\text{NOL DTA} \quad 1.1 \text{ million} \\
\text{Deferred tax benefit} \quad 1.1 \text{ million} \\
\text{[5 million NOL carryforward \times 21\% tax rate]} \\
\]

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

\[
\text{NOL DTA} \quad 1.1 \text{ million} \\
\text{Deferred tax benefit} \quad 1.1 \text{ million} \\
\text{Retained earnings} \quad 1.1 \text{ million} \\
\text{NOL DTA} \quad 1.1 \text{ million} \\
\]

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).

8.5 Valuation Allowance in Separate or Carve-Out Financial Statements

See Chapter 5 for a general discussion of valuation allowances under ASC 740. The manner in which valuation allowances are accounted for in separate or carve-out financial statements depends on whether income taxes are allocated by using the separate-return or the parent-company-down method (see Section 8.3 for further discussion of each method):
8.5.1 Separate-Return Method

If the separate-return method is used to allocate taxes in separate or carve-out financial statements, the separate or carve-out entity’s DTAs should be assessed for realizability on the basis of available evidence related to only the operations of the separate or carve-out entity. Therefore, if that entity 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 at the consolidated group level (e.g., a history of profitable operations of the consolidated filing group level).

8.5.2 Parent-Company-Down Method

If the parent-company-down method is used to allocate taxes in separate or carve-out financial statements, the determination of the need for a valuation allowance in the separate or carve-out financial statements 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 or carve-out financial statements.

8.6 Change in Status of the Separate Reporting Entity

Many circumstances can arise that result in the initial recognition or derecognition of current and deferred income taxes in separate or carve-out financial statements. See Section 3.5.2 for a general discussion of an entity’s accounting for a change in status and Sections 11.2.2 and 11.7.4.2 for a discussion of recognition and derecognition of income taxes in predecessor and successor financial statements (which may be separate or carve-out financial statements) and separate financial statements of an acquiree.

8.7 Disclosures Required in the Separate Financial Statements of a Member 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.

**Pending Content (Transition Guidance: ASC 740-10-65-8)**

50-17A An entity that is both not subject to tax and disregarded by the taxing authority that elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements in accordance with paragraph 740-10-30-27A shall disclose that fact and provide the disclosures required by paragraph 740-10-50-17.
For general disclosure requirements related to the accounting for income taxes, see Chapter 14. ASC 740-10-50-17 contains disclosure requirements specific to separate financial statements of a member of a consolidated filing group.

**Changing Lanes**

The Board issued ASU 2019-12 in December 2019 (discussed in Section 8.2.4), adding ASC 740-10-50-17A, which requires an entity that is not subject to tax and is disregarded by the taxing authority to disclose that an allocation of income taxes has been made in the separate financial statements.

For more information on ASU 2019-12, see Appendix B.

### 8.7.1 Disclosures in Separate or Carve-out Financial Statements to Be Included in a Filing With the SEC

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 about 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, as SAB Topic 1.B.1 states, the disclosures do not provide information needed to help financial statement users understand “what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent.” For example, the disclosures required by ASC 740-10-50-17 do not describe either the (1) nature of DTAs and DTLs, NOLs, and tax credit carryforwards or (2) uncertain tax positions of the consolidated return group that are attributable to the assets, liabilities, operations, and tax positions of the member.

Therefore, while it is not clear in ASC 740-10-50-17, we believe that the separate financial statements of a member that will be included in a filing with the SEC should generally provide the disclosures required by ASC 740-10-50-17 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. We believe that the same is true for carve-out financial statements that will be included in a filing with the SEC.

In addition, as discussed in Section 8.3.2, a pro forma income statement reflecting a tax provision calculated on a separate-return basis is required if the separate or carve-out financial statements include an allocation of current and deferred income taxes that uses a method other than the separate-return method.

### 8.7.2 Disclosures in Separate or Carve-Out Financial Statements That Will Not Be Included in a Filing With the SEC

If a member's separate or carve-out 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 discussed 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 member or carve-out entity are critical to users' understanding of the financial statements. The circumstances under which additional disclosures should be provided in such financial statements are a matter of judgment, and consultation with accounting advisers is recommended.
If the separate financial statements are those of a single member LLC and no allocation of income taxes has been made, the single member LLC should disclose that fact in the notes to the separate financial statements and the reasons why.

8.7.3 **Disclosures in Abbreviated Separate or Carve-Out Financial Statements**

See [Section 8.2.5](#) of this Roadmap, [Section 5.2.4](#) of Deloitte's *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*, and [Section 1.5](#) of Deloitte's *A Roadmap to SEC Reporting Considerations for Business Combinations* for further discussion of when abbreviated financial statements may be appropriate.

When abbreviated separate or carve-out financial statements of a business acquired or to be acquired are prepared 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.

8.7.4 **Disclosures Associated With Attributes (i.e., NOL or Tax Credit Carryforwards) in Separate or Carve-Out Financial Statements**

See [Section 8.4.4.3](#) for a discussion of appropriate disclosures in separate or carve-out financial statements associated with attributes (i.e., NOL or tax credit carryforwards) that result from the operations of the separate or carve-out entity.
Chapter 9 — Foreign Currency Matters

9.1 Overview

The primary objective of ASC 830 is for reporting entities to present their consolidated financial statements as though they are the financial statements of a single entity. Therefore, if a reporting entity operates in more than one currency environment, it must translate the financial results of those operations into a single currency (referred to as the reporting currency). However, this process should not affect the financial results and relationships that were created in the economic environment of those operations.

In accordance with the primary objective of ASC 830, a reporting entity must use a “functional currency approach” in which all transactions are first measured in the currency of the primary economic environment in which the reporting entity operates (i.e., the functional currency) and then translated into the reporting currency.

In preparing consolidated financial statements as though they are the financial statements of a single entity, an entity has essentially three currencies to consider:

- **Local currency** — Generally the currency of the country in which the entity operates, it is also the currency in which the financial statements are maintained for local reporting purposes and is commonly, but not always, the currency in which an entity files its tax returns. In the examples in this chapter, we use “LC” to refer to local currency.

- **Functional currency** — The ASC master glossary states that “[a]n 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” from its activities. It is also commonly, but not necessarily, the local currency. In the examples in this chapter, we use “FC” to refer to functional currency.

- **Reporting currency** — This is the currency in which the financial statements of the reporting group are prepared for consolidated financial reporting purposes.

Local currency amounts are **remeasured** into functional currency, and functional currency amounts are **translated** into the reporting currency in accordance with the guidance in ASC 830, as discussed in more detail below.

See Deloitte’s *A Roadmap to Foreign Currency Transactions and Translations* for a detailed discussion of foreign currency matters.
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.

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.

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.

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. 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. 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.

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.

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.
Chapter 9 — Foreign Currency Matters

ASC 830-740 (continued)

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.

30-3 Example 1 (see paragraph 830-740-55-1) illustrates the application of this guidance.

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.

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.

Related Implementation Guidance and Illustrations
   • Example 1: Illustration of Foreign Financial Statements Restated for General Price-Level Changes [ASC 830-740-55-1].

9.2 Remeasurement: Functional Currency and Local Currency Are Different

An entity's functional currency is determined by considering each of the economic factors in ASC 830-10-55. After considering these factors, management may determine that an entity's functional currency is the currency of the jurisdiction in which the entity operates (i.e., the local currency). Management may also conclude, on the basis of the facts and circumstances, that the functional currency is that of another jurisdiction (e.g., a U.K. subsidiary of a U.S. parent might have a local currency of pounds sterling, a functional currency of euros, and a reporting currency of U.S. dollars).

Each balance sheet and income statement account must be measured in an entity's functional currency for financial reporting purposes. Therefore, if an asset or liability or transaction is denominated in a currency other than the functional currency (e.g., local currency), it must be remeasured from that currency into the functional currency. In addition, if an entity's books and records are not maintained in the functional currency, the entity must remeasure each balance sheet and income statement account into the functional currency. Therefore, an entity's book basis in an asset or liability is also established in its functional currency.
ASC 830 provides the following guidance on the rate to be used in converting local currency balance sheet and income statement amounts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary assets and liabilities</td>
<td>Current exchange rate</td>
</tr>
<tr>
<td>Nonmonetary assets and liabilities</td>
<td>Historical exchange rate</td>
</tr>
<tr>
<td>Revenue and expense items</td>
<td>Weighted-average or historical exchange rate</td>
</tr>
</tbody>
</table>

Remeasurement of various balance sheet and income statement items by using different exchange rates will generally cause the balance sheet to not balance; unlike the translation adjustment, the adjustment required to bring the balance sheet into balance is usually recorded through the income statement.

Regardless of an entity's functional currency for financial reporting purposes, its tax return is generally prepared in the local currency. Therefore, an entity's tax basis in an asset or liability is also typically established in the local currency. As a result, the remeasurement gains and losses noted above are generally never taxable or deductible in the local jurisdiction and, hence, represent a permanent difference, as discussed in more detail below.

**Example 9-1**

**Remeasurement — Monetary**

Entity S is a foreign subsidiary of Entity X. The functional currency (FC) of S is the euro, which is not the local currency (LC). Assume the following:

- On January 1, 20X1, S obtains a 500,000 LC loan from a third party (i.e., monetary liability) when the exchange rate is 1 LC to 1 FC.
- Entity S's tax basis in the loan is 500,000 LC on January 1, 20X1.
- On December 31, 20X2, the exchange rate is 1 LC to 2 FC.

On December 31, 20X2, S remeasures the liability from its local-currency-denominated value of 500,000 LC to 1 million FC. The remeasured value results in an unrealized pretax remeasurement loss of 500,000 FC for financial reporting purposes. However, there is no change in book/tax basis difference since the amount required to settle the liability (500,000 LC = 1 million FC ÷ 2) and the tax basis (500,000 LC) has not changed. Therefore, although the fluctuations in the exchange rate resulted in a pretax loss for financial reporting purposes, S would not record any deferred taxes (i.e., remeasurement loss represents a permanent item since it is not deductible for income tax reporting purposes).

**Connecting the Dots**

Because the tax return is generally prepared in the local currency (and taxable income therefore is determined in the local currency), an entity must also calculate the temporary differences in the local currency to determine the amount that will ultimately result in an increase or decrease to taxes payable in future years.
A fundamental assumption in ASC 740 regarding the accounting for temporary differences is that assets will be recovered and liabilities will be settled at their respective book basis, which is determined in the entity's functional currency. Therefore, if the functional currency is different from the local currency, changes in the exchange rate will also change the amount of local currency revenues necessary to recover or settle the book basis of an asset or liability; however, the local currency tax basis will not have changed. In addition, because temporary differences (i.e., the deductible/taxable difference between the book basis and tax basis) must be determined in the local currency, fluctuations in exchanges will affect the book basis of an asset or liability when calculated in the local currency.

The income tax accounting for nonmonetary and monetary assets and liabilities is discussed in further detail in the sections below.

### 9.2.1 Nonmonetary Assets and Liabilities

When the functional currency is not the local currency, an entity is required to remeasure nonmonetary assets and liabilities (e.g., PP&E) 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 9-2

**Temporary Differences Not Recognized Under ASC 740**

Entity S is a foreign subsidiary of Entity P. The FC of S is USD, which is not the LC. Assume the following:

- On January 1, 20X1, S purchases a piece of equipment for 500,000 LC when the exchange rate is 1 USD to 1.25 LC (i.e., FC book basis is 400,000 USD).
- The equipment is depreciable over 10 years for both financial reporting and tax purposes.
- The foreign tax basis and book basis in the asset is 500,000 LC (the amount paid to acquire the asset). Therefore, no temporary difference exists at the time of purchase.
- The exchange rate on December 31, 20X1, is 1 USD to 1.5 LC.
- The tax rate in S’s jurisdiction is 30 percent.

In this example, if S were to sell the equipment for its functional currency book basis of $360,000 ($400,000 historical cost less $40,000 of accumulated depreciation) as of December 31, 20X1, S would not recognize any book gain or loss in its functional currency financial statements. However, S would realize a taxable gain of 90,000 LC in its local tax return, as illustrated in the following table:

| Financial-reporting carrying value of the equipment | 360,000 USD |
| Spot rate on December 31, 20X1 | 1.5 |
| Hypothetical sale proceeds | 540,000 LC |
| Tax basis | 450,000 LC |
| Taxable gain (loss) | 90,000 LC |

The difference between the local-currency-denominated hypothetical sale proceeds and the tax basis meets the definition of a temporary difference. However, because ASC 740-10-25-3(f) prohibits the recognition of deferred taxes associated with differences related to nonmonetary assets and liabilities that are caused by changes in the exchange rate, S should not record deferred taxes for the 90,000 LC basis difference.

In this example, there are no other differences between the local currency book basis and the local currency tax basis of the equipment that would give rise to deferred taxes.

Example 9-3

**Temporary Differences Recognized Under ASC 740**

Assume the same facts as in Example 9-2 above, except:

- The equipment is depreciated over five years for tax purposes.
- The weighted-average exchange rate during 20X1 is 1 USD to 1.35 LC.
Example 9-3 (continued)

As of December 31, 20X1, S measures the deferred taxes related to the equipment, as illustrated in the following table (all amounts are in local currency):

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>Temporary Difference</th>
<th>DTA (DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis as of January 1, 20X1</td>
<td>500,000</td>
<td>500,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>20X1 depreciation expense</td>
<td>50,000</td>
<td>100,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Basis as of December 31, 20X1</td>
<td>450,000</td>
<td>400,000</td>
<td>(50,000)</td>
<td>(15,000)</td>
</tr>
</tbody>
</table>

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 local currency book basis and local currency tax basis caused by the difference in depreciation methods. The DTL is then remeasured into the functional currency at the reporting-date spot rate. In addition, S recognizes a deferred tax expense of 15,000 LC in 20X1 as a result of the increase in the DTL, which is then remeasured into the functional currency at the weighted-average exchange rate in effect during 20X1. The difference between these two amounts results in a foreign currency transaction gain during 20X1, as illustrated in the following table:

<table>
<thead>
<tr>
<th></th>
<th>LC</th>
<th>Exchange Rate</th>
<th>FC</th>
<th>Transaction Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning-of-year DTL at beginning-of-year rate</td>
<td>—</td>
<td>1.25</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Beginning-of-year DTL at end-of-year rate</td>
<td>—</td>
<td>1.5</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Foreign currency transaction gain (loss)</td>
<td>—</td>
<td></td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Deferred tax expense at weighted-average rate</td>
<td>(15,000)</td>
<td>1.35</td>
<td>(11,111)</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense at end-of-year rate</td>
<td>(15,000)</td>
<td>1.5</td>
<td>(10,000)</td>
<td></td>
</tr>
<tr>
<td>Foreign currency transaction gain (loss)</td>
<td></td>
<td></td>
<td></td>
<td>1,111</td>
</tr>
<tr>
<td>Total foreign currency transaction gain (loss)</td>
<td></td>
<td></td>
<td></td>
<td>1,111</td>
</tr>
</tbody>
</table>

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.

9.2.2 Indexing of the Tax Basis of Nonmonetary Assets and Liabilities

In addition to fluctuations in the exchange rate, basis differences may arise for nonmonetary assets and liabilities as a result of indexing that is permitted or required under the local tax law. Specifically, certain countries (especially those with economies that are considered highly inflationary) 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 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” (emphasis added).

As discussed in Section 9.2, under ASC 830, assets and liabilities are remeasured when the local currency and the functional currency are not the same. The exception in ASC 740-10-25-3(f) applies only with respect to nonmonetary assets and liabilities when the parent remeasures the foreign entity's financial statements from the local currency into the functional currency (i.e., by using historical exchange rates). DTAs and DTLs are considered to be monetary assets and liabilities,1 and therefore, the prohibition in ASC 740-10-25-3(f) would not apply to the indexation of NOL carryforwards, if permitted. 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 9-4 below illustrates this concept.

Example 9-4

Assume that X, an entity reporting under U.S. GAAP in USD, has operations in a foreign country in which the local currency is the functional currency. At the beginning of 20X2, the foreign jurisdiction enacts tax legislation that increases 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 FC units for tax and financial reporting purposes; the foreign tax rate is 50 percent; and the current exchange rate between the foreign currency and the USD is 2 FC to $1.

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] × 50%) in the foreign currency books of record. That DTA would be translated as $25 (50 FC × 0.5) on the basis of the current exchange rate.

9.2.3 Monetary Assets and Liabilities When the Reporting Currency Is the Functional Currency

As stated above, 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 different from the local currency (e.g., the 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.

9.2.3.1 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.

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1 Paragraph 54 of FASB Statement 52 (not codified).
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 exist only 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 ETR (i.e., pretax income or loss with no related tax expense or benefit).

### Example 9-5

#### Local-Currency-Denominated Debt

Entity A, a foreign entity located in Canada, has a U.S. parent that uses the 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 obtains a loan for CAD 100 million from its U.S. parent when the exchange rate is USD 1 to CAD 1.25. The exchange rate on December 31, 20X5, is USD 1 to 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 (there are equal and offsetting pretax amounts) and no Canadian tax effect for A; however, there will be a tax effect for the U.S. parent, which will affect the ETR.

### 9.2.3.2 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, 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 ETR that should be appropriately disclosed in the footnotes to the financial statements.

### Example 9-6

**Reporting-Currency-Denominated Debt**

Assume the same facts as in Example 9-5 except that the loan is denominated in USD and A’s tax rate is 30 percent.

On September 30, 20X5, the date of the borrowing, A records the loan at its USD-equivalent value of USD 100 million. Entity A’s initial tax basis in the loan is CAD 125 million, the local-currency equivalent of the amount borrowed, which is calculated by using the exchange rate in effect on the date of the borrowing (USD 100 million × 1.25).
Example 9-6 (continued)

On December 31, 20X5, the financial-reporting carrying value of the loan is still USD 100 million since the loan is denominated in the functional currency. However, the local-currency-equivalent value of the loan has changed to CAD 133 million as a result of the fluctuation in the exchange rate. Therefore, the change in the exchange rate has created an unrealized tax loss of CAD 8 million (equal to the difference between the book and tax basis of the loan when converted into the local currency).

If A is taxed under the settlement approach, it would record a DTA of CAD 2.4 million, which is equal to the tax effect of the difference between the tax basis of the loan and the local-currency-equivalent value on December 31, 20X5 ([CAD 125 million – CAD 133 million] × 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 9-5) 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 9-5, there are equal and offsetting pretax amounts; in this example [Example 9-6], 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 ETR, since there is a tax effect with no corresponding pretax amount; however, see Section 9.7 for a possible exception). In Example 9-5, the loan is denominated in CAD so the tax effect is in the U.S. parent; in this example (Example 9-6), the loan is denominated in USD so the tax effect is in A.

### 9.3 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.”

The following graphic illustrates the calculation of deferred tax expense or benefit:

9.4 Cumulative Translation Account Overview

Under ASC 830-30, all financial statement elements must be translated from the functional currency to the reporting currency by using a current exchange rate, which ASC 830-30-45-4 defines as “the rate as of the end of the period covered by the financial statements or as of the dates of recognition in those statements in the case of revenues, expenses, gains, and losses.” For practical reasons, ASC 830 permits the use of weighted-average exchange rates or other methods that provide a reasonable approximation of the rates in effect on the date of recognition.

The following is a summary of the exchange rates used in the translation process:

<table>
<thead>
<tr>
<th>Current</th>
<th>Historical</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Assets</td>
<td>• Common stock</td>
<td>• Revenues</td>
</tr>
<tr>
<td>• Liabilities</td>
<td>• Preferred stock</td>
<td>• Expenses</td>
</tr>
<tr>
<td></td>
<td>• APIC</td>
<td>• Gains</td>
</tr>
<tr>
<td></td>
<td>• Dividends</td>
<td>• Losses</td>
</tr>
<tr>
<td></td>
<td>• Beginning retained earnings</td>
<td>• Change in retained earnings from net income</td>
</tr>
</tbody>
</table>

9.4.1 Recognition of Deferred Taxes for Temporary Differences Related to the CTA

As stated above, 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 often creates basis 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 may be 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 9-7 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 affect 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 9-7**

Assume that Entity X, a calendar-year U.S. entity whose reporting currency is USD, has a majority-owned subsidiary, S, located in the United Kingdom, and that S’s functional currency is the British pound. In addition, assume that as of December 31, 20X1, S’s net assets subject to translation under ASC 830 are 1,100 British pounds, the exchange rate between USD and the British 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,” which was also 1 to 1.

Moreover, assume that on December 31, 20X2, S’s common stock subject to translation is unchanged at 1,000 British pounds, S’s undistributed earnings for 20X2 are 200 British pounds (the total undistributed earnings as of December 31, 20X2, are 300 British pounds), and the weighted-average exchange rate during the year between USD and the British pound remained at 1 to 1. As of December 31, 20X2, however, the exchange rate is 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 (inclusive of the CTA). Thus, in accordance with ASC 740-10-25-3(a)(1), no DTL is recognized on the portion of the outside basis difference related to the undistributed earnings of S (inclusive of the CTA). Further, in accordance with ASC 830-30-45-21, no deferred taxes are provided on the translation adjustments related to the common stock.

However, if X does not have the intent and ability to indefinitely reinvest S’s earnings (although X believes that its original investment in S is considered indefinite under ASC 740-30), a DTL should be recorded for the portion of the outside basis difference related to unremitted earnings, including the $300 translation adjustment on the earnings (on the basis of a weighted average of exchange rates for the period). However, X would not have to record a DTL for the $1,000 of CTA related to the 1,000 British pounds of common stock.

Note that after the enactment date of the Tax Cuts and Jobs Act, undistributed earnings may not give rise to a taxable outside basis difference because such earnings are/were immediately includable in an entity’s U.S. taxable income (whether as a result of (1) the entity’s deemed repatriation tax (IRC Section 965) or (2) deemed repatriation as a GILTI inclusion or Subpart F inclusion in the year earned) or are eligible for the IRC Section 245A dividends received deduction when the entity is measuring the U.S. DTL.

When a DTL or DTA related to a parent entity’s cumulative foreign currency translation adjustments is recognized, the tax consequences of foreign currency exchange translations are generally in accordance with the intraperiod allocation rules, reported as a component of the CTA account in accordance with ASC 740-20-45-11(b).

See [Chapter 6](#) for a detailed discussion of intraperiod allocation.
9.5 **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), because the tax consequences are generally recognized upon settlement (e.g., settlement at the end of a contract period or repayment of a loan). Therefore, usually 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. In accordance with the intraperiod allocation rules, specifically ASC 740-20-45-11(b), the tax consequences of establishing a DTA or DTL in hedging transactions are typically reported as a component of the CTA.

9.6 **Changes in an Entity's Functional Currency**

An entity may determine that it needs to change its functional currency as a result of significant changes in economic facts and circumstances. For example, changes in functional currency may result from one-time transactions, such as a merger or acquisition, or from a longer-term shift in an entity's operations.

In addition, when the economy in the country in which a foreign entity operates becomes highly inflationary, the entity must change its functional currency to its immediate parent’s reporting currency (e.g., USD). Likewise, when the economy in the country in which a foreign entity operates ceases to be highly inflationary, the entity should discontinue using its immediate parent's reporting currency as its functional currency, provided that the entity's facts and circumstances have not changed in such a way that its functional currency should now be the same as the reporting currency used for highly inflationary accounting (e.g., analysis of the economic indicators described in ASC 830-10 results in the determination that the entity’s functional currency should be that of its parent regardless of the inflationary status of its local economy).

Regardless of the reason, ASC 830 requires entities to account for the effects of a change in the functional currency by remeasuring the carrying value of their assets and liabilities into the new functional currency. ASC 830-740 addresses the accounting for the income tax effects related to a change in the functional currency, which differs depending on whether the functional currency changed to or from the reporting currency.

**9.6.1 Changes From the Local Currency to the Reporting Currency**

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 [Section 9.2.1](#), 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 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), excluding the effects of indexing. As
discussed in Section 9.2.2, certain countries (especially those that are considered highly inflationary)
permit the tax basis of assets to be indexed. ASC 830-10-45-16 states, in part:

[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.

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 current-period tax benefit and a favorable permanent difference. Therefore, the excess
tax depreciation (because of unrecognized indexing) will result in a lower ETR 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 recognition
of the tax benefit related to indexing to shift from the period in which the indexing occurs to the period
in which the additional tax basis is depreciated or amortized (even when the resulting deduction
increases an NOL carryforward).
**Example 9-8**

Entity A, a foreign entity, uses the LC as its functional currency. Entity A’s parent is a U.S. entity that uses USD as its reporting currency. On January 1, 20X5, A acquires a piece of equipment for 1 million 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), which is depreciated over the remaining tax life of the equipment. 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 local currency):

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>Book Basis</th>
<th>Temporary Difference</th>
<th>DTA / (DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis on January 1, 20X5</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>—</td>
</tr>
<tr>
<td>20X5 depreciation expense</td>
<td>250,000</td>
<td>250,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>750,000</td>
<td>750,000</td>
<td>—</td>
</tr>
<tr>
<td>20X5 indexing</td>
<td>112,500</td>
<td>—</td>
<td>112,500</td>
</tr>
<tr>
<td>Basis on December 31, 20X5</td>
<td>862,500</td>
<td>750,000</td>
<td>112,500</td>
</tr>
</tbody>
</table>

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). The exchange rate on January 1, 20X6, is 1 USD to 5 FC, the average exchange rate for 20X6 is 1 USD to 12.5 FC, and the exchange rate on December 31, 20X6, is 1 USD to 20 FC. 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 local currency):

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>Not Recognized Under ASC 740</th>
<th>Recognized Under ASC 740</th>
<th>Book Basis</th>
<th>Temporary Difference</th>
<th>DTA / (DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis on January 1, 20X6</td>
<td>—</td>
<td>862,500</td>
<td>750,000</td>
<td>112,500</td>
<td>45,000</td>
</tr>
<tr>
<td>20X6 depreciation expense</td>
<td>—</td>
<td>287,500</td>
<td>250,000</td>
<td>37,500</td>
<td>(15,000)</td>
</tr>
<tr>
<td></td>
<td>—</td>
<td>575,000</td>
<td>500,000</td>
<td>75,000</td>
<td>30,000</td>
</tr>
<tr>
<td>20X6 indexing</td>
<td>86,250</td>
<td>—</td>
<td>—</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Basis on December 31, 20X6</td>
<td>86,250</td>
<td>575,000</td>
<td>500,000</td>
<td>75,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>
Example 9-8 (continued)

On December 31, 20X6, A would recognize a DTA of 30,000 LC (temporary difference of 75,000 LC × 40% tax rate). The change in the local currency DTA from the beginning of the year to the end of the year would be recognized at the average exchange rate (to determine the amount to recognize as an income tax expense) (45,000 LC − 30,000 LC = 15,000 LC ÷ 12.5 = $1,200), and the end-of-year local currency DTA would then be converted at the exchange rate in effect on December 31, 20X6; any difference between the change in the USD beginning-of-the-year DTA ($9,000 = 45,000 LC ÷ 5) and the USD end-of-year DTA ($1,500 = 30,000 LC ÷ 20) and the amount recognized as an income tax expense ($1,200) would be included in the income statement ($6,300 = [$9,000 − $1,500] − $1,200). Under ASC 830-740-45-1, A may present the transaction gain or loss that results from remeasuring the DTA (i.e., $6,300) 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 37,500 LC more tax depreciation than book depreciation. 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). 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 because the equipment is remeasured from the local currency into the functional currency by using historical exchange rates (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 local currency):

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>Not Recognized Under ASC 740</th>
<th>Recognized Under ASC 740</th>
<th>Book Basis</th>
<th>Temporary Difference</th>
<th>DTA / (DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis on January 1, 20X7</td>
<td>86,250</td>
<td>575,000</td>
<td>500,000</td>
<td>75,000</td>
<td>30,000</td>
</tr>
<tr>
<td>20X7 depreciation expense</td>
<td>43,125</td>
<td>287,500</td>
<td>250,000</td>
<td>37,500</td>
<td>(15,000)</td>
</tr>
<tr>
<td>20X7 indexing</td>
<td>49,594</td>
<td>287,500</td>
<td>250,000</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Basis on December 31, 20X7</td>
<td>92,719</td>
<td>287,500</td>
<td>250,000</td>
<td>37,500</td>
<td>15,000</td>
</tr>
</tbody>
</table>

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 9-8 (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. 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 ETR 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 LC × 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.

9.6.2 Change in the Functional Currency When an Economy Ceases to Be Considered Highly Inflationary

As discussed above, 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 9-9 below illustrates this concept.

Example 9-9

A foreign subsidiary of a U.S. entity operating in a highly inflationary economy purchases equipment with a 10-year useful life for 100,000 LC on January 1, 20X1. The exchange rate on the purchase date is 10 LC to $1, so USD-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 1 USD. 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 USD and the foreign currency on the date of purchase).

3 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.
At the beginning of 20X6, the economy in which the subsidiary operates ceases to be considered highly inflationary. Accordingly, assuming the functional currency and local currency are now the same, the foreign subsidiary would establish a new functional currency accounting basis for the equipment 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 1 USD. The new functional currency accounting basis on the date of change would be 375,000 LC (5,000 × 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 LC × 50%) would be recorded on the local books of record. That DTL would then be translated at the current exchange rate between USD and the local currency and reported as $2,167 in the consolidated financial statements (162,500 LC ÷ 75) with a corresponding charge to the cumulative translation account. The foreign subsidiary would compare the functional currency book basis with the tax basis prospectively to determine the temporary difference and change in the DTL recognized.

9.7 Long-Term Intra-Entity Loans to Foreign Subsidiaries

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 for financial reporting purposes 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 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. The sections below discuss in further detail the income tax accounting for a loan that is of a long-term investment nature.

9.7.1 Deferred Tax Considerations When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Denominated in the Subsidiary’s Functional Currency

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 in Section 9.7.1.1 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.

**9.7.1.1 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 be recognized for the loan-related temporary difference only 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 the intraperiod allocation rules, specifically ASC 740-20-45-11(b), deferred income tax expense or benefit related to an unrealized exchange gain or loss with respect to the loan would generally be allocated to the CTA account within OCI.
9.7.2 Deferred Tax Considerations When Intra-Entity Loans That Are of a Long-Term-Investment Nature Are Denominated in the Parent’s Functional Currency

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”).

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 generally 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 Section 9.2.3.

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 recognition of 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.

### 9.8 Changes in U.S. Deferred Income Taxes Related to a Foreign Branch CTA

As discussed in Section 3.3.6.3, a branch is subject to taxation in two countries; therefore, it will generally have in-country temporary differences and U.S. temporary differences. Further, 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 USD. When the U.S. parent uses the 1991 proposed regulations under IRC Section 987, the branch's taxable income or loss is 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

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5 On December 7, 2016, the IRS and the U.S. Treasury issued new final and temporary regulations under IRC Section 987 (the “2016 Regulations”) with a prospective effective date. The IRS subsequently issued additional guidance that further deferred the prospective effective date of the regulations and withdrew a portion of the temporary regulations. For reporting periods including and after the issuance of the 2016 Regulations, entities will generally need to adjust their computation of deferred taxes related to IRC Section 987.
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.

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**Example 9-10**

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 USD, and that of Branch Co. is the British pound. Parent Co. is subject to tax in the United States at 21 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. and U.K. income tax reporting purposes, Branch Co. has a taxable temporary difference of £100,000 because of 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. uses the 1991 proposed regulations to determine its IRC Section 987 gain/loss.
Example 9-10 (continued)

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

<table>
<thead>
<tr>
<th>U.S. Temporary Difference</th>
<th>Beginning of Year</th>
<th>Calendar Year</th>
<th>End of Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>—</td>
<td>(£100,000)</td>
<td>(£100,000)</td>
</tr>
<tr>
<td>Tax rate</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
</tr>
<tr>
<td>DTL</td>
<td>—</td>
<td>(£21,000)</td>
<td>(£21,000)</td>
</tr>
<tr>
<td>Branch taxes — anticipatory FTCs (DTA)</td>
<td>—</td>
<td>£20,000</td>
<td>£20,000</td>
</tr>
<tr>
<td>Net DTL</td>
<td>—</td>
<td>(£1,000)</td>
<td>(£1,000)</td>
</tr>
<tr>
<td>Year-end spot exchange rate</td>
<td></td>
<td></td>
<td>1.2</td>
</tr>
<tr>
<td>U.S. DTA (DTL) required on December 31, 20X6</td>
<td></td>
<td></td>
<td>($1,200)</td>
</tr>
<tr>
<td>U.S. beginning-of-year DTA (DTL) plus change in U.S. DTA/DTL recognized at weighted average during 20X6</td>
<td></td>
<td></td>
<td>($1,300)</td>
</tr>
<tr>
<td>Adjustment required</td>
<td></td>
<td></td>
<td>$100</td>
</tr>
</tbody>
</table>

To record the currency adjustment of $100, Parent Co. would make the following journal entries:

**Journal Entry: View A and B**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>1,300</td>
</tr>
<tr>
<td>DTA (anticipatory FTCs) (£20,000 × 1.3)</td>
<td>26,000</td>
</tr>
<tr>
<td>DTL (fixed assets) (£21,000 × 1.3)</td>
<td>27,300</td>
</tr>
</tbody>
</table>

**Journal Entry 2: View A**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>100</td>
</tr>
<tr>
<td>CTA</td>
<td>100</td>
</tr>
</tbody>
</table>

**Journal Entry 2: View B**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>100</td>
</tr>
</tbody>
</table>

Transaction gain or deferred tax benefit | 100 |
10.1 Background and Scope

ASC 718-740

Overview and Background
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.

Scope and Scope Exceptions
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.

15-2 The guidance in this Subtopic applies to share-based payment transactions with both employees and nonemployees.

Pending Content (Transition Guidance: ASC 718-10-65-11)
15-2 The guidance in this Subtopic applies to share-based payment transactions.

Understanding the tax law relevant to share-based payment awards is critical to understanding the proper accounting for the income tax effects of such awards. An entity must carefully consider the specific facts and circumstances of its share-based payment awards to determine the appropriate income tax treatment for them, and consultation with the entity's tax advisers is encouraged. Taxation of transfers of property (including shares) to employees and vendors in connection with performance of
services and delivery of goods is generally governed by IRC Section 83. This chapter summarizes U.S. tax law related to share-based payment awards under IRC Section 83.

10.1.1 Nonvested Shares
Under IRC Section 83, the grantee of a nonvested share award is generally taxed on the date the grantee vests in the share for income tax purposes (which may be different from the vesting date for accounting purposes). The fair market value of the share on the income tax vesting date is treated as ordinary income for the grantee, and the employer generally will receive a corresponding deduction on that date.

10.1.2 Share Options
For share options, taxation depends on whether the transfer of shares resulting from exercise of the option is considered a qualifying transfer under IRC Sections 421 and 422.

For the transfer of shares resulting from the exercise of an option to be considered a qualifying transfer, the following must be true of the option and option plan:

- The option plan is approved by the stockholders of the company.
- The option is granted within 10 years of adoption of the plan or, if earlier, the date on which the stockholders approve the plan.
- The maximum term of the option is 10 years from the grant date. For employees who 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 5 years.
- The option price is not less than the fair market value of the stock at the time the option is granted. For employees who own more than 10 percent of the total combined voting power of the employer or of its parent or subsidiary, 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.

Share options that meet these criteria are commonly referred to as ISOs or qualified options, and shares transferred or issued in connection with the exercise of such options are referred to as statutory option stock. Options that do not meet these criteria are commonly referred to as nonqualified options (NQSOs). ISOs may be issued only to employees, whereas NQSOs may be issued to nonemployees.

To continue being considered as a qualifying transfer, the transfer of shares resulting from the exercise of an option must meet the criteria above, and the individual acquiring statutory option stock may not dispose of it 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 transfer is no longer considered a qualifying transfer. Also, the maximum amount of ISOs that may first become exercisable by an employee in a calendar year is $100,000. That maximum is determined by reference to the fair market value of the shares underlying the option on the grant date (i.e., the fair value of the shares, not the fair value of the option, on the grant date). Generally, options to acquire shares that exceed the maximum should be treated as NQSOs.
10.1.2.1 Qualifying Transfers

Qualifying transfers receive favorable tax treatment from the perspective of the employee. These transfers are not taxable to the employee (or former employee) for “regular” tax purposes until the statutory option stock has been disposed of (although there may be AMT consequences — see the next paragraph). Upon disposition of the stock, 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.

Under the tax law, an individual must recognize a “tax preference” item upon exercise of an ISO 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 below). An employer does not receive a deduction corresponding with an employee’s AMT liability upon exercise of an ISO.

10.1.2.2 Nonqualifying Transfers

If the transfer is considered nonqualifying because the terms of the award preclude it from being considered an ISO, the intrinsic value of the option on the date of exercise is included in the employee’s ordinary income and the employer receives a corresponding deduction.

If the transfer is considered nonqualifying because of a disqualifying disposition, the lesser of (1) the excess of the fair market value of the stock on the exercise date over the strike price or (2) the actual gain on sale is included in the employee’s ordinary income as compensation in the year of the disqualifying disposition. The employer receives a tax deduction for the amount of income included by the employee.

10.1.3 Restricted Share Units and SARs

Share-settled RSUs and share appreciation rights (SARs) are both generally taxed when the shares are transferred in settlement of the award. Taxation of share-settled RSUs is the same as that for deferred compensation, resulting in ordinary income for the employee equal to the value of shares when distributed and a corresponding deduction for the employer. RSUs are not considered legally issued shares and therefore do not represent actual property interests (e.g., equity in the company). Unlike nonvested shares, RSUs can be structured to defer income beyond the vesting date.

Taxation of SARs is similar to that of NQSOs. Like NQSOs, SARs result in income on “exercise” or settlement. The employee has ordinary income on the basis of the fair value of the cash or shares transferred at settlement, and the employer receives a corresponding deduction.

10.1.4 ESPPs

Employees may also have the option to acquire stock of their employer in accordance with an employee stock purchase plan (ESPP). In a manner similar to ISOs, the acquisition of stock in connection with an ESPP that meets the criteria in IRC Section 423 also generally does not result in income to the employee at the time the stock is purchased. Therefore, the employer would not ordinarily receive a deduction related to shares purchased under an ESPP unless a disqualifying disposition occurs. The maximum amount of stock that can be purchased under an ESPP is $25,000 per year.
10.2 Deferred Tax Effects of Share-Based Payments

<table>
<thead>
<tr>
<th>ASC 718-740</th>
</tr>
</thead>
</table>

**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.

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 718-10-65-11)</th>
</tr>
</thead>
</table>

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 25-19A. 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.

**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.

**Initial Measurement**

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.

10.2.1 Equity-Classified Awards That Ordinarily Result in a Deduction

ASC 718-740-25-2 indicates that 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 [ASC 740] (emphasis added). This represents the first of two key exceptions to ASC 740’s balance sheet model contained in ASC 718 (see Section 10.2.10 for discussion of the second). Because the accounting for an equity award under ASC 718 does not result in a difference in the basis of an asset or liability recognized for income tax or financial reporting purposes (i.e., because the offsetting entry to compensation cost is equity of the issuer), no temporary basis difference would exist, and therefore no deferred taxes would be recorded for such an award. ASC 718-740-25-2, however, requires that the cumulative amount of compensation cost itself be considered a deductible temporary difference for which a DTA is recorded.

As described in Section 10.1, examples of awards that ordinarily would result in a future tax deduction under U.S. tax law include nonvested shares, SARs, RSUs, and NQSOs.
10.2.2 Liability-Classified Awards That Ordinarily Result in a Deduction

As indicated in ASC 718-740-25-4, the accounting for liability-classified awards that would ordinarily result in a deduction is the same as that for equity-classified awards. That is, the cumulative amount of compensation cost recognized for financial reporting purposes represents a deductible temporary difference for which a DTA is recorded. While ASC 718-740 does not make a distinction between equity- and liability-classified awards for this purpose, the deferred tax accounting for liability awards does not represent an exception to the balance sheet model under ASC 740 because the cumulative amount of compensation cost recorded for financial reporting purposes under ASC 718 does result in a temporary difference (i.e., a liability recorded for financial reporting purposes with no corresponding liability for tax purposes).

Example 10-1 below illustrates the basic deferred income tax effects of deductible, equity-classified share-based payment awards when the amount of cumulative compensation cost and the ultimate amount of the associated deduction are equal.

Example 10-1

Assume the following:

- Company A grants 100 equity-classified NQSOs on its $0.01 par value common stock to its employees in 20X1.
- The strike price of the options is equal to the fair value of A’s common stock of $5 on the grant date. The fair value of the options on the grant date is $4.
- The options vest at the end of the fourth year of service (cliff vesting).
- The options are exercised immediately after the completion of the four-year vesting period, when the share price is $9, and A receives a deduction when the options are exercised.
- Company A has a 21 percent tax rate in all years.

Because the $400 of compensation cost (100 awards × $4 fair-value-based measure) that will result in a future deduction is recognized over the requisite service period, a temporary difference arises, and A records a DTA in accordance with ASC 740. This DTA is equal to the book compensation cost multiplied by A’s applicable tax rate. The effect of forfeitures is ignored for simplicity in this example. Therefore, the following journal entries are made at the end of each service year to recognize the compensation cost and tax benefits associated with the options:

**Journal Entries (Years 1–4)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost (25% × $400)</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To recognize compensation cost (25% × $400).

To recognize the DTA for the temporary difference related to compensation cost (100 × 21% = 21).
Example 10-1 (continued)

Upon exercise of the options, the fair value of the company’s stock is $9, resulting in a deduction of $400 for income tax purposes.

**Journal Entry: Pretax Entries Upon Exercise of Options**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash ($5 × 100)</td>
<td>500</td>
</tr>
<tr>
<td>APIC</td>
<td>499</td>
</tr>
<tr>
<td>Common stock (100 × $0.01)</td>
<td>1</td>
</tr>
</tbody>
</table>

To record the receipt of cash for the exercise price and recognize the issuance of common stock.

**Journal Entries: Tax Effects of Exercise of Options**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax payable</td>
<td>84</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>84</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>84</td>
</tr>
<tr>
<td>DTA</td>
<td>84</td>
</tr>
</tbody>
</table>

To reverse the DTA and adjust the income tax payable. Because the cumulative compensation cost and the amount of the deduction upon exercise of the options are equal, there is no net impact to income tax expense or benefit as a result of the exercise.

### 10.2.3 Determining Deductibility of Awards Under IRC Section 162(m)

IRC Section 162(m) may limit the deductibility of an ordinarily deductible share-based payment award. The statute specifically limits the deductibility of compensation paid to a company’s CEO and CFO as well as its three other highest paid officers (referred to collectively as the “covered employees”). Under IRC Section 162(m), only the first $1 million in compensation (whether cash or share based) paid to a covered employee is deductible for tax purposes in a given year. Before the enactment of the Tax Cuts and Jobs Act (the “Act”) in 2017, compensation that was performance based was not subject to this limitation, thereby lessening the impact of IRC Section 162(m) on executive compensation given that performance-based compensation is common for covered employees.

The Act modified IRC Section 162(m) by (1) expanding which employees are considered covered employees by including the CFO; (2) providing that if an individual is a covered employee for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years; and (3) removing the exceptions for commissions and performance-based compensation. These changes do not apply to compensation stemming from contracts entered into on or before November 2, 2017, unless such contracts were materially modified on or after that date. Compensation agreements entered into and share-based payment awards granted after that date will be subject to the revised terms of IRC Section 162(m) and, as a result, may be more significantly limited in their deductibility. Further, DTAs related to compensation arrangements existing as of the effective date of the Act are unlikely to require remeasurement; however, measurement of any new DTAs resulting from new

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1 The tax deduction represents 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.
2 The Act contains explicit wording indicating that material modifications made to a compensation agreement on or after November 2, 2017, will cause the agreement to become subject to the updated requirements of IRC Section 162(m). Judgment may be required in the determination of whether a modification is material. Further, if a modified compensation agreement is related to a share-based payment award, companies will need to consider whether the modification guidance in ASC 718-20 should be applied.
compensation arrangements entered into after November 2, 2017, will be subject to the provisions of IRC Section 162(m), as amended by the Act.

Because IRC Section 162(m) applies to all types of compensation issued to covered employees, it may be difficult to determine the extent to which the share-based component of the covered employees’ compensation is limited by IRC Section 162(m). We are aware of three approaches that have been commonly applied in practice both before and since enactment of the Act regarding the accounting for deferred taxes in cases in which compensation is expected to be limited by IRC Section 162(m). These approaches are as follows:

- **Deductible compensation is allocated to cash compensation first** — A DTA would not be recorded for share-based compensation if cash compensation is expected to exceed the limit.

- **Deductible compensation is allocated to earliest compensation recognized for financial statement purposes** — Because stock-based compensation is typically expensed over a multiple-year vesting period but deductible when fully vested or exercised, and cash-based compensation is generally deductible in the period in which it is expensed for financial statement purposes, stock-based compensation is generally considered the earliest compensation recognized for financial statement purposes, and a DTA for share-based compensation would be recorded up to the deductible limit.

- **Limitation is allocated pro rata between stock-based compensation and cash compensation** — A partial DTA may result on the basis of the expected ratio of share-based compensation to cash compensation.

The choice of which approach to apply is a policy election that should be applied consistently.

See Section 10.3 for guidance on the accounting for an award subject to IRC Section 162(m) that is determined not to be deductible.

### 10.2.4 Excess Tax Benefits and Tax Deficiencies

**ASC 718-740**

<table>
<thead>
<tr>
<th>Treatment of Tax Consequences When Actual Deductions Differ From Recognized Compensation Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
The tax deduction that arises for an equity-classified share-based payment award will frequently differ from the amount of compensation cost recorded for financial reporting purposes. Such a difference is referred to as an excess tax benefit (when the amount of the deduction is greater than the compensation cost recognized for financial reporting purposes) or as a tax deficiency (when the amount of the deduction is less than the compensation cost recognized for financial reporting purposes). In accordance with ASC 718-740-35-2, the excess tax benefits and tax deficiencies are recognized as decreases or increases to current tax expense in the income statement in the period in which the excess tax benefits or tax deficiencies arise. This results in a permanent difference between the amount of cumulative compensation for financial reporting purposes and the deduction taken for income tax purposes and has an impact on an entity’s ETR in the period in which the excess or deficiency arises. Example 10-2 below illustrates an excess tax benefit and a tax deficiency for a deductible equity-classified award. See Section 10.3 for further discussion of permanent differences associated with share-based payments.

**Example 10-2**

Assume the following:

- Company A grants 100 NQSOs on its $0.01 par value common stock to its employees in 20X1.
- The strike price of the options is equal to the fair value of A’s common stock of $5 on the grant date. The fair value of the options on the grant date is $4.
- The options vest at the end of the fourth year of service (cliff vesting).
- The options are exercised immediately after the completion of the four-year vesting period, when the share price is $10, and A receives a deduction when the options are exercised.
- Company A has a 25 percent tax rate in all years.
Because the $400 of compensation cost (100 awards × $4 fair-value-based measure) that will result in a future deduction is recognized over the requisite service period, a temporary difference arises, and A records a DTA in accordance with ASC 740. This DTA is equal to the book compensation cost multiplied by A’s applicable tax rate. The effect of forfeitures is ignored for simplicity in this example. Therefore, the following journal entries are made at the end of each service year to recognize the compensation cost and tax benefits associated with the options:

**Journal Entries (Years 1–4)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost (25% × $400)</td>
<td>100</td>
<td>To recognize compensation cost (25% × $400).</td>
</tr>
<tr>
<td>APIC</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>25</td>
<td>To recognize the DTA for the temporary difference related to compensation cost (100 × 25% = 25).</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>25</td>
<td></td>
</tr>
</tbody>
</table>

Upon exercise of the options, the fair value of the company’s stock is $10, resulting in a deduction of $500 for income tax purposes.

**Journal Entry: Pretax Entries Upon Exercise of Options**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash ($5 × 100)</td>
<td>500</td>
<td>To record the receipt of cash for the exercise price and recognize the issuance of common stock.</td>
</tr>
<tr>
<td>APIC</td>
<td>499</td>
<td></td>
</tr>
<tr>
<td>Common stock (100 × $0.01)</td>
<td>1</td>
<td></td>
</tr>
</tbody>
</table>

**Journal Entry: Tax Effects of Exercise of Options**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax payable</td>
<td>125</td>
<td>To reverse the DTA and record the current tax effect. Because the amount of the deduction upon exercise of the options is greater than the cumulative compensation cost, there is a $25 net excess tax benefit impact to the income statement.</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>125</td>
<td></td>
</tr>
</tbody>
</table>

---

3 See footnote 1.
Example 10-2 (continued)

If the share price at the time of exercise was instead $8, a tax deficiency would be recognized as follows:

Journal Entry: Upon Exercise of Options

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax payable</td>
<td>75</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>100</td>
</tr>
<tr>
<td>DTA</td>
<td>100</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>75</td>
</tr>
</tbody>
</table>

To reverse DTA and record the current tax effect. Because the amount of the deduction upon exercise of the options is less than the cumulative compensation cost, there is a $25 net tax deficiency in the income statement.

10.2.4.1 Excess Tax Benefits and Tax Deficiencies in Interim Financial Statements

ASC 740-270-30-4, ASC 740-270-30-8, and ASC 740-270-30-12 require entities to account for excess tax benefits and tax deficiencies as discrete items in the period in which they occur (i.e., entities should exclude them from the AETR). Therefore, the effects of expected future excesses and deficiencies should not be anticipated. The tax effects of the expected compensation expense should be included in the AETR. See Chapter 7 for further guidance on the accounting for income taxes associated with share-based payments in interim financial statements.

10.2.4.2 Tax Deficiency Resulting From Expiration of an Award

When a fully vested NQSO award has expired unexercised, the tax effects are accounted for as if the tax deduction taken is zero. Thus, the DTA recorded in the financial statements would be reduced to zero through a charge to deferred income tax expense. See ASC 718-20-55-23.

Example 10-3

A company grants 1,000 “at-the-money” fully vested NQSOs, each of which has a grant-date fair-value-based measure of $4. The company's applicable tax rate is 25 percent. Further assume that no valuation allowance has been established for the DTA and that the awards subsequently expire unexercised. The company would record the following journal entries:

Journal Entries: Upon Grant

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>4,000</td>
</tr>
<tr>
<td>APIC</td>
<td>4,000</td>
</tr>
</tbody>
</table>

To record compensation cost upon the grant of the award.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To record the tax effects upon the grant of the award.

Journal Entry: Upon Expiration

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>1,000</td>
</tr>
<tr>
<td>DTA</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To reverse the tax effects of unexercised options.
10.2.5 Deferred Tax Effects of a Change in Share Price on Equity-Classified Awards

The DTA associated with stock-based compensation is computed on the basis of the cumulative amount of stock-based compensation cost recorded in the financial statements and is not affected by the grantor's current stock price. Such DTAs should not be remeasured or written off because of a decline in the grantor's stock price, even if it has declined so significantly that (1) an award's exercise is unlikely to occur or (2) the intrinsic value on the exercise date will most likely be less than the cumulative compensation cost recorded in the financial statements.

10.2.6 Deferred Tax Effects of a Change in Share Price on Liability-Classified Awards

The primary difference between the deferred income tax accounting for equity-classified awards and that for liability-classified awards under ASC 718 is that the measurement of the DTA associated with liability-classified awards inherently takes into account the grantor's current stock price in each period. This is because liability-classified awards are remeasured to their fair-value-based amount each period until settlement. The DTA (and corresponding deferred income tax benefit) is recognized in the same manner as the compensation cost (i.e., either immediately or over the remaining service period, depending on the vested status of the award). Because the DTA and the associated compensation cost are remeasured in each reporting period, the tax benefit of the liability-classified award will, upon settlement, equal the DTA. Accordingly, the settlement of a liability-classified award generally will not result in an excess tax benefit or a tax deficiency as described in Section 10.2.4 for equity-classified awards.

Example 10-4 below illustrates the differences between the income tax accounting for deductible equity-classified versus liability-classified awards issued in the form of SARs (including an excess tax benefit).

---

**Example 10-4**

On January 1, 20X1, Company A grants 1,000 SARs to one employee. The SARs vest at the end of the second year of service (cliff vesting). The fair-value-based measures of the SARs are as follows:

- $10 on January 1, 20X1.
- $15 on December 31, 20X1.
- $14 on December 31, 20X2.
- $18 on December 31, 20X3.

For simplicity, the effects of forfeitures have been ignored. Company A's applicable tax rate is 21 percent. There are no interim reporting requirements. In Scenario 1 (see table below), A is required to settle the SARs with shares (equity-classified award). Note that the income tax accounting for an equity-classified SAR is the same as the accounting for an equity-classified NQSO. In Scenario 2 (see table below), A is required to settle the SARs with cash (liability-classified award). The award is settled on May 15, 20X4, and the value of the shares (Scenario 1) and cash (Scenario 2) delivered upon settlement is $16.
### Example 10-4 (continued)

**Scenario 1 — Equity-Classified SARs**

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Compensation Cost</th>
<th>DTA Increase/ (Decrease)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X1</td>
<td>$ 5,000</td>
<td>$ 1,050</td>
<td>Compensation cost is based on the number of SARs granted, the grant-date fair-value-based measure of the equity-classified SARs, and the amount of services rendered in the period (1,000 SARs × $10 grant-date fair-value-based measure × 50%* services rendered). The DTA is based on the compensation cost recognized and A’s income tax rate ($5,000 compensation cost × 21% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>$ 5,000</td>
<td>$ 1,050</td>
<td>Compensation cost is based on the number of SARs granted, the grant-date fair-value-based measure of the equity-classified SARs, and the amount of services rendered (1,000 SARs × $10 grant-date fair-value-based measure × 50% services rendered). The DTA is based on compensation cost recognized and A’s income tax rate ($5,000 compensation cost × 21% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X3</td>
<td>—</td>
<td>—</td>
<td>Remeasurement of equity-classified awards is not required.</td>
</tr>
<tr>
<td>Period from</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>January 1, 20X4,</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>to May 15, 20X4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 10,000</strong></td>
<td><strong>$ 2,100</strong></td>
<td></td>
</tr>
</tbody>
</table>

* In this calculation, 50 percent indicates that the employee is providing one of two years of service.

<table>
<thead>
<tr>
<th>Compensan</th>
<th>Cost</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 15, 20X4</td>
<td>—</td>
<td>Remeasurement of the equity award on settlement is not required. The tax accounting will be based on the tax deduction A receives.</td>
</tr>
</tbody>
</table>

**Journal Entries:**

- **Taxes payable**
  
  *Current tax benefit*: 3,360

- **To adjust current tax expense and taxes payable for the SAR deduction ($16 × 1,000 awards × 21%).**

- **Deferred tax expense**
  
  *DTA*: 2,100

- **To reverse the DTA.**
### Example 10-4 (continued)

#### Scenario 2 — Liability-Classified SARs

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Compensation Cost</th>
<th>DTA Increase/Decrease</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X1</td>
<td>$ 7,500</td>
<td>$ 1,575</td>
<td>Compensation cost is based on the number of SARs granted, the fair-value-based measure of the liability-classified SARs on the reporting date, and the amount of services rendered (1,000 SARs × $15 fair-value-based measure × 50% services rendered). The DTA is based on compensation cost recognized and A's income tax rate ($7,500 compensation cost × 21% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>6,500</td>
<td>1,365</td>
<td>Compensation cost is based on the number of SARs granted, the fair-value-based measure of the liability-classified SARs on the reporting date, and the amount of services rendered, less compensation costs previously recognized ([1,000 SARs × $14 fair-value-based measure × 100% services rendered] – $7,500 compensation cost previously recognized). The DTA is based on the compensation cost recognized and A's income tax rate ($6,500 compensation cost × 21% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X3</td>
<td>4,000</td>
<td>840</td>
<td>Once all services have been provided, the liability-classified SAR is remeasured on each reporting date until the SARs are settled. Remeasurement is based on the number of SARs vested and the fair-value-based measure of the liability-classified SARs on the reporting date, less compensation cost previously recognized ([1,000 SARs × $18 fair-value-based measure] – $14,000 compensation cost previously recognized). Adjustment to the DTA is based on the change in the compensation cost recognized and A's income tax rate ($4,000 compensation cost × 21% income tax rate).</td>
</tr>
<tr>
<td>May 15, 20X4</td>
<td>(2,000)</td>
<td>(420)</td>
<td>Once all services have been provided, the liability is remeasured each reporting date until the award is settled. Remeasurement is based on the number of awards vested and the fair value of the liability award on the reporting date, less amounts previously recognized ([1,000 awards × $16] – 18,000). Adjustment to the DTA is based on the change in the compensation cost recognized and A's income tax rate ($2,000 decrease in compensation cost × 21% income tax rate).</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 16,000</strong></td>
<td><strong>$ 3,360</strong></td>
<td></td>
</tr>
</tbody>
</table>
Example 10-4 (continued)

Comments

<table>
<thead>
<tr>
<th>Tax entries on final settlement</th>
<th>Journal Entries:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxes payable 3,360</td>
</tr>
<tr>
<td></td>
<td>Current tax benefit 3,360</td>
</tr>
<tr>
<td></td>
<td>To record the current tax benefit of the SAR deduction.</td>
</tr>
<tr>
<td></td>
<td>Deferred tax expense 3,360</td>
</tr>
<tr>
<td></td>
<td>DTA 3,360</td>
</tr>
<tr>
<td></td>
<td>To reverse the DTA.</td>
</tr>
</tbody>
</table>

10.2.7 Deferred Tax Effects of a Change in Tax Status of an Award

If an entity has non-tax-deductible awards (e.g., ISOs) that are expected to be subject to disqualifying dispositions, it should follow the guidance under ASC 718-740-25-3, which explains that an entity cannot record a tax benefit in the income statement until the disqualifying disposition of an award occurs. Therefore, no DTA and related tax benefit can be recognized in connection with such an award until a disqualifying disposition occurs.

When a disqualifying disposition occurs, a deduction is available to be taken in the employer’s tax return. The benefit of any tax deduction resulting from the disqualifying disposition would be recorded as a reduction of current-period tax expense in the income statement.

Example 10-5

A company grants a fully vested ISO with a grant-date fair-value-based measure of $100, which is recorded in the income statement as compensation cost. Since the award is an ISO, no corresponding DTA or tax benefit is recorded because the award does not ordinarily result in a tax deduction for the company.

Assume that a disqualifying disposition occurs and results in the company’s taking a deduction of $120 in its tax return. If the company’s applicable tax rate is 25 percent, the company would record a $30 current income tax benefit in the income statement ($120 deduction taken on the income tax return × 25% tax rate).

Example 10-6

Assume the same facts as in Example 10-5 above except that the disqualifying disposition results in a deduction of only $80. If the company’s applicable tax rate is 25 percent, the company would record a tax benefit of $20 as a reduction of current income tax expense in the income statement ($80 deduction taken on the income tax return × 25% tax rate).
10.2.8 Deferred Tax Effects of Changes in Tax Rates

When enacted changes in a tax rate occur, a DTA related to temporary differences arising from tax-deductible share-based payment awards should be adjusted in the period in which the change in the applicable tax rate is enacted into law. To determine the amount of the new DTA, an entity should multiply the new tax rate by the existing temporary difference for outstanding tax-deductible share-based payment awards measured as of the enactment date of the rate change. The difference between the new DTA and the existing DTA should be recorded as a deferred tax benefit or expense and allocated to income from continuing operations. See Section 3.5.1 for a broader discussion of the accounting for deferred tax effects of changes in rates.

10.2.9 Deferred Tax Effects of IRC Section 83(b) Elections and “Early” Exercises of NQSOs

The grantee of a nonvested share may, within 30 days of that grant, make an election under IRC Section 83(b) to be taxed when the award is received (i.e., when the property is transferred) rather than when it vests for tax purposes (commonly referred to as an 83(b) election). In that case, the grantee will have ordinary income equal to the fair value of the stock on the date the award is granted and the employer will receive a corresponding deduction. Any subsequent appreciation realized by the employee upon sale of those shares is taxed at capital gains rates.

Similarly, a grantee of an NQSO may be permitted to exercise the option before it is vested (commonly referred to as an early exercise). The stock received upon an early exercise represents a nonvested share for which the grantee may make an 83(b) election. In this scenario, the grantee will have ordinary income equal to the intrinsic value of the option on the date of the early exercise (which, for options issued at the money, will be zero if early exercised on the grant date) and the employer will receive a corresponding deduction. Such awards often include an employer call feature that allows the issuer to repurchase the option share if the employee leaves before the end of the requisite service period.

When an employee makes an 83(b) election upon receipt of a nonvested share, a DTL should be recorded for the amount of the tax benefit on the basis of the tax deduction that the employer receives. For example, if an employee receives an equity-classified nonvested share with a grant-date fair value of $10 and makes an 83(b) election, the employee will be taxed on ordinary income of $10 and the employer will receive a tax deduction of $10. Assuming a tax rate of 21 percent, the employer would record a current tax benefit (and reduced income tax payable) of $2.10 to account for the deduction. The employer would also record a DTL and deferred tax expense of $2.10 in the period of the grant. The DTL will then be reversed in proportion to the amount of expense recorded over the requisite service period, resulting in a normal rate.

10.2.10 Deferred Tax Effects When Compensation Cost Is Capitalized

Under U.S. GAAP, compensation cost is capitalized for employees who spend time on production of inventory or construction of fixed assets. This results in recording an asset over the requisite service period for financial reporting purposes with no corresponding tax basis and, under ASC 740, would ordinarily represent a taxable temporary difference and corresponding DTL. However, ASC 718-740-25-2 indicates that “[c]ompensation 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.” This represents the second of two key exceptions to ASC 740’s balance sheet model contained in ASC 718 (see Section 10.2.1 for a discussion of the first). As a result of this exception, the book and tax basis of the capitalized compensation cost initially are considered to be equal and no DTL is recorded. If

---

4 Because RSUs do not represent actual property interests (e.g., equity in the company), an employee receiving RSUs does not have an opportunity to make an IRC Section 83(b) election on the grant date.
Depreciation is taken for financial reporting purposes before a deduction (or capitalization) for income tax purposes, a temporary difference will arise. Upon generating a deduction (or upon capitalization) for income tax purposes, an entity should recognize any excess tax benefit or tax deficiency in the income statement.

### Example 10-7

In year 1, Company A grants fully vested NQSOs 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 25 percent.
- The employees exercise the options with an intrinsic value of $4,000 at the end of year 3.
- None of the compensation cost is capitalized for income tax purposes upon exercise.

#### Journal Entry: Grant Date in Year 1

On the grant date, the share-based compensation cost related to the NQSOs increases the carrying amount of A's fixed asset under construction by $1,500. The offsetting entry is a credit to APIC.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed asset</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>1,500</td>
</tr>
</tbody>
</table>

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 $37.50 DTA: \( [($1,500 \text{ tax basis} - $1,350 \text{ book basis}) \times 25\% \text{ tax rate}]. \)

#### Journal Entries: Year 2

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense ($1,500 ÷ 10)</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Accrued depreciation</td>
<td></td>
<td>150</td>
</tr>
<tr>
<td>DTA</td>
<td>37.50</td>
<td></td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td></td>
<td>37.50</td>
</tr>
</tbody>
</table>

#### Journal Entries: Year 3

**Record Depreciation and DTA (Same as Year 2)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Accrued depreciation</td>
<td></td>
<td>150</td>
</tr>
<tr>
<td>DTA</td>
<td>37.50</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td></td>
<td>37.50</td>
</tr>
</tbody>
</table>
Example 10-7 (continued)

Record Exercise of Options

When accounting for the impact of exercising the options, A must (1) record a reduction in income taxes payable and corresponding reduction of current tax expense of $1,000 resulting from the exercise ($4,000 × 25%), (2) reverse the $75 DTA generated in years 2 and 3, and (3) establish a DTL for the basis difference resulting from the exercise ([[$1,200 remaining book basis − $0 remaining tax basis] × 25% tax rate = $300 DTL]. Note that this results in the entire excess tax benefits being recorded immediately in the income statement upon exercise.

Income taxes payable
  1,000
Current tax benefit
  1,000
Deferred tax expense
  375
  DTA (year 2 + year 3)
  75
  DTL
  300

In years 4 through 11, A would continue to record depreciation expense. In addition, A 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
  37.50
  Deferred tax benefit
  37.50

10.3 Permanent Differences Resulting From Share-Based Payment Awards

ASC 718-740

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.

As discussed in Section 10.2.4.1, excess tax benefits and tax deficiencies result in permanent differences between the amount of cumulative compensation cost recorded for equity-classified share-based payments and the amount of the corresponding deduction taken for tax purposes. Other circumstances that result in permanent differences are discussed in the sections below.

10.3.1 Equity- and Liability-Classified Awards That Do Not Ordinarily Result in a Deduction

ASC 718-740-25-3 indicates that the cumulative amount of compensation cost for awards that would not ordinarily result in a future deduction under existing tax law does not represent a deductible temporary difference. No deferred taxes would be recorded for these awards unless a change in circumstances occurs. A common example of this type of an award is an ISO (see Section 10.1). When an entity issues an ISO, it will record compensation cost as the award is earned but will not receive a tax deduction upon
the holder’s exercise of the award (i.e., a deduction will result only if the holder subsequently disposes of the shares in a disqualifying disposition). Thus, the resulting book expense is considered a permanent book-to-tax difference and will have the effect of increasing the issuing entity's ETR.

### 10.3.2 Tax Benefits of Dividends on Share-Based Payment Awards

<table>
<thead>
<tr>
<th>ASC 718-740</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Benefits of Dividends on Share-Based Payment Awards to Employees</strong></td>
</tr>
<tr>
<td>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 shall be recognized as income tax expense or benefit in the income statement:</td>
</tr>
<tr>
<td>a. Nonvested equity shares</td>
</tr>
<tr>
<td>b. Nonvested equity share units</td>
</tr>
<tr>
<td>c. Outstanding equity share options</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 718-10-65-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Benefits of Dividends on Share-Based Payment Awards</strong></td>
</tr>
<tr>
<td>45-8 An income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to grantees for any of the following equity classified awards shall be recognized as income tax expense or benefit in the income statement:</td>
</tr>
<tr>
<td>a. Nonvested equity shares</td>
</tr>
<tr>
<td>b. Nonvested equity share units</td>
</tr>
<tr>
<td>c. Outstanding equity share options</td>
</tr>
</tbody>
</table>

As discussed further in Section 3.10 of Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards*, dividend payments for dividend-protected awards should be charged to retained earnings to the extent that the awards are expected to vest. If an employee is entitled to retain dividends paid on shares that fail to vest, the dividend payment for dividend-protected awards that are not expected to vest should be charged to compensation cost.

For income tax purposes, dividends paid on such awards may result in a deduction and corresponding income tax benefit. The income tax benefit resulting from payment of dividends on (1) nonvested equity shares, (2) nonvested equity share units, and (3) outstanding equity share options should be recorded as an income tax benefit in the income statement. If the dividend is charged against retained earnings for pretax accounting purposes, a permanent difference will result.

### 10.4 “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 by the parent to employees of a foreign subsidiary. Likewise, in most jurisdictions, the foreign subsidiary that does not bear the cost of the compensation (i.e., because the foreign parent who issued the award to the foreign subsidiary’s employees is bearing the cost) will not be able to deduct the award in the foreign jurisdiction. Accordingly, some arrangements may specify that a foreign subsidiary will make a “recharge payment” to the U.S. parent company that is equal to the intrinsic value of the stock option upon its exercise so that the foreign subsidiary is entitled to take a local tax deduction equal to the amount of the recharge payment. Under such an arrangement, the U.S. parent company is not taxed on the payment made by the foreign subsidiary with respect to the parent company’s stock.
At its July 21, 2005, meeting, the FASB Statement 123(R) Resource Group agreed that in this case, the direct tax effects of share-based compensation awards should be accounted for under the ASC 718 income tax accounting model. Because the U.S. parent company does not receive a deduction on its U.S. tax return for awards granted to employees of the foreign subsidiary, the foreign subsidiary's applicable tax rate is used to measure (1) DTAs and (2) excess tax benefits and tax deficiencies recorded by the foreign subsidiary in accordance with ASC 718. Any indirect effects of the recharge payment are not accounted for under ASC 718. For example, if payment of the recharge results in an increase in an outside basis deductible temporary difference or a reduction in an outside basis taxable temporary difference, the corresponding deferred tax benefit will be recognized in the income statement at the time the recharge payment is made and the deduction actually occurs for income tax reporting purposes.

10.5 Cost-Sharing Arrangements

Related entities in different tax jurisdictions may enter into cost-sharing agreements under which one party is reimbursed for a portion of certain costs it incurred in undertaking shared development activities associated with intangible property. A jurisdiction may permit or require the resident entity to include stock-based compensation cost in the joint cost pool that is reimbursed (commonly referred to as the all costs rule).

The guidance in this section is applicable for entities that are allocating stock-based compensation to related parties under a qualified cost-sharing arrangement. See Section 4.6.3 for a discussion of uncertain tax positions associated with transfer pricing.

The issue of accounting for income taxes related to cost-sharing arrangements in the U.S. federal tax jurisdiction was discussed at the FASB Statement 123(R) Resource Group's July 21, 2005, meeting. The discussion document for the 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.

The example below, adapted from the discussion document, illustrates the accounting for income taxes associated with the allocation of share-based payment awards under a cost-sharing arrangement in the U.S. federal tax jurisdiction.

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5 The original example included in the discussion document for the FASB Statement 123(R) Resource Group's July 21, 2005, meeting was developed before the issuance of ASU 2016-09. The example has been modified herein to reflect the guidance in ASC 718-740-35-2, as amended by ASU 2016-09, which indicates that all excess tax benefits and tax deficiencies should be recorded in the income statement.
Example 10-8

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 R&D of certain technology. Company B reimburses Company A for 30 percent of the R&D costs incurred by Company A. The U.S. tax rate is 25 percent. Cumulative book compensation for a fully vested option is $100 for the year ending on December 31, 20X6. The award is exercised during 20X7, when the intrinsic value of the option is $150.

The tax accounting impact is as follows:

Exercise Method

On December 31, 20X6, Company A records $18 as the DTA related to the option ($100 book compensation expense × 70% not subject to reimbursement × 25% tax rate). When, in 20X7, the option is exercised, any net tax benefit that exceeds the DTA is an excess tax benefit and is recorded in the income statement. The company is entitled to a U.S. deduction resulting in a benefit (net of the inclusion) of $26 ($150 intrinsic value when the option is exercised × 70% not reimbursed × 25%). Accordingly, $8 ($26 – $18) would be recorded in the income statement as an excess tax benefit.

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. DTA related to share-based compensation. If there was $100 of stock-based compensation during 20X6, the impact on the December 31, 20X6, current tax provision would be $8 ($100 book compensation expense × 30% reimbursed × 25%). If the stock-based charge under ASC 718 is considered a deductible temporary difference, a DTA also should be recorded in 20X6 for the financial statement expense, in the amount of $25 ($100 book compensation expense × 25%). The net impact on the 20X6 income statement is a tax benefit of $17 ($25 – $8). At settlement, the excess tax deduction of $13 would be recorded in the income statement.

An entity should consider the impact of cost-sharing arrangements when measuring, on the basis of the tax election it has made or plans to make, the initial and subsequent deferred tax effects associated with its stock compensation costs. If regulations in a particular jurisdiction vary significantly from those in the U.S. federal tax jurisdiction described above, the entity should consult with its accounting advisers regarding the appropriate accounting treatment.

10.6 Accounting Considerations for Valuation Allowances Related to Share-Based Payment DTAs

ASC 718-740

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.

In assessing whether a valuation allowance should be provided on DTAs related to stock-based compensation cost, an entity should not consider the current price of the grantor's stock. ASC 718-740-30-2 prohibits an entity from considering the current price of the grantor’s stock and adjusting the gross amount of the DTA.
When an entity is evaluating the need for a valuation allowance, it should apply the guidance in ASC 740-10-30-17 through 30-23. That is, whether the entity needs to record a valuation allowance depends on whether it is more likely than not that there will be sufficient taxable income to realize the DTA.

Therefore, even if the award is deep out-of-the-money to a degree that its exercise is unlikely or the award's intrinsic value on the exercise date is most likely to be less than its grant-date fair value, the entity should not record a valuation allowance unless and until it is more likely than not that future taxable income will not be sufficient to realize the related DTAs. See Chapter 5 for a broader discussion of valuation allowance considerations.

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**Example 10-9**

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 25 percent. On December 31, 20Y0, the entity's share price is $5. The entity has generated taxable income in the past and expects to continue to do so in the future.

In each reporting period, the entity would record compensation cost on the basis of the number of awards expected to vest, the grant-date fair-value-based measure of the award, and the amount of services rendered. Contemporaneously, a DTA would be recorded on the basis of the amount of compensation cost recorded and the entity's applicable tax rate. On December 31, 20Y0, even though the likelihood that the employee will exercise the award is remote (i.e., the award is "deep out-of-the-money") and the DTA therefore will not be realized, the entity would not be allowed to write off any part of the gross DTA or to provide a valuation allowance against the DTA until the award expires unexercised (January 1, 20Y1) (if there is sufficient future taxable income to realize that DTA). The entity would be able to record a valuation allowance against the DTA only when it is more likely than not that the entity will not generate sufficient taxable income to realize the DTA.

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### 10.7 Deferred Tax Effects of Replacement Awards Issued in a Business Combination

**ASC 805-740**

**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.

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

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 a precombination exchange of goods or services and therefore included in consideration transferred in the business combination.
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.

Pending Content (Transition Guidance: ASC 718-10-65-11)

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.

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 be different from the fair-value-based measure of the award. The tax effect of that difference shall be recognized as income tax expense or benefit in the income statement of the acquirer.

In a business combination, share-based payment awards held by employees of the acquiree are often exchanged for share-based payment awards of the acquirer. ASC 805 refers to the new awards as “replacement awards.”

10.7.1 Tax Effects of Replacement Awards Issued in a Business Combination That Ordinarily Would Result in a Deduction

10.7.1.1 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., NQSOs), an acquirer should record a DTA as of the acquisition date for the tax benefit of the fair-value-based measure of the acquirer’s replacement awards included in the consideration transferred, generally with a corresponding reduction of goodwill. For guidance on calculating the amount of the fair-value-based measure to include in the consideration transferred, see Section 10.2 of Deloitte’s A Roadmap to Accounting for Share-Based Payment Awards.

10.7.1.2 Income Tax Accounting After the Acquisition Date

For the portion of the fair-value-based measure of the acquirer’s replacement awards that is attributed to postcombination vesting and therefore included in postcombination compensation cost, a DTA is recorded over the remaining vesting period (i.e., as the postcombination compensation cost is recorded).

In accordance with ASC 718, the DTA for replacement awards classified as equity is not subsequently adjusted to reflect changes in the entity’s share price. By contrast, for replacement awards classified as a liability, the DTA is remeasured, along with the compensation cost, in every reporting period until settlement.
10.7.1.3 **Income Tax Accounting Upon Vesting or Exercise of the Share-Based Payment Awards**

ASC 805-740-45-5 states that “the deduction reported on a tax return for a replacement award classified as equity may be different from the fair-value-based measure of the award. The tax effect of that difference shall be recognized as income tax expense or benefit in the income statement of the acquirer.”

The examples below, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits associated with equity-classified replacement awards that are issued in a business combination.

**Example 10-10**

Assume the following:

- Entity A acquired Entity B in a business combination on June 30, 20X1.
- Entity A was obligated to issue replacement awards to B’s employees under the acquisition agreement’s terms.
- The replacement awards are stock options that would typically result in a tax deduction (e.g., NQSOs).
- Entity A’s applicable tax rate is 20 percent.

For simplicity, the par value of the common stock issued and the cash received for the option’s exercise price are not considered.

Entity A issues replacement awards of $110 (fair-value-based measure) on the acquisition date in exchange for 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 rendered all of the required service for the replaced 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 fair-value-based measure 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.

**Journal Entries: June 30, 20X1**

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To record the portions of the fair-value-based measure of the replacement awards that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

To record the associated income tax effects of the fair-value-based measure of the portions of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).
Example 10-10 (continued)

On September 30, 20X1, all replacement awards issued by A are exercised when the market price of A's shares is $150. Given the exercise of the replacement awards, A will realize a tax deduction of $135 ($150 market price of A's shares less the $15 exercise price). The tax benefit of the tax deduction is $27 ($135 × 20% tax rate). Therefore, an excess tax benefit of $5 (tax benefit of the tax deduction of $27 less the previously recorded DTA of $22) is recorded to the current income tax expense.

Journal Entry: September 30, 20X1

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<td>DTA</td>
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To record the income tax effects of the awards upon exercise.

Example 10-11

Assume the following:
- Entity A acquired Entity B in a business combination on June 30, 20X1.
- Entity A was obligated to issue replacement awards to B's employees under the acquisition agreement's terms.
- The replacement awards are stock options that would typically result in a tax deduction (e.g., NQSOs).
- Entity A's applicable tax rate is 20 percent.

For simplicity, the par value of the common stock issued and the cash received for the options' exercise price are not considered.

Entity A exchanges replacement awards that require one year of postcombination service for B's share-based payment awards 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 awards 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 awards completed before the acquisition date (four years) plus the requisite service period for the replacement awards (one year).

The portion attributable to precombination service equals the fair-value-based measure of the replaced awards ($100) multiplied by the ratio of the precombination service period (four years) to the total service period (five years). Thus, $80 ($100 × [4 years/5 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.

Journal Entries: June 30, 20X1

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To record the portion of the fair-value-based measure of the replacement awards attributable to precombination service (i.e., consideration transferred) and the associated income tax effects.
Example 10-11 (continued)

Journal Entries: December 31, 20X1

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<tr>
<td>Income tax provision</td>
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To record the compensation cost and the associated income tax effects for the six-month period from the date of the acquisition until December 31, 20X1.

Journal Entries: June 30, 20X2

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<td></td>
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<tr>
<td>Income tax provision</td>
<td></td>
<td>2</td>
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</tbody>
</table>

To record the compensation cost and the associated income tax effects for the six-month period ended June 30, 20X2.

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 $27 ($135 × 20% tax rate). Therefore, an excess tax benefit of $7 (tax benefit of the tax deduction of $27 less the previously recorded DTA of $20 [$16 + $2 + $2]) is recorded to the current income tax provision.

Journal Entry: June 30, 20X2

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To record the income tax effects of the award upon exercise.

10.7.2 Tax Effects of Replacement Awards Issued in a Business Combination That Would Not Ordinarily Result in Tax Deductions

Under ASC 805-740-25-11, an acquirer should not record a DTA as of the acquisition date for the tax benefits of the fair-value-based measure of its replacement share-based payment awards included in the consideration transferred that do not ordinarily result in a tax deduction (e.g., ISOs).

10.7.2.1 Tax Effects of a Disqualifying Disposition in a Business Combination

The acquirer may receive a tax deduction associated with replacement awards that would not ordinarily result in deductions as a result of events that occur after the acquisition date (e.g., a disqualifying disposition). The tax effects of such events are recognized only when they occur and would be recorded in the income tax provision.
10.7.3 Exchange of Vested Acquiree Employee Awards for Unvested Share Awards of Acquirer in a Business Combination

To incentivize a key employee of an acquiree, an acquirer may permit or require that employee to surrender fully vested shares of the acquiree for nonvested shares of the acquirer. In this situation, the original restricted stock award would have resulted in a tax liability for the employee and a tax deduction for the acquiree on the original vesting date. The employee may make an IRC Section 83(b) election upon receipt of the nonvested acquirer share. Typically, the exchange on the date of the business combination is for equal value; therefore, the employee making the 83(b) election would not owe any additional tax on the exchange and would pay more favorable capital gains tax on any appreciation when the acquirer shares vest and are ultimately sold. Similarly, the employer would not get a tax deduction for the new award.

For financial reporting purposes, the acquirer would account for the exchange and 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 vesting period. Thus, the recognition of the compensation cost for financial reporting purposes would result in a permanent difference that would affect the entity's ETR.
Chapter 11 — Business Combinations

11.1 Introduction

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.

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.

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 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.

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.
ASC 805-740 (continued)

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.

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.

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.

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.

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.

A business combination occurs when one substantive legal entity obtains control of a group of assets that meets the ASC master glossary’s definition of a business. A business combination can be legally structured in a variety of ways and as discussed further below, the determination of whether a legal entity (or group of assets) being acquired meets the definition of a business is often a conclusion that requires significant judgment as well as a good understanding of the components of the transaction.

The main difference between the accounting for an acquisition of a business (i.e., a business combination) and that for an acquisition of a group of assets that is not a business (i.e., an asset acquisition) is the existence of goodwill. As discussed further in Section 11.8, the accounting for income tax consequences differs between an asset acquisition and a business combination as well.

The underlying premise of accounting for a business combination (which is addressed by ASC 805) is that when an entity obtains a controlling financial interest in a business, it becomes accountable for all of the acquiree’s assets and liabilities. This results in an accounting recognition event for which the entity should recognize the assets acquired and liabilities assumed at their fair values on the acquisition date. This is true regardless of whether the acquirer obtains 100 percent or lesser controlling financial interest in a business. That is, the acquisition method of accounting, whereby acquired assets and liabilities are recorded at fair value by the acquirer, is applied whenever an entity obtains control of a business.
ASC 805 has two key principles, known as the “recognition principle” and the “measurement principle.” According to the recognition principle, for financial reporting purposes, an acquirer must “recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.” Under the measurement principle, for financial reporting purposes, the acquirer must then measure “the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.”¹ The application of these principles will have an impact on the accounting for income taxes since, depending on how the transaction is structured for tax purposes, deductible and taxable temporary differences might need to be recorded in connection with the accounting for the business combination or asset acquisition.

Before an entity can apply the acquisition method, it must determine whether a transaction meets the definition of a business combination. The ASC master glossary defines a business combination as “[a] transaction or other event in which an acquirer obtains control of one or more businesses.” Typically, a business combination occurs when an entity purchases the equity interests or the net assets of one or more businesses in exchange for cash, equity interests of the acquirer, or other consideration. However, the definition of a business combination applies to more than just purchase transactions: It incorporates all transactions or events in which an entity or individual obtains control of a business.

Control has the same meaning as “controlling financial interest,” and an entity applies the guidance in ASC 810-10 to determine whether it has obtained a controlling financial interest in a business. Under ASC 810-10, an entity determines whether it has obtained a controlling financial interest by applying the VIE model or the voting interest entity model.

In January 2017, the FASB issued ASU 2017-01 to clarify the definition of a business because the previous definition in ASC 805 was often applied so broadly that transactions that were more akin to asset acquisitions were being accounted for as business combinations. The ASU introduces a screen for determining when a set of activities and assets is not a business. An entity uses the screen to assess whether substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets. If so, the set is not a business. The screen is intended to reduce the number of transactions that an entity must further evaluate to determine whether they are business combinations or asset acquisitions.

To be considered a business, an acquired group of assets must (1) pass the screen and (2) include an input and a substantive process that together significantly contribute to the ability to create outputs. Under the previous definition of a business, it was not always clear whether an element was an input or a process or whether a process had to be substantive to affect the determination. Therefore, the ASU provides a framework to help entities evaluate whether both an input and a substantive process are present.

ASU 2017-01 is effective for PBEs for annual periods beginning after December 15, 2017, including interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The ASU must be applied prospectively, but early adoption is permitted for transactions that have not been reported.

It is expected that fewer acquisitions will be business combinations for entities that have adopted ASU 2017-01. See Chapter 1 of Deloitte’s A Roadmap to Accounting for Business Combinations for additional guidance on the determination of whether an acquired group of assets meets the definition of a business.

¹ As discussed further in this chapter, there are certain exceptions to the measurement principle.
Once it has been concluded that a business combination has occurred and the amount of consideration to acquire the business has been determined, the next step in applying the acquisition method is recognizing and measuring the identifiable assets, liabilities, and any noncontrolling interest in the acquiree. Acquired assets and liabilities are generally initially measured at their acquisition-date fair value. However, certain assets or liabilities are exceptions to the recognition principle, the measurement principle, or both, and are measured in accordance with other U.S. GAAP. These would include income taxes that are recognized and measured in accordance with ASC 740, which is discussed throughout this chapter.

11.1.1 Measurement Period

Because it may take time for an entity to obtain the information necessary to recognize and measure all the items exchanged in a business combination, the acquirer is allowed a period in which to complete its accounting for the acquisition. That period — referred to as the measurement period — ends as soon as the acquirer (1) receives the information it had been seeking about facts and circumstances that existed as of the acquisition date or (2) learns that it cannot obtain further information. However, the measurement period cannot be more than one year after the acquisition date. During the measurement period, the acquirer recognizes provisional amounts for the items for which the accounting is incomplete, including income taxes. Adjustments to any of these items will affect the amount of goodwill recognized or bargain purchase gain.

ASC 805 originally required that if a measurement-period adjustment was identified, the acquirer retrospectively revised comparative information for prior periods, including making any change in depreciation, amortization, or other income effects as if the accounting for the business combination had been completed as of the acquisition date. However, revising prior periods to reflect measurement-period adjustments added cost and complexity to financial reporting, and many believed that it did not significantly improve the usefulness of the information provided to users. To address those concerns, the FASB issued ASU 2015-16 in September 2015. Under the ASU, an acquirer must recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined rather than retrospectively, including the effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date.

Measurement-period adjustments (i.e., those that result in an adjustment to goodwill or bargain gain) do not result from new information that was not available as of the acquisition date (e.g., new information that might affect the assessment of realization of uncertain tax benefits). Adjustments to acquired assets and liabilities related to events or occurrences after the acquisition date would be recorded immediately to income even if the new information was obtained within the measurement period. See Section 11.4 for additional information.

11.1.2 Asset Acquisitions

An asset acquisition is an acquisition of an asset, or a group of assets, that does not meet the definition of a business; such an acquisition therefore does not meet the definition of a business combination. The accounting for these transactions is addressed in the “Acquisition of Assets Rather Than a Business” subsections of ASC 805-50 but has many of the same considerations related to the accounting for income taxes as a business combination.
For financial reporting purposes, asset acquisitions are accounted for by using a cost accumulation model (i.e., the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values, with some exceptions). By contrast, a business combination is accounted for by using a fair value model (i.e., the assets and liabilities are generally recognized at their fair values, and the difference between the consideration paid, excluding transaction costs, and the fair values of the assets and liabilities is recognized as goodwill). As a result, there are differences between the accounting for an asset acquisition and the accounting for a business combination.

A significant difference in an asset acquisition is that there is no goodwill recorded. That is, the cost paid to acquire the assets and liabilities is allocated entirely to the assets and liabilities acquired. This includes acquired DTLs and DTAs that result from an asset acquisition. This adds complexities to the calculation of acquired DTAs and DTLs in asset acquisitions since there is no goodwill to record as an offset to acquired DTAs and DTLs (resulting in the need to perform a simultaneous calculation to determine the DTAs or DTLs). As noted in Section 11.1, ASU 2017-01 narrows the definition of a business, which could result in fewer acquisitions’ being accounted for as business combinations but rather being accounted for as asset acquisitions. See Section 11.8 for additional discussion about the accounting for income tax consequences of asset acquisitions.

11.1.3 Taxable Versus Nontaxable Business Combination

Once recognition and measurement of the identifiable assets, liabilities, and any noncontrolling interest in the acquiree has occurred (for financial reporting purposes under the principles of U.S. GAAP), 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. Determining the appropriate tax bases of those assets and liabilities depends in part on whether the transaction is treated as taxable or nontaxable.

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.

A taxable business combination will usually occur when the purchase transaction is structured as an asset purchase wherein the acquirer purchases the specific assets and liabilities of the acquiree but does not assume ownership of the target’s stock. This type of transaction allows the acquirer to step up the tax basis of the assets and liabilities to their fair value. By contrast, a nontaxable business combination will typically be the result in a stock purchase wherein the acquirer will assume the acquiree’s tax basis of the assets and liabilities. However, certain elections under the tax code related to the establishment of the tax bases of assets and liabilities acquired may be available that will allow an acquirer to treat a stock purchase in a manner similar to an asset purchase.

**Connecting the Dots**

Asset acquisitions or business combinations under U.S. GAAP could be asset purchases or stock purchases for tax purposes. It is critical that an entity understand the structure and accounting for a given transaction under ASC 805 and the tax code, including what tax elections may apply, when determining the deferred tax consequences of the transaction.
In both taxable and nontaxable business combinations, the amounts assigned to the individual assets acquired and liabilities assumed for financial statement purposes may differ from the amounts assigned or carried forward for tax purposes. A DTL or DTA is recognized for each of these temporary differences with certain exceptions (e.g., recognition of deferred taxes on goodwill), as described throughout this Roadmap. An entity would apply the recognition and measurement criteria of ASC 740 (or other authoritative literature) to record acquired DTAs and DTLs instead of the general measurement principles of ASC 805.

11.1.4 Other General Considerations

Some key accounting requirements outside ASC 805 that 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 (see Section 11.3.2).
- 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 (see Section 11.5).
- 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 (see Section 11.5).
- Discounting of the income tax consequences of temporary differences and carryforwards to their present values is prohibited.

The remaining sections of this chapter will discuss these considerations and others in greater detail.

11.2 General Principles of Income Tax Accounting for a Business Combination

Understanding the details of a business combination transaction is important to understanding the related impacts on income tax accounting. For example, depending on the nature of the transaction, certain elements may be accounted for as part of purchase accounting or as separate transactions in the postcombination financial statements of the acquirer or in the precombination financial statements of the acquiree.

11.2.1 Identifying Parts of the Business Combination

ASC 805-20-25-6 states, in part:

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, changes in tax status, tax planning, and subsequent business integration steps that occur post-closing are generally accounted for separately and apart from the business combination (i.e., on “day 2”). However, some income tax
elections, changes in tax status, 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 (see Section 1.1.9 of Deloitte’s A Roadmap to Accounting for Business Combinations), there is no direct guidance addressing whether the tax effects of income tax elections, tax planning, and subsequent business integration steps that occur post-closing 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, changes in tax status, tax planning, or other subsequent business integration steps that occur post-closing in its application of the acquisition method of accounting to the business combination.

- Was the income tax election, change in tax status, 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 post-closing?
- 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 post-closing?
- 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?

**11.2.2 Change in Tax 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 Section 3.5.2 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. 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 Section 11.5.1 for more information. Also see Section 3.5.2 for additional financial reporting considerations related to a change in tax status.

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 Section 6.2.7 for further discussion and examples of transactions “among or with shareholders.”

See Section 8.3.1 for a discussion of accounting for change in status in the separate or carve-out financial statements of the acquiree resulting from a business combination.

### 11.2.3 The Applicable Tax Rate

Another question that arises when an entity is accounting for the tax impacts of a business combination is what tax rate should be used to establish initial DTAs and DTLs as a result of the acquisition. The combined entity may have different tax characteristics than the predecessor and successor entities.

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).

In some cases, the process of establishing the enacted rate(s) expected to apply is not straightforward. Among other situations, complexities arise during tax holidays and when an entity adds state jurisdictions to the acquirer’s state tax profile as a result of the acquisition.
11.2.3.1 Tax Holidays

Deferred taxes are not recognized for the expected taxable or deductible amounts of temporary differences that are related to assets or liabilities that are expected to be recovered or settled during a tax holiday. Paragraph 183 in the Basis for Conclusions of FASB 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.

For additional information on the effect of tax holidays on the applicable tax rate, see Section 3.3.4.5.

11.2.3.2 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.)

11.3 Recognition and Measurement of Temporary Differences Related to Identifiable Assets Acquired and Liabilities Assumed

As noted in Section 11.1, the recognition principle and the measurement principle of ASC 805 require an entity to “recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree” and to measure “the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.” These recognition and measurement principles may differ for financial reporting and tax purposes (i.e., an asset may be recorded at fair value for book purposes versus at carryover basis for tax purposes). As a result, deductible and taxable temporary differences (i.e., basis differences) might need to be recorded in connection with the accounting for the business combination or asset acquisition. For example, the recognition and measurement principles for acquired goodwill may be different for financial reporting and tax purposes, resulting in the potential need to record deferred taxes for the basis difference. This section discusses how to account for basis differences resulting from a business combination and provides examples of common scenarios that require additional consideration.
11.3.1 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 Section 3.3.1.)

The paragraphs below describe the accounting for inside and outside basis differences that arise in a business combination.

11.3.1.1 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.

11.3.1.2 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 described in Section 3.3.2 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 meets the definition of a business under ASC 805.
- TC has two subsidiaries (S1 and S2), each of which was acquired in a previous taxable stock acquisition.
- S1’s and S2’s assets consist of buildings and equipment, which have fair values of $750 and $250, respectively.
- All of the entities are domestic corporations with respect to AC.
- The tax rate is 21 percent.

TC’s only assets are its shares of S1 and S2, as illustrated in the following table:

<table>
<thead>
<tr>
<th>Identifiable Assets</th>
<th>TC’s Stock</th>
<th>S1</th>
<th>S2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>$ 1,000</td>
<td>$ 750</td>
<td>$ 250</td>
</tr>
<tr>
<td>TC’s tax basis in S1’s and S2’s stock</td>
<td>N/A</td>
<td>600</td>
<td>200</td>
</tr>
<tr>
<td>S1’s and S2’s tax bases in their underlying identifiable assets (assume no tax goodwill)</td>
<td>N/A</td>
<td>300</td>
<td>100</td>
</tr>
</tbody>
</table>
Example 11-1 (continued)

The journal entries recording the accounting for the initial acquisition are as follows:

To record AC’s investment in TC:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AC’s Investment in TC</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

To record TC’s investment in S1 and S2:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>TC’s Investment in S1</td>
<td>750</td>
<td></td>
</tr>
<tr>
<td>TC’s Investment in S2</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>1,000</td>
<td></td>
</tr>
</tbody>
</table>

To record deferred taxes on the temporary differences inside S1 and S2:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1’s Assets</td>
<td>750</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>94.5*</td>
<td></td>
</tr>
<tr>
<td>DTL</td>
<td>94.5**</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>750</td>
<td></td>
</tr>
</tbody>
</table>

* No DTL is recorded for the amount of goodwill for financial reporting in excess of the tax basis of goodwill.

** (750 – 300) × 21%.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>S2’s Assets</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>31.5*</td>
<td></td>
</tr>
<tr>
<td>DTL</td>
<td>31.5**</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>250</td>
<td></td>
</tr>
</tbody>
</table>

* No DTL is recorded for the amount of goodwill for financial reporting in excess of the tax basis of goodwill.

** (250 – 100) × 21%.

Note that while pushdown accounting is not required by ASC 805, journal 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 Section 11.7.3 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:

<table>
<thead>
<tr>
<th></th>
<th>TC's Stock</th>
<th>S1's Stock</th>
<th>S2's Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial book basis</td>
<td>1,000</td>
<td>750</td>
<td>250</td>
</tr>
<tr>
<td>Tax basis</td>
<td>1,000</td>
<td>600</td>
<td>200</td>
</tr>
<tr>
<td>Difference</td>
<td>—</td>
<td>150</td>
<td>50</td>
</tr>
<tr>
<td>DTL (if recognized)</td>
<td>—</td>
<td>31.5</td>
<td>10.5</td>
</tr>
</tbody>
</table>

As illustrated in the table 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 Section 3.4.3 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.

11.3.2 Goodwill
As previously noted, the acquisition method of accounting requires the acquirer to recognize and measure all separately identifiable assets and liabilities acquired or assumed in connection with a business combination. As discussed further in Section 11.3.4, deferred taxes may need to be recorded as part of purchase accounting for these acquired assets and liabilities. For financial reporting purposes, the difference between the acquisition price and the fair value of the acquired assets and liabilities will be recorded as goodwill (or on rare occasions as a bargain purchase gain). A business combination may also result in an entity's acquiring goodwill for tax purposes. Special accounting consideration (discussed further below) is required when an entity is determining how to account for the tax effects of acquired goodwill.

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 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.
Chapter 11 — Business Combinations

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.

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.

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.

Related Implementation Guidance and Illustrations

- Example 1: Nontaxable Business Combination [ASC 805-740-55-2].

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 in which deductions are not allowed for the amortization or impairment of the goodwill. In tax jurisdictions in which 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 (see illustration below).
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.

If component 2 goodwill is an excess of tax-deductible goodwill over financial reporting goodwill, an entity must recognize a DTA related to the excess as of the acquisition date 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 11-3 below illustrates the application of the simultaneous equations method.

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.

Further, 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 11-3

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 25 percent.
- Income before taxes in year 1 is $10,000, in year 2 is $11,000, and in year 3 is $12,000.
Example 11-3 (continued)

On Acquisition Date:
1. Preliminary calculation of goodwill components:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Component 1 goodwill</td>
<td>$800</td>
<td>$800</td>
</tr>
<tr>
<td>Component 2 goodwill</td>
<td>—</td>
<td>200</td>
</tr>
<tr>
<td>Total goodwill</td>
<td>$800</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

2. Calculation of the DTA:
   • DTA = (0.25 ÷ [1 – 0.25]) × $200.
   • DTA = $67.

3. Journal entry to record the DTA:

   DTA
   Goodwill

   (Note that “final” financial reporting goodwill is $733.)

Accounting in Years 1–3:
1. Calculation of taxes payable:

<table>
<thead>
<tr>
<th>Year</th>
<th>Book income (pretax)</th>
<th>Tax amortization</th>
<th>Taxable income</th>
<th>Taxes payable (25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$10,000</td>
<td>500</td>
<td>$9,500</td>
<td>$2,375</td>
</tr>
<tr>
<td>Year 2</td>
<td>$11,000</td>
<td>500</td>
<td>$10,500</td>
<td>$2,625</td>
</tr>
<tr>
<td>Year 3</td>
<td>$12,000</td>
<td>—</td>
<td>$12,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th></th>
<th>January 1, 20X9</th>
<th>End of Year 1</th>
<th>End of Year 2</th>
<th>End of Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial reporting basis — goodwill</td>
<td>$ 733</td>
<td>$ 733</td>
<td>$ 733</td>
<td>$ 733</td>
</tr>
<tr>
<td>Tax basis — component 1 goodwill</td>
<td>733</td>
<td>367</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Tax basis — component 2 goodwill</td>
<td>267</td>
<td>133</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total tax basis in goodwill</td>
<td>1,000</td>
<td>500</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Temporary difference — component 1 goodwill</td>
<td>—</td>
<td>367</td>
<td>733</td>
<td>733</td>
</tr>
<tr>
<td>Temporary difference — component 2 goodwill</td>
<td>—</td>
<td>—</td>
<td>267</td>
<td>133</td>
</tr>
<tr>
<td>DTL — component 1 goodwill</td>
<td>—</td>
<td>—</td>
<td>92</td>
<td>183</td>
</tr>
<tr>
<td>DTA — component 2 goodwill</td>
<td>$ 67</td>
<td>$ 33*</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>Deferred income tax expense</td>
<td>$ 125</td>
<td>$ 125</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>Current income tax benefit</td>
<td>$ (125)</td>
<td>$ (125)</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

* 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 $33).

3. Realization of the tax benefit:

A tax benefit will be realized for the tax deduction associated with goodwill.

**Journal Entries for Years 1 and 2:**

<table>
<thead>
<tr>
<th>Income tax expense</th>
<th>125</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>92</td>
</tr>
<tr>
<td>DTA</td>
<td>33*</td>
</tr>
</tbody>
</table>

* Represents deferred taxes associated with the component 2 goodwill temporary difference amortized over two years ($267 ÷ 2) × 25%.)
Example 11-3 (continued)

4. P&L snapshot:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book income (pretax)</td>
<td>$10,000</td>
<td>$11,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Tax amortization</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>2,375</td>
<td>2,625</td>
<td>3,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>125</td>
<td>125</td>
<td>—</td>
</tr>
<tr>
<td>Total income tax expense</td>
<td>2,500</td>
<td>2,750</td>
<td>3,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>$7,500</td>
<td>$8,250</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

11.3.2.1 Pre-FASB Statement 141(R) Transactions

Given the long-term nature of goodwill balances, some goodwill may have been generated in connection with business combinations that were accounted for under FASB Statement 141 before the issuance of FASB Statement 141(R) (codified in ASC 805), which amended paragraph 262 of FASB Statement 109 to require that the tax benefit associated with component 2 tax-deductible goodwill (an excess of tax-deductible goodwill over financial reporting goodwill) be recognized as of the acquisition date. Before the amendments made by Statement 141(R), the tax benefit associated with component 2 tax-deductible goodwill was recognized only when realized on the tax return. This tax benefit was applied first to reduce goodwill related to the acquisition to zero, then to reduce other noncurrent intangible assets related to the acquisition to zero, and lastly to reduce income tax expense.

After the effective date of Statement 141(R) (codified in ASC 805), the tax benefit associated with component 2 tax-deductible goodwill should continue to be recognized for business combinations previously accounted for in accordance with FASB Statement 141 (i.e., business combinations consummated in periods before the effective date of Statement 141(R)).

Paragraph 77 of Statement 141(R) states, “[f]or business combinations in which the acquisition date was before the effective date of this Statement, the acquirer shall apply the requirements of Statement 109, as amended by this Statement, prospectively” (emphasis added). Therefore, an entity would still need to apply the guidance in paragraphs 262 and 263 of Statement 109 (before the Statement 141(R) 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. Example 11-4 below has been adapted from paragraph 263 of Statement 109 (as published before the amendments of Statement 141(R)) and illustrates the accounting that a reporting entity should apply to tax benefits associated with component 2 tax-deductible goodwill from business combinations originally accounted for under Statement 141. As described above, this accounting method applies even after the effective date of Statement 141(R).

**Example 11-4**

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 FASB Statement 141(R) on January 1, 20X9.
- Income before income taxes is $1,000 in each of years 20X8–2X11.
- The tax rate is 25 percent for all years.

Income taxes payable for years 20X8–2X11 are:

<table>
<thead>
<tr>
<th></th>
<th>20X8</th>
<th>20X9</th>
<th>2X10</th>
<th>2X11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before amortization of goodwill</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Tax amortization of goodwill</td>
<td>400</td>
<td>400</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Taxable income</td>
<td>600</td>
<td>600</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>$ 150</td>
<td>$ 150</td>
<td>$ 250</td>
<td>$ 250</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Reported Amount</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>First component</td>
<td>$ 600</td>
<td>$ 600</td>
</tr>
<tr>
<td>Second component</td>
<td>—</td>
<td>200</td>
</tr>
<tr>
<td>Total goodwill</td>
<td>$ 600</td>
<td>$ 800</td>
</tr>
</tbody>
</table>

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.
### Example 11-4 (continued)

The second component of goodwill is deductible at $100 per year in years 20X8 and 20X9. Those tax deductions provide $25 ($100 at 25 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 TTB allocated to reduce the first component of goodwill in years 20X8 and 20X9 is the sum of (1) the $25 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:

\[ \text{TTB} = \text{realized tax benefit plus (tax rate times TTB)} \]

\[ \text{TTB} = 25 + (0.25 \times \text{TTB}) \]

\[ \text{TTB} = 33 \]

Goodwill for financial reporting purposes for years 20X8–2011 is:

<table>
<thead>
<tr>
<th></th>
<th>20X8</th>
<th>20X9</th>
<th>2X10</th>
<th>2X11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at beginning of year</td>
<td>$600</td>
<td>$567</td>
<td>$534</td>
<td>$534</td>
</tr>
<tr>
<td>TTB allocated to reduce goodwill</td>
<td>33</td>
<td>33</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Balance at end of year</td>
<td>$567</td>
<td>$534</td>
<td>$534</td>
<td>$534</td>
</tr>
</tbody>
</table>

The DTL for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 20X8–2011 are:

<table>
<thead>
<tr>
<th></th>
<th>20X8</th>
<th>20X9</th>
<th>2X10</th>
<th>2X11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported goodwill at end of year</td>
<td>$567</td>
<td>$534</td>
<td>$534</td>
<td>$534</td>
</tr>
<tr>
<td>Tax basis of goodwill (first component)</td>
<td>300</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Taxable temporary difference</td>
<td>$267</td>
<td>$534</td>
<td>$534</td>
<td>$534</td>
</tr>
<tr>
<td>DTL:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At end of year (25 percent)</td>
<td>67</td>
<td>134</td>
<td>134</td>
<td>134</td>
</tr>
<tr>
<td>At beginning of year</td>
<td>—</td>
<td>67</td>
<td>134</td>
<td>134</td>
</tr>
<tr>
<td>Deferred tax expense for the year</td>
<td>$67</td>
<td>$67</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Income for financial reporting for years 20X8–2011 is:

<table>
<thead>
<tr>
<th></th>
<th>20X8</th>
<th>20X9</th>
<th>2X10</th>
<th>2X11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before income tax</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income tax expense:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>150</td>
<td>150</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Deferred</td>
<td>67</td>
<td>67</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Benefit applied to reduce goodwill</td>
<td>33</td>
<td>33</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Net income</td>
<td>$750</td>
<td>$750</td>
<td>$750</td>
<td>$750</td>
</tr>
</tbody>
</table>
11.3.2.2 Amortization of Goodwill

As discussed in Section 11.3.2, 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 11-5 below demonstrates the two approaches and their similar effects on the financial statements.

**Example 11-5**

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 $1.3 million. Entity X’s tax rate is 25 percent. Because tax-deductible goodwill exceeds goodwill for financial reporting purposes, X recognizes a DTA of $100,000 as part of the business combination accounting (see Section 11.3.2 for guidance on calculating this amount), with an offset to goodwill for financial reporting purposes (i.e., final goodwill for financial reporting purposes is $900,000 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 $900,000 (i.e., the lesser of goodwill for financial reporting purposes and tax-deductible goodwill) and component 2 goodwill would be $400,000 (i.e., the difference between total tax-deductible goodwill of $1.3 million and component 1 goodwill of $900,000).
Example 11-5 (continued)

The following journal entries would be recorded to recognize the first year of tax amortization:

- **Approach 1** — The tax amortization of $130,000 ($1,300,000 ÷ 10 years) would be allocated to the component 2 goodwill. Therefore, component 2 goodwill would be reduced to $270,000 ($400,000 – $130,000) and the DTA recognized as of the acquisition date would be reduced by $32,500 ($130,000 × 25%).

  Income taxes payable 32,500
  Income tax expense 32,500
  To record the income tax benefit of the tax amortization.

  Income tax expense 32,500
  DTA 32,500
  To allocate the tax amortization between component 1 and component 2 goodwill under Approach 1.

- **Approach 2** — The tax amortization of $130,000 ($1,300,000 ÷ 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 $360,000 ($400,000 – ($400,000 ÷ $1,300,000 × $130,000)) and the DTA associated with component 2 goodwill would be reduced by $10,000 (($400,000 ÷ $1,300,000 × $130,000) × 25%). Component 1 goodwill would be reduced to $810,000 ($900,000 – ($900,000 ÷ $1,300,000 × $130,000)), which would create a DTL of $22,500 (($900,000 ÷ $1,300,000 × $130,000) × 25%) for the taxable temporary difference between goodwill for financial reporting purposes and tax-deductible goodwill.

  Income taxes payable 32,500
  Income tax expense 32,500
  To record the income tax benefit of the tax amortization.

  Income tax expense 32,500
  DTL 22,500
  DTA 10,000
  To allocate the tax amortization between component 1 and component 2 goodwill under Approach 2.

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 $67,500).

### 11.3.2.3 Private Company Alternative

The accounting for goodwill by a private company may differ from the accounting for goodwill by a public company. Under ASC 350-20-15-4, a private company may elect a simplified, alternative approach to subsequently account for goodwill (the “goodwill accounting alternative”). Under this approach, the company can amortize financial reporting 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 ETR (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 Section 11.3.2 for more information about the recognition of deferred taxes on the basis of the components of goodwill.) When an entity is determining the amount of financial reporting goodwill amortization attributable to the components of goodwill, it should consider whether it has already established a policy for such attribution in connection with a past impairment and, if so, should apply that policy consistently. One method that is commonly used in such circumstances is a pro rata allocation. (See Section 11.3.2.4 below for an example illustrating a pro rata allocation.) Under a pro rata allocation approach for goodwill amortization, an entity would proportionally allocate the amortization to tax-deductible and nondeductible goodwill on the basis of the proportion of each. Other approaches may also be acceptable. Further complexities arise when the goodwill in a reporting unit is associated with multiple acquisitions or spans multiple taxing jurisdictions.

In addition, an entity’s postacquisition tax amortization of component 1 goodwill (see Section 11.3.2) 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.

### 11.3.2.4 Impairment Testing

ASC 350-20 requires that goodwill be tested for impairment either annually or between annual tests if certain events or circumstances occur. Goodwill is tested for impairment at the reporting unit level. The ASC master glossary defines a reporting unit as “[t]he 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).”

The current guidance in ASC 350 includes a goodwill impairment test that consists of two steps. Under that guidance, an entity may perform the two-step goodwill impairment test if it (1) qualitatively determines the fair value of the reporting unit is more likely than not less than the carrying amount or (2) chooses not to perform the qualitative assessment outlined in ASC 350-20-35-3 through 35-3G.
ASC 350-20-35-4 through 35-17 outline the two steps as follows on the basis of the fair value determined for each reporting unit:

- **Step 1:**
  - Quantitatively determine whether the fair value of the reporting unit is less than its carrying amount, including goodwill. If so, proceed to step 2.
  - If the fair value of the reporting unit is not less, further testing of goodwill for impairment is not performed.
  - If the carrying amount of the reporting unit is zero or negative, proceed to step 2 if, on the basis of qualitative considerations, it is more likely than not that a goodwill impairment exists.

- **Step 2:**
  - Determine the implied fair value of the goodwill of the reporting unit by assigning the fair value of the reporting unit used in step 1 to all the assets and liabilities of that reporting unit (including any recognized and unrecognized intangible assets) as if the reporting unit had been acquired in a business combination.
  - Compare the implied fair value of goodwill with the carrying amount of goodwill to determine whether goodwill is impaired.

In January 2017, the FASB issued **ASU 2017-04**, which eliminates step 2 from the goodwill impairment test (i.e., the measurement of the amount of impairment loss when the carrying amount of a reporting unit is greater than its fair value). Instead, when an entity performs a quantitative goodwill impairment test, it compares the fair value of a reporting unit with the reporting unit's carrying amount (i.e., performs what was previously step 1 of the two-step goodwill impairment test) to determine whether the reporting unit is impaired and, if so, the amount of impairment loss.

Further, in accordance with ASU 2017-04, “if a reporting unit has tax deductible goodwill, recognizing a goodwill impairment loss may cause a change in deferred taxes that results in the carrying amount of the reporting unit immediately exceeding its fair value upon recognition of the loss. In those circumstances, the entity shall calculate the impairment loss and associated deferred tax effect in a manner similar to that used in a business combination in accordance with the guidance in paragraphs 805-740-55-9 through 55-13. The total loss recognized shall not exceed the total amount of goodwill allocated to the reporting unit.”

ASU 2017-04 is effective for a PBE that is an SEC filer for any annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. The ASU is effective for a business entity that is not an SEC filer for any annual interim goodwill impairment tests in fiscal years beginning after December 15, 2020, and is effective for all other entities for any annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2021. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.
11.3.2.4.1 Assumptions Related to a Reporting Unit Bought or Sold in a Taxable or Nontaxable Business Combination

Determining the fair value of a reporting unit requires some assumptions about the sale of the reporting unit to a market participant. ASC 350-20-35-25 states that an entity’s assumption about whether a reporting unit would be bought or sold in a taxable or nontaxable business combination in its step 1 analysis of the goodwill impairment test2 is a matter of judgment and will depend on facts and circumstances.

ASC 350-20-35-26 provides the following considerations to help entities make this determination:

a. Whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value
b. The feasibility of the assumed structure
c. Whether the assumed structure results in the highest and best use and would provide maximum value to the seller for the reporting unit, including consideration of related tax implications.

In addition, under ASC 350-20-35-27, an entity must also consider the following factors (not all-inclusive) when assessing whether it is appropriate to assume a nontaxable transaction:

a. Whether the reporting unit could be sold in a nontaxable transaction
b. Whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity’s ability to treat a sale of the unit as a nontaxable transaction.

11.3.2.4.2 Assigning Deferred Taxes and Related Valuation Allowances to a Reporting Unit

When determining a reporting unit’s carrying value in step 1 of the goodwill impairment test,3 an entity should assign deferred taxes and any related valuation allowances to its reporting units.

ASC 350-20-35-7 states that the deferred taxes and any related valuation allowances related to the assets and liabilities of the reporting unit should be included in the carrying value of the reporting unit. This is true regardless of whether the entity assumes, in its determination of the fair value of the reporting unit, that the reporting unit would be bought or sold in a taxable or nontaxable business combination. In determining whether to assign DTAs associated with 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:

35-39 For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of the acquisition date if both of the following criteria are met:

a. The asset will be employed in or the liability relates to the operations of a reporting unit.
b. The asset or liability will be considered in determining the fair value of the reporting unit.

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the preceding criteria are met. Examples of corporate items that may meet those criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets.

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2 Upon the adoption of ASU 2017-04, when an entity performs a quantitative goodwill impairment test (i.e., performs what was previously step 1 of the two-step goodwill impairment test), it compares the fair value of a reporting unit with the reporting unit’s carrying amount to determine whether the reporting unit is impaired and, if so, the amount of impairment loss.

3 See footnote 2.
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.

### 11.3.2.4.3 Tax Bases Used to Determine Implied Fair Value of a Reporting Unit’s Goodwill

When an entity is determining the implied fair value of a reporting unit’s goodwill in step 2 of the goodwill impairment test (i.e., before the adoption of ASU 2017-04), ASC 350-20-35-20 states that the entity should use the tax bases of a reporting unit’s assets and liabilities implicit in the assumed tax structure (i.e., taxable or nontaxable) in performing step 1 of the goodwill impairment test. If the entity assumed a nontaxable transaction, it should use its existing tax bases. If the entity assumed a taxable transaction, new tax bases are established on the basis of the fair value (i.e., fair value according to applicable tax law) of the reporting unit’s assets and liabilities.

After the adoption of ASU 2017-04, consideration of the implied fair value of a reporting unit’s goodwill is no longer necessary. While impairments will still occur, this specific step is not required when an entity is measuring a required impairment (if any) after it has adopted ASU 2017-04.

### 11.3.2.4.4 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 Sections 11.1.3 and 11.3.2 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\(^4\) 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.”

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\(^4\) Once effective, ASU 2017-04 amends ASC 350-20-35-1 to state that “goodwill shall be tested at least annually for impairment at a level of reporting referred to as a reporting unit” (emphasis added). While ASC 350-20-35-1 is amended, as described above, the requirement under ASC 350-20-35-28 to test goodwill at least annually did not change.
A reporting unit’s goodwill balance subject to impairment testing may comprise both tax-deductible and nondeductible goodwill. One common method used to allocate the goodwill impairment among the legal entities that constitute 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 11-6 below demonstrates the application of the pro rata allocation approach. Note that this approach involves consolidated financial statements. When one or more of the legal entities within a reporting unit prepare separate-company financial statements, the allocations may differ between the separate and consolidated financial statements. Entities are encouraged to consult with their income tax accounting advisers when determining an appropriate approach.

**Example 11-6**

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

<table>
<thead>
<tr>
<th>Component 1 Goodwill</th>
<th>Component 2 Goodwill</th>
<th>Tax Basis</th>
<th>Total Book Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X9</td>
<td>$1,000,000</td>
<td>$500,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Tax amortization</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>December 31, 20X9, before impairment</td>
<td>$1,000,000</td>
<td>$500,000</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

### Legal Entity Z

<table>
<thead>
<tr>
<th>Component 1 Goodwill</th>
<th>Component 2 Goodwill</th>
<th>Tax Basis</th>
<th>Total Book Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X9</td>
<td>$4,000,000</td>
<td>$500,000</td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Tax amortization</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>December 31, 20X9, before impairment</td>
<td>$4,000,000</td>
<td>$500,000</td>
<td>$4,500,000</td>
</tr>
</tbody>
</table>

On December 31, 20X9, before its annual goodwill impairment test:

- Unit R has total goodwill of $6 million ($1.5 million + $4.5 million) for financial reporting purposes.
- Unit R has remaining tax-deductible goodwill of $4.5 million ($0.9 million + $3.6 million).
- Entity Y has a DTL of $30,000 ([$1,000,000 – $900,000] × 30%) related to the taxable temporary difference of its component 1 goodwill.
- Entity Z has a DTL of $160,000 ([$4,000,000 – $3,600,000] × 40%) related to the taxable temporary difference of its component 1 goodwill.

In accordance with ASC 805-740-25-9, neither legal entity has recognized deferred taxes for component 2 goodwill because component 2 goodwill comprises an excess of goodwill for financial reporting purposes over tax-deductible goodwill.
Example 11-6 (continued)

Entity X performs its annual goodwill impairment test on December 31, 20X9, and concludes that a goodwill impairment of $2 million exists for R. In accordance with its accounting policy election, for tax purposes, X allocates the $2 million impairment proportionately between Y and Z on the basis of the carrying amount of goodwill. Thus, $500,000 ([$1,500,000 ÷ $6,000,000] × $2,000,000) of the impairment is allocated to Y and $1,500,000 ([$4,500,000 ÷ $6,000,000] × $2,000,000) of the impairment is allocated to Z. Entities Y and Z then allocate their portions of the impairment proportionately between component 1 and component 2 goodwill on the basis of the relative carrying amount of each component, as shown below.

### Legal Entity Y

<table>
<thead>
<tr>
<th>Component 1 Goodwill</th>
<th>Component 2 Goodwill</th>
<th>Tax Basis</th>
<th>Book Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X9, before impairment</td>
<td>$1,000,000</td>
<td>$500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Impairment</td>
<td>333,333*</td>
<td>166,667**</td>
<td>—</td>
</tr>
<tr>
<td>December 31, 20X9</td>
<td>$666,667</td>
<td>$333,333</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

* ($1,000,000 ÷ $1,500,000) × $500,000.
** ($500,000 ÷ $1,500,000) × $500,000.

### Legal Entity Z

<table>
<thead>
<tr>
<th>Component 1 Goodwill</th>
<th>Component 2 Goodwill</th>
<th>Tax Basis</th>
<th>Book Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X9, before impairment</td>
<td>$4,000,000</td>
<td>$500,000</td>
<td>$3,600,000</td>
</tr>
<tr>
<td>Impairment</td>
<td>1,333,333*</td>
<td>166,667**</td>
<td>—</td>
</tr>
<tr>
<td>December 31, 20X9</td>
<td>$2,666,667</td>
<td>$333,333</td>
<td>$3,600,000</td>
</tr>
</tbody>
</table>

* ($4,000,000 ÷ $4,500,000) × $1,500,000.
** ($500,000 ÷ $4,500,000) × $1,500,000.

On the basis of the allocations in the above tables, Y and Z would record the following journal 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) × 30%.
Example 11-6 (continued)

<table>
<thead>
<tr>
<th>Legal Entity Z</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment loss</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>1,500,000</td>
</tr>
<tr>
<td>DTL</td>
<td>160,000*</td>
</tr>
<tr>
<td>DTA</td>
<td>373,333**</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>533,333</td>
</tr>
</tbody>
</table>

* Represents the DTL that was originally recognized from the tax amortization.
** \((3,600,000 – 2,666,667) \times 40\%\).

11.3.2.5 Disposal of Goodwill

In accordance with ASC 350-20, when all or a portion of a reporting unit that constitutes a business is disposed of, all or a portion of the goodwill allocated to that reporting unit needs to be included in the carrying amount of the reporting unit (or disposal group) when an entity is determining the gain or loss on disposal. Given the intricacies involved with determining the deferred tax accounting for goodwill (e.g., calculating component 1 and component 2 goodwill), additional complexities may arise when a reporting unit (or portion thereof) that has goodwill is disposed of.

An acquired business that generates goodwill will often be integrated into an existing reporting unit (or reporting units) of the acquirer. The reporting unit to which the assets and liabilities of the acquiree are assigned may be composed of multiple legal entities that were either acquired in previous business combinations or formed by the acquirer. Although the goodwill generated in the business combination will continue to be associated with the reporting unit to which it is allocated, the goodwill may not be specifically associated with the assets and liabilities from the business combination that generated the goodwill. For example, if an acquired business is significantly integrated with other subsidiaries of a reporting unit and a subsidiary within the reporting unit is subsequently disposed of, the acquirer may need to allocate a portion of the total goodwill of the reporting unit to the disposal group regardless of how the goodwill was generated.

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.
Chapter 11 — Business Combinations

A second approach is to determine the character of the goodwill to be retained by reference to the character of the goodwill of the component being deconsolidated, even though ASC 350-20-40-1 through 40-7\(^5\) suggest that acquired goodwill loses its entity-specific character when an entity is performing an impairment test or determining the amount of goodwill to be deconsolidated when part of a reporting unit is sold.

A third approach is to interpret ASC 350-20-40-1 through 40-7\(^6\) as simply requiring the reporting entity to retain a portion of its investment in the disposed-of subsidiary 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” is deducted upon the sale of the disposed-of entity’s stock for income tax purposes.

A fourth approach is to treat any goodwill retained by the reporting unit as a permanent difference (i.e., not a temporary difference). Under this approach, any goodwill remaining in the reporting unit is effectively characterized as internally generated goodwill that must be capitalized. Accordingly, ASC 740-10-25-3(d) would preclude the reporting entity 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.”

All of the approaches described above may be considered acceptable when a portion of the goodwill originally related to the component to be deconsolidated is retained. 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.

While complexities are likely to be encountered when any of the approaches described above are applied, the second approach, in particular, will need to be supplemented by additional policies when the amount being deconsolidated exceeds the amount recognized on the books of that specific component. Entities are encouraged to consult with their accounting advisers in these situations.

Note that each approach described above assumes that a subsidiary has been fully integrated into a reporting unit before deconsolidation. 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.


\(^6\) See footnote 5.
Example 11-7 below illustrates the methods described above applied to the disposal of goodwill.

**Example 11-7**

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 (i.e., all goodwill is component 2 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 after 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 $42 tax benefit (assume a 21 percent tax rate and that P can realize a tax benefit for a capital loss).

If P uses the pro rata method to determine the deferred tax consequences, 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-of 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.

If P uses the second approach to determine the deferred tax consequences, 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.

Under the third approach, P would 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.

If P uses the fourth method described above to determine the deferred tax consequences, 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 that is not deductible for tax purposes.

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7 See footnote 5.
11.3.3 Bargain Purchase

In some limited situations, the fair value of assets acquired (net of assumed liabilities) exceeds the consideration paid to acquire the business. A bargain purchase occurs when the net of the fair value of the identifiable assets acquired and liabilities assumed exceeds the sum of:

- 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).
- The fair value of any noncontrolling interest in the acquiree.

These instances are expected to be infrequent and require an acquirer to reconsider whether all acquired assets have been separately recognized and properly measured. However, after the acquirer confirms that the fair value of acquired net assets exceeds the consideration paid, 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 Section 11.3.1 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 11-8**

**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 $158 gain on the bargain purchase. Assume a 21 percent tax rate.

For the inside basis difference, a DTL of $42 is recorded on the difference between the book basis ($1,000) and tax basis ($800) of the acquired assets.

The journal entries for the acquisition, gain on the bargain purchase, and resulting deferred taxes are as follows:

**TC’s journal entry**

<table>
<thead>
<tr>
<th>Assets</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>42</td>
</tr>
<tr>
<td>Equity</td>
<td>958*</td>
</tr>
</tbody>
</table>

* $800 consideration plus $158 gain on bargain purchase.

**AC’s journal entry**

<table>
<thead>
<tr>
<th>Investment in TC</th>
<th>958</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>800</td>
</tr>
<tr>
<td>Gain on bargain purchase</td>
<td>158</td>
</tr>
</tbody>
</table>

Regarding the outside basis difference, the carrying amount of AC’s investment in TC for financial reporting purposes will increase by $158 and there will be a corresponding increase in TC’s equity as a result of the recognition of the $158 gain.
Example 11-8 (continued)

The following table illustrates AC's investment in TC:

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>New Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>TC stock</td>
<td>$ 800</td>
<td>$ 800</td>
</tr>
<tr>
<td>Gain on bargain purchase</td>
<td>158</td>
<td>$ 800</td>
</tr>
<tr>
<td>Total</td>
<td>$ 958</td>
<td>$ 800</td>
</tr>
</tbody>
</table>

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 Section 3.4.3 for further discussion of tax-free liquidation or merger of a subsidiary.

Example 11-9

Nontaxable Business Combination — No Bargain Purchase Gain Recognized as a Result of the DTL
AC pays $900 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 21 percent.

The following are TC's and AC's journal entries recording the acquisition and resulting deferred taxes:

**TC's journal entry**

Assets  
1,000

Goodwill  
26

DTL  
126

Equity  
900

**AC's journal entry**

Investment in TC  
900

Cash  
900

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 $874) 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 11-10

Nontaxable Business Combination — Bargain Purchase

Assume the same facts as in Example 11-9 except that the tax bases of the identifiable assets are $700 rather than $400.

A DTL of $63 is recorded for the difference between the book basis of $1,000 and tax basis of $700 for the assets acquired. The journal entries recording the acquisition gain on the bargain purchase and resulting deferred taxes are as follows:

**TC's journal entry**

<table>
<thead>
<tr>
<th>Assets</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTL</td>
<td>63</td>
</tr>
<tr>
<td>Equity</td>
<td>937</td>
</tr>
</tbody>
</table>

**AC's journal entry**

| Investment in TC | 937 |
| Cash             | 900 |
| Gain on bargain purchase | 37 |

These journal entries show that AC recognizes a $37 gain on the bargain purchase. As a result of AC's recognition of a $37 gain, AC's investment in TC will increase by $37, with a corresponding increase in TC's equity. Thus, an outside basis difference will arise between the book basis of $937 and tax basis of $900 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 journal entry**

| Deferred tax expense | 8 |
| DTL                  | 8 |

The DTL represents a $37 basis difference at a tax rate of 21 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.

11.3.4 Other Assets Acquired

Although recognition and measurement of income taxes related to goodwill acquired in a business combination are considered among the most significant exceptions to the basic principles of acquisition accounting, special consideration must also be made for other types of assets acquired.

11.3.4.1 Other Intangibles

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.
11.3.4.2 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 11-11 below.)

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 11-12.]

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 11-11

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 21 percent. Company A has calculated the following values for the license agreement:

- **$7.5 million** — Value of the license for the remaining three-year contractual term.
- **$20 million** — Fair value of the license agreement, calculated in accordance with the principles of ASC 820, which takes into account future renewals by market participants.
- **$60 million** — Other tangible assets.
Example 11-11 (continued)

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

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>New Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other tangible assets</td>
<td>$ 60,000,000</td>
<td>$ 60,000,000</td>
</tr>
<tr>
<td>License agreement</td>
<td>7,500,000</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>32,500,000*</td>
<td>20,000,000</td>
</tr>
<tr>
<td></td>
<td><strong>$100,000,000</strong></td>
<td><strong>$100,000,000</strong></td>
</tr>
</tbody>
</table>

* Before the impact of deferred taxes is considered.

Company A will record the following journal entry on the acquisition date:

Other tangible assets 60,000,000
License agreement 7,500,000
Goodwill 29,875,000*
DTA 2,625,000
Cash 100,000,000

* ($32,500,000 – $2,625,000).

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 $2.625 million ([$20 million – $7.5 million] × 21%). In accordance with ASC 805-740-25-3 and ASC 805-740-25-9, no DTL is recorded for the book-over-tax-basis goodwill of $7.5 million ($27.5 million – $20 million).

Example 11-12

Assume the same facts as in Example 11-11, 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 11-11 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.
**Example 11-12 (continued)**

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

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>New Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other tangible assets</td>
<td>$60,000,000</td>
<td>$60,000,000</td>
</tr>
<tr>
<td>License agreement</td>
<td>7,500,000</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>32,500,000*</td>
<td>20,000,000</td>
</tr>
<tr>
<td></td>
<td>$100,000,000</td>
<td>$100,000,000</td>
</tr>
</tbody>
</table>

* Before the loss on the unfavorable license agreement and the impact of deferred taxes are considered.

Company A will record the following journal entry on the acquisition date:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Other tangible assets</td>
<td>60,000,000</td>
</tr>
<tr>
<td>License agreement</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>30,000,000*</td>
</tr>
<tr>
<td>Loss on unfavorable license agreement</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000,000</td>
</tr>
</tbody>
</table>

* Before the impact of deferred taxes is considered.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>2,625,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,100,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>525,000</td>
</tr>
</tbody>
</table>

Company A recognizes a DTA related to the license agreement’s tax-over-book basis of $2.625 million ([$20 million – $7.5 million] × 21%), of which $2.1 million is a DTA recorded in the acquisition accounting (as a reduction to goodwill). The remaining component of the DTA of $525,000 is associated with the $2.5 million financial reporting loss that was recognized in the statement of operations by the acquirer (i.e., separately 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 ASC 805-740-25-9 prohibit the recognition of a DTL for the book-over-tax-basis goodwill.

### 11.3.4.3 R&D Assets

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 Section 5.3.1.3 for guidance on using these DTLs to evaluate DTAs for realization.)

### 11.3.4.4 Leveraged Leases Acquired

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.

The guidance above is applicable for entities that have not yet adopted ASC 842.

In February 2016, the FASB issued ASU 2016-02, its new leasing standard (codified as ASC 842). ASC 842 introduces a lessee model that brings most leases onto the balance sheet; aligns certain of the underlying principles of the lessor model with those in ASC 606, the FASB’s new revenue recognition standard; and addresses other concerns related to the leasing model from the previous guidance under ASC 840. The new guidance is effective for PBEs for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2020 (i.e., calendar periods beginning on January 1, 2021), and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted for all entities.

Under ASC 842-50-30-2, the initial recognition of a leveraged lease acquired in a business combination is unchanged from the guidance in ASC 840. That is, 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.

Example 4 in ASC 842-50-55-27 through 55-33 illustrates the accounting for a leveraged lease acquired in a business combination.

For additional information about ASC 842, see Deloitte’s *A Roadmap to Applying the New Leasing Standard*. 
11.3.4.5 Obtaining Tax Basis Step-Up of Acquired Assets Through Direct Transaction With Governmental Taxing 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. Such a transaction is not with the acquiree and is not in exchange for the business acquired. Accordingly, the resulting step-up in tax basis should not be accounted for as part of the recording of deferred taxes under the acquisition method of accounting.

Rather, the acquisition of tax basis from the tax authority should be accounted for as a transaction that is separate and apart from the business combination in accordance with ASC 740-10-25-53. That guidance indicates that the deferred tax effects of a payment to a taxing authority to obtain a step-up in tax basis are generally accounted for directly in income (net of the amount of the payment). See ASC 740-10-55-202 through 55-204 for an example of such a transaction.

Further, ASC 740-10-25-54 states that if the step-up in tax basis relates to previously non-deductible goodwill that will become deductible, no DTA would be recorded, except for instances in which the deductible goodwill amount established by the step-up transaction with the taxing authority exceeds goodwill recorded for book purposes.

Changing Lanes

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB's Simplification Initiative). The ASU amends the guidance in ASC 740-10-25-54 that prohibits recognition of a DTA for a step-up in tax basis “except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill.” Stakeholders noted that applying the guidance in U.S. GAAP did not necessarily result in outcomes that reflected the economics of the underlying transactions. For example, an entity may have sacrificed an NOL carryforward in exchange for tax basis in goodwill. In that case, economically, the entity would have exchanged one asset for another and yet may have been precluded from recognizing the asset received.

As a result of stakeholder feedback, the FASB removed the guidance in ASC 740-10-25-54 that prohibited recognition of a DTA for a step-up in tax basis “except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill.” Instead, the FASB provided a list of factors to assist an entity in determining whether the step-up in tax basis is related to the business combination that caused the initial recognition of goodwill or to a separate transaction. If the step-up is related to the business combination in which the book goodwill was originally recognized, the entity would not record a DTA for the step-up in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill. If the step-up is related to a subsequent transaction, however, the entity would record a DTA.

The Board noted in paragraph BC19 of the ASU that entities still need to apply judgment in this area, and the factors provided in the ASU are intended to assist entities in doing so.

These amendments should be applied prospectively. For further information about ASU 2019-12, see Appendix B.
11.3.5 Liabilities Assumed

Recognition and measurement principles of certain liabilities assumed in a business combination may differ for financial reporting and tax purposes, resulting in deferred taxes. In addition, certain liabilities may be accounted for under exceptions to the general principles of ASC 805, requiring additional consideration when an entity is determining the appropriate tax accounting consequences.

11.3.5.1 Contingencies

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).

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.

11.3.5.1.1 Taxable Business Combination

11.3.5.1.1.1 Recognition and Initial Measurement

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 Section 11.3.2 for further discussion of the acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill.
11.3.5.1.1.2 Subsequent Measurement

In a taxable business combination, a subsequent increase or decrease in the 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 (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 Section 11.3.2 for a discussion of goodwill components). In this case, a DTL is recognized and the related income tax expense is recorded (see Example 11-13 below).

11.3.5.1.2 Nontaxable Business Combination

11.3.5.1.2.1 Recognition and Initial Measurement

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.

11.3.5.1.2.2 Subsequent Measurement

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 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 11-13 below.

---

Example 11-13

**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 IRC Section 338). In connection with the acquisition, AC recognizes a contingent liability at a fair value of $650,000. AC’s applicable tax rate is 25 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.
Example 11-13 (continued)

Tax-deductible goodwill is compared with financial reporting goodwill as follows:

<table>
<thead>
<tr>
<th>Goodwill Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-deductible goodwill</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>Acquisition-date fair value of the contingent liability</td>
<td>650,000</td>
</tr>
<tr>
<td>Hypothetical tax-deductible goodwill</td>
<td>4,150,000</td>
</tr>
<tr>
<td>Financial reporting goodwill</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Excess of hypothetical tax-deductible goodwill over financial reporting goodwill</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

Because hypothetical tax-deductible goodwill exceeds financial reporting goodwill, AC records a DTA by using the following iterative calculation, as described in Section 11.3.2:

\[
\text{DTA} = \left( \frac{0.25}{1 - 0.25} \right) \times 150,000
\]

DTA = $50,000

**June 30, 20X9**

The following journal 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 journal entries to TC’s books)**
- Identifiable assets 41,650,000
- DTA 50,000
- Goodwill ($4,000,000 – $50,000) 3,950,000
  - 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 journal 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 journal entries to TC’s books)**
- Contingent liability 350,000
- Deferred tax expense 87,500*
  - Gain on remeasurement — contingent liability 350,000
  - DTA 50,000
  - DTL 37,500

* $350,000 × 25%.
Example 11-13 (continued)

December 31, 20X9

On December 31, 20X9, AC settles the contingent liability for $1 million. 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 × 25% tax rate). At settlement, AC adjusts its tax-deductible goodwill for the $1 million amount. Deferred taxes are adjusted accordingly.

The following journal 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 journal entries to TC’s books)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent liability</td>
<td>300,000</td>
</tr>
<tr>
<td>Expense on remeasurement — contingent liability</td>
<td>700,000</td>
</tr>
<tr>
<td>DTA</td>
<td>137,500</td>
</tr>
<tr>
<td>DTL</td>
<td>37,500</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>175,000</td>
</tr>
</tbody>
</table>

Example 11-14

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 25 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.

June 30, 20X9

The following journal entries are recorded on June 30, 20X9:

AC

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>45,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>45,000,000</td>
</tr>
</tbody>
</table>

TC (to reflect “push-down” of the journal entries to TC’s books)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable assets</td>
<td>41,650,000</td>
</tr>
<tr>
<td>DTA</td>
<td>162,500</td>
</tr>
<tr>
<td>Goodwill ($4,000,000 – $162,500)</td>
<td>3,837,500</td>
</tr>
<tr>
<td>Contingent liability</td>
<td>650,000</td>
</tr>
<tr>
<td>Equity</td>
<td>45,000,000</td>
</tr>
</tbody>
</table>
Example 11-14 (continued)

**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 journal entry is recorded on September 30, 20X9:

**TC (to reflect “push-down” of the journal entries to TC’s books)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent liability</td>
<td>350,000</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td></td>
<td>87,500</td>
</tr>
<tr>
<td>Gain on remeasurement — contingent liability</td>
<td>350,000</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>87,500</td>
</tr>
</tbody>
</table>

* $350,000 × 25%.

**December 31, 20X9**

On December 31, 20X9, AC settles the contingent liability for $1 million. 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 journal entry is recorded on December 31, 20X9:

**TC (to reflect “push-down” of the journal entries to TC’s books)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent liability</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Expense on remeasurement — contingent liability</td>
<td>700,000</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td></td>
<td>75,000</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td></td>
<td>250,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>75,000</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td></td>
<td>250,000</td>
</tr>
</tbody>
</table>

**11.3.5.2 Environmental Liabilities**

A specific type of contingency that can be encountered as part of a business combination is an environmental remediation liability. 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.
Further, U.S. 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 Section 11.3.5.1, 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 Section 11.3.2 for further discussion of the acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill.

**Example 11-15**

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 IRC Section 338). 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 25 percent.

Goodwill for both financial reporting and tax purposes is calculated below:

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$5,000,000</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>All other assets</td>
<td>37,000,000</td>
<td>37,000,000</td>
</tr>
<tr>
<td>Contingent environmental liability</td>
<td>(1,000,000)</td>
<td>—</td>
</tr>
<tr>
<td>Consideration transferred</td>
<td>(45,000,000)</td>
<td>(45,000,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$4,000,000*</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

* Before the impact of deferred taxes is considered.
Example 11-15 (continued)

AC will recognize a DTL of $250,000 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) × 25%.

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-deductible goodwill</td>
<td>$ 4,000,000</td>
</tr>
<tr>
<td>Acquisition-date fair value of the contingent environmental liability</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Hypothetical tax-deductible goodwill</td>
<td>$ 5,000,000</td>
</tr>
<tr>
<td>Financial reporting goodwill ($4,000,000 + $250,000)</td>
<td>4,250,000</td>
</tr>
<tr>
<td>Excess of hypothetical tax-deductible goodwill over financial reporting goodwill</td>
<td>$ 750,000</td>
</tr>
</tbody>
</table>

Because hypothetical tax-deductible goodwill exceeds financial reporting goodwill, AC records a DTA by using the following iterative calculation, as further described in Section 11.3.2:

$$\text{DTA} = \left( \frac{0.25}{1 - 0.25} \right) \times 750,000$$

$$\text{DTA} = 250,000$$

June 30, 20X9
The following journal entries are recorded on June 30, 20X9:

**AC**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>45,000,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>45,000,000</td>
</tr>
</tbody>
</table>

**TC (to reflect “push-down” of the journal entries to TC’s books)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>All other identifiable assets</td>
<td>37,000,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>5,000,000</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,000,000*</td>
<td></td>
</tr>
<tr>
<td>Contingent environmental liability</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>DTL</td>
<td>250,000**</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>45,000,000</td>
<td></td>
</tr>
</tbody>
</table>

* ($4,000,000 + $250,000 DTL) – $250,000 DTA.

** DTL recognized for the taxable temporary difference in the land acquired ($5,000,000 – $4,000,000) × 25%.

11.3.6 Other Considerations
Other special considerations in connection with the recognition, measurement, and subsequent measurement of income taxes related to a business combination include those regarding transaction costs incurred, the settlement of preexisting relationships, assets that were previously subject to intra-entity sale guidance, and indemnification assets. As previously noted, it is important to fully understand the components of a business combination to appropriately apply the guidance.
11.3.6.1 Transaction Costs

Significant acquisition-related costs are often incurred in connection with a business combination, and the accounting for such costs may differ for financial and tax reporting purposes. To determine the appropriate accounting for acquisition-related costs, entities may need to also consider (among other factors) the timing of the expenditures (i.e., before or after the business combination is consummated) and which entity incurs the costs (i.e., the acquiree or the acquirer).

11.3.6.1.1 Transaction Costs Incurred by the Acquirer

In accordance with ASC 805-10, acquisition-related costs incurred by the acquirer in connection with a business combination (e.g., deal fees for attorneys, accountants, investment bankers, and valuation experts) must be expensed as incurred for financial reporting purposes unless they are subject to other U.S. GAAP (e.g., costs related to the issuance of debt or equity securities).

When acquisition-related costs are incurred, it may not be clear whether they will ultimately be deductible for income tax reporting purposes. For example, certain acquisition-related costs may have to be capitalized for income tax reporting purposes when incurred and become immediately deductible if the business combination is not consummated. If the business combination is consummated, the capitalized costs may be added (1) to the basis of the assets acquired in a taxable asset acquisition or (2) to the basis in the stock of the acquired entity in a nontaxable stock acquisition. 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).

When acquisition-related costs are incurred in a period before a business combination is consummated and those costs are capitalized for tax purposes, a book/tax basis difference results. The acquirer will need to assess whether that basis difference represents a deductible temporary difference for which a DTA should be recorded. In making this determination, the acquirer may use either of the following two approaches.8

- **Approach 1** — If the costs that were capitalized for tax purposes will become deductible in the event the business combination does not occur, a deductible temporary difference exists, and a DTA should be recorded when the expense is recognized for financial reporting purposes. If the business combination is ultimately consummated, the acquirer would need to reassess the DTA to determine whether recognition continues to be appropriate. For example, if the business combination occurs and is a taxable asset acquisition, the capitalized costs would be added to the basis of the net assets acquired, and a DTA would generally result. Alternatively, if the business combination is consummated and is a nontaxable stock acquisition, the capitalized costs would be added to the basis of the stock acquired, and an outside basis deductible temporary difference would typically be created. However, the entity would need to evaluate whether an exception to recognition of the outside basis DTA is applicable (i.e., the entity would need to evaluate ASC 740-30-25-9). If recognition is no longer appropriate, the DTA should be reversed to the income statement.

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8 The approach an entity selects is an accounting policy election that, like all such elections, should be applied consistently.
• Approach 2 — The acquirer can record a DTA if, on the basis of (1) the probability that the business combination will be consummated and (2) the expected tax structure of the business combination, the acquisition-related expenses would result in a future tax deduction. Approach 2 requires the acquirer, in determining whether to record all or a portion of the DTA for the acquisition expenses, to make assumptions about how the transaction would be structured from a tax perspective and about the probability that the business combination would be consummated. As a result of this approach, the entity would conform its financial reporting to its “expectation” as of each reporting date (i.e., the DTA may be recognized and subsequently derecognized if expectations change from one reporting period to the next).

11.3.6.1.2 Transaction Costs Incurred by the Target

Like acquisition-related costs incurred by the acquirer, precombination transaction costs incurred by the target are generally expensed as incurred for financial reporting purposes. It may not be clear at the time the costs are incurred whether they will ultimately be deductible for income tax reporting purposes. In some jurisdictions, capitalized transaction costs incurred by the target may result in a tax deduction (1) if the business combination is not consummated or (2) if the business combination is consummated and is treated as a taxable asset sale. However, if the business combination is consummated in the form of a nontaxable stock sale, the target’s capitalized transaction costs may not be deductible or amortizable.

When the target incurs precombination transaction costs and those costs are capitalized for tax purposes, the target will also need to assess whether that temporary difference is a deductible temporary difference for which a DTA should be recorded. We believe that the target may use either of the aforementioned approaches available to the acquirer to account for the expected tax consequences of the precombination transaction costs.9

Example 11-16

**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 income tax reporting purposes, AC adds the $200 acquisition-related costs to the total amount that is allocated to assets, resulting in tax-deductible goodwill of $500. Assume that the tax rate is 21 percent.

AC would record the following journal entries on the acquisition date:

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Acquisition expense</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>42*</td>
<td></td>
</tr>
<tr>
<td>Income tax expense</td>
<td>42</td>
<td></td>
</tr>
</tbody>
</table>

* $200 (acquisition-related costs that are capitalized as amortizable goodwill for tax purpose) × 21%.

9 See footnote 8.
Example 11-16 (continued)

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 with financial reporting goodwill nor (2) the iterative calculation described in ASC 805-740-25-8 and 25-9 and Section 11.3.2 is required.

Example 11-17

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 21 percent tax rate.

AC would record the following journal entries on the acquisition date:

<table>
<thead>
<tr>
<th>Assets</th>
<th>700</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>394.5</td>
</tr>
<tr>
<td></td>
<td>DTL</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>Acquisition expense</td>
<td>200</td>
</tr>
<tr>
<td>Cash</td>
<td>200</td>
</tr>
</tbody>
</table>

* ($700 fair value – $250 tax basis) × 21%.

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.

11.3.6.2 Contingent Consideration

Many business combinations include contingent consideration features whereby the amount of consideration the buyer ultimately pays for the business will depend on the outcome of future events (for example, the earnings generated by the business for a period after the acquisition). ASC 805 requires the buyer to initially measure the contingent consideration at fair value and include the incurred liability as part of the purchase price for the acquired business. However, as discussed further below, there can be complexities regarding the initial and subsequent accounting for the tax impacts of contingent consideration.
11.3.6.2.1 The Income Tax Measurement Consequences of Contingent Consideration in a Business Combination

Differences exist between the accounting for contingent consideration in a business combination under U.S. GAAP and that accounting under the tax code. 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. The accounting consequences of the classification of contingent consideration are as follows:

- 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. As a result, a book-to-tax basis difference may arise.

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 as of the acquisition date. The tax consequences will, in part, depend on how the business combination is structured for tax purposes (i.e., as a taxable or nontaxable business combination).

11.3.6.2.1.1 Taxable Business Combination — Initial Measurement

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 Section 11.3.2 for further discussion of the acquisition-date comparison of financial reporting goodwill with tax-deductible goodwill.

11.3.6.2.1.2 Taxable Business Combination — Subsequent Measurement

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 Section 11.3.2 for a discussion of goodwill components). In this case, a DTL is recognized and the related income tax expense is recorded (see Example 11-18 below).

### 11.3.6.2.1.3 Nontaxable Business Combination — Initial Measurement

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; for more information about “inside” and “outside” basis differences, see Section 3.3.1). 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 Section 11.3.1.2 for further discussion of recognizing DTAs and DTLs related to outside basis differences.

### 11.3.6.2.1.4 Nontaxable Business Combination — Subsequent Measurement

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 11-19.

#### Example 11-18

**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 IRC Section 338). The identifiable assets have a fair value of $45 million and an initial tax basis of $45 million. AC’s applicable tax rate is 21 percent.

**June 30, 20X9**

The following journal entries are recorded on June 30, 20X9:

<table>
<thead>
<tr>
<th>AC</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment in TC 50,000,000</td>
</tr>
<tr>
<td></td>
<td>Cash 45,000,000</td>
</tr>
<tr>
<td></td>
<td>Contingent consideration liability 5,000,000</td>
</tr>
</tbody>
</table>
Example 11-18 (continued)

TC (to reflect “push-down” of the journal entries to TC’s books)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable assets</td>
<td>45,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Equity</td>
<td>50,000,000</td>
</tr>
</tbody>
</table>

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**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent consideration liability</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Gain on remeasurement — contingent</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>420,000</td>
</tr>
<tr>
<td>DTL</td>
<td>420,000</td>
</tr>
</tbody>
</table>

The $2 million decrease would reduce the hypothetical tax-deductible component 1 goodwill by $2 million. Accordingly, a $420,000 DTL is recognized ($2 million × 21%), with an offsetting journal entry to deferred tax expense.

**December 31, 20X9**

On December 31, 20X9, AC settles the contingent consideration for $11 million (fair value).

**AC**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense on remeasurement — contingent consideration</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Contingent consideration liability</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>11,000,000</td>
</tr>
<tr>
<td>DTA</td>
<td>1,260,000</td>
</tr>
<tr>
<td>DTL</td>
<td>420,000</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>1,680,000</td>
</tr>
</tbody>
</table>

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 $1.26 million DTA is recognized along with a decrease of the $420,000 DTL that was recognized on September 30, 20X9. The offsetting journal entry is to recognize deferred tax expense of $1.68 million.
Example 11-19

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 21 percent.

June 30, 20X9

The following journal entries are recorded on June 30, 20X9:

AC

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>50,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>45,000,000</td>
</tr>
<tr>
<td>Contingent consideration liability</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>

TC (to reflect “push-down” of the journal entries to TC's books)

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable assets</td>
<td>45,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Equity</td>
<td>50,000,000</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax basis of AC's investment in TC</td>
<td>$ 45,000,000</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Hypothetical tax basis</td>
<td>50,000,000</td>
</tr>
<tr>
<td>AC's investment in TC for financial reporting</td>
<td>50,000,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$ —</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent consideration liability</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Gain on remeasurement — contingent consideration</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>
Example 11-19 (continued)

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).

<table>
<thead>
<tr>
<th>AC</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense on remeasurement — contingent consideration</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Contingent consideration liability</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>11,000,000</td>
</tr>
</tbody>
</table>

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.

### 11.3.6.3 Business Combinations Achieved in Stages

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 OCI 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 Section 3.3.1.)

### 11.3.6.3.1 DTLs for Domestic Subsidiaries Acquired in Stages

If the acquiree is a domestic subsidiary, 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.
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 also 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 11-20 below.

**Example 11-20**

In year 1, AC purchased 20 percent of TC, a domestic investee, for $100. In year 2, AC records $100 of equity method earnings. Accordingly, at the end of year 2, AC has a $200 book basis and $100 tax basis in its equity method investment and records a DTL of $21 on the outside basis difference. Assume that the tax rate is 21 percent.

AC’s journal entries are as follows:

**Year 1**

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>100</td>
</tr>
<tr>
<td>Cash</td>
<td>100</td>
</tr>
</tbody>
</table>

**Year 2**

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>100</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>21</td>
</tr>
<tr>
<td>DTL</td>
<td>21</td>
</tr>
<tr>
<td>Equity in earnings of TC</td>
<td>100</td>
</tr>
</tbody>
</table>

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 journal entries for the remeasurement of its original investment in TC:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>300</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>63</td>
</tr>
<tr>
<td>Gain on remeasurement — original investment</td>
<td>300</td>
</tr>
<tr>
<td>DTL</td>
<td>63*</td>
</tr>
</tbody>
</table>

* Tax effects of the increase in the outside-basis difference ($300 × 21%).

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).
Example 11-20 (continued)

AC records the following journal entries for the acquisition and resulting deferred taxes:

**AC**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
</tbody>
</table>

**TC (to reflect “push-down” of the journal entries to TC’s books)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable assets</td>
<td>2,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>815</td>
</tr>
<tr>
<td>DTL</td>
<td>315</td>
</tr>
<tr>
<td>Equity</td>
<td>2,500</td>
</tr>
</tbody>
</table>

A DTL of $315 is recorded on the inside basis difference attributable to the asset acquired, 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 ($815 – $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.

As discussed in Section 11.3.6.3.2, 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.

Example 11-21

Assume the same facts as in Example 11-20, 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 journal entries for the remeasurement of its original investment in TC:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>300</td>
</tr>
<tr>
<td>DTL</td>
<td>21</td>
</tr>
<tr>
<td>Gain on remeasurement — original investment</td>
<td>300</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>21</td>
</tr>
</tbody>
</table>

Because AC determines that its outside basis difference in TC (a domestic investee) is not a taxable temporary difference under ASC 740-30-25-7, AC reverses the previously recorded DTL for the outside basis difference ([$200 book basis – $100 tax basis] × 21% tax rate) and records no DTL for the outside basis difference created from the remeasurement gain.

AC records the following journal entries for the acquisition and resulting deferred taxes:

**AC**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in TC</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
</tbody>
</table>
Example 11-21 (continued)

TC (to reflect “push-down” of the journal entries to TC’s books)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable assets</td>
<td>2,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>815</td>
</tr>
<tr>
<td>DTL</td>
<td>315</td>
</tr>
<tr>
<td>Equity</td>
<td>2,500</td>
</tr>
</tbody>
</table>

A DTL of $315 ([$2,000 – $500] × 21%) is still recorded on the inside basis difference of the assets acquired, since the exception in ASC 740-30-25-7 is related only to the outside basis differences.

As discussed in Section 11.3.6.3.2 below, 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 $21 shown in the first journal entry above would not be applicable. In addition, a DTL resulting from the remeasurement of AC’s original investment in TC may also be required (see the discussion in Section 11.3.6.3.2 below).

If TC were a partnership for U.S. tax purposes and AC purchased its interest via a separate subsidiary so that TC’s partnership status postacquisition was preserved, 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.

11.3.6.3.2 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:

- The DTL associated with the entire outside basis difference, including any DTL associated with the remeasurement of the original investment, should be retained.
- 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.
Changing Lanes

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB's Simplification Initiative). The ASU amends the guidance in ASC 740-30-25-16 on situations in which a foreign equity method investment becomes a subsidiary. The previous guidance stated that the DTL previously recognized for a foreign investment could not be derecognized when the investment became a subsidiary unless dividends received from the subsidiary exceeded earnings from the subsidiary after the date it became a subsidiary. This was this case regardless of whether an exception under ASC 740-30-25-18(a) applied.

The FASB noted that this requirement increased the cost and complexity of applying ASC 740 because it essentially required an entity to bifurcate its outside basis difference in the subsidiary and account for the components separately. This complicated the accounting for investments and foreign subsidiaries and reduced comparability across entities (i.e., some of a reporting entity's subsidiaries may not have been eligible to apply the exception simply because of the nature of the investment before it became a subsidiary).

To decrease the complexity of applying ASC 740 and increase the usefulness of information for financial statement users, the FASB removed the exception in ASC 740-30-25-16 that freezes the DTL on the outside basis difference that existed before the investment became a subsidiary. Accordingly, an entity may need to reverse a DTL and recognize a tax benefit if it asserts indefinite reinvestment of earnings of the subsidiary. This treatment results in consistency among all the entity's subsidiaries for which indefinite reinvestment is asserted.

Entities should apply these amendments by using a modified retrospective approach, which would require removing deferred liabilities as of the beginning of the period of adoption, with a cumulative-effect adjustment to retained earnings. For further information about ASU 2019-12, see Appendix B.

11.3.6.4 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 11-22).
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.

Example 11-22 (below) and Example 11-23 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 11-22**

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 21 percent. Assume a **taxable** transaction in a jurisdiction that allows for tax-deductible goodwill.

AC will record the following journal 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: $1,050,000
- Income tax expense: $1,050,000

The $5 million loss on the supply contract is recognized as an expense in the statement of operations for financial reporting purposes (e.g., separately and apart from the acquisition accounting). Typically, the supply contract will not be viewed as a separate transaction for tax purposes and will be included in tax-deductible goodwill, resulting in a temporary difference. This will give rise to a DTA and a tax provision credit as a result of tax affecting the $5 million loss recognized in the statement of operations. The resulting DTA would be reversed when the goodwill is deducted on the tax return (as long as there are no realization concerns).

Note that if this transaction was structured as a **nontaxable** business combination (i.e., AC acquires the stock of TC), the basis difference that arises related to the $5 million loss would not give rise to a DTA as discussed in the preceding paragraph (i.e., because it would now be related to an excess tax over financial reporting basis in a subsidiary and be subject to the exception in ASC 740-30-25-9).
Example 11-23

Assume the same facts as in Example 11-22 (e.g., a taxable business combination and tax-deductible goodwill), except that AC had recorded a $6 million liability and a $1.26 million DTA related to the supply contract with TC before the business combination.

AC will record the following journal entries on the acquisition date:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine equipment</td>
<td>42,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Liability — unfavorable supply contract</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>50,000,000</td>
</tr>
<tr>
<td>Gain</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>1,260,000</td>
</tr>
<tr>
<td>DTA</td>
<td>1,260,000</td>
</tr>
</tbody>
</table>

In applying ASC 805-10-55-21(b), AC recognizes a $1 million settlement gain on the contract (the $5 million measured loss on the contract less the $6 million loss previously recognized), along with the corresponding tax effects, separately from the business combination. The $3 million at-market component of the contract is part of goodwill.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>1,050,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>1,050,000</td>
</tr>
</tbody>
</table>

Because the transaction is structured as a taxable business combination, the tax impact on the total $5 million loss related to the supply contract is treated the same as in Example 11-22 (i.e., the supply contract will not be viewed as a separate transaction for tax purposes and will be included in tax-deductible goodwill, resulting in a temporary difference and corresponding DTA and tax provision credit).

11.3.6.5 Accounting for Assets Acquired in a Business Combination That Were Subject to an Intra-Entity Sale

Changing Lanes

In October 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 related to assets other than inventory applies before the adoption of ASU 2016-16. After adoption, the guidance below will apply only to inventory.

As discussed in Section 3.5.6, 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).

### 11.3.6.6 Recognition of Changes in Indemnification Assets Under a Tax
Indemnification Arrangement

Business combinations commonly involve tax indemnification arrangements between the former parent
and the acquirer of a subsidiary in which the parent partly or fully indemnifies the acquirer for tax
uncertainties related to uncertain tax positions taken by the subsidiary in periods before the sale of the
subsidiary.

ASC 805 addresses the accounting for indemnifications in a business combination. Specifically, ASC
805-20-25-27 states that the “acquirer shall recognize an indemnification asset at the same time that
it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to
the need for a valuation allowance for uncollectible amounts.” ASC 805-20-30-19 further elaborates on
indemnifications provided for uncertain tax positions:

> [A]n indemnification may relate to an asset or a liability, for example, one that results from an uncertain tax
> position that is measured on a basis other than acquisition-date fair value. [I]n those circumstances, the
> indemnification asset shall be recognized and measured using assumptions consistent with those used to
> measure the indemnified item, subject to management’s assessment of the collectibility of the indemnification
> asset and any contractual limitations on the indemnified amount.

Therefore, if the subsidiary (after the acquisition) has UTBs determined in accordance with ASC 740,
and if the related tax positions are indemnified by the former parent, the subsidiary could recognize an
indemnification asset on the basis of the indemnification agreement and the guidance in ASC 805-20-
25-27 and ASC 805-20-30-19. ASC 805-20-35-4 also provides guidance on subsequent measurement of
indemnification assets.

**Example 11-24**

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.

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10 Entities should not use this example as a basis for recording an indemnification receivable since they would need additional facts to reach such a
collection. 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 11-24 (continued)

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 Section 2.8 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 Section 4.6.6 for considerations involving UTBs in a spin-off transaction.

For additional considerations related to income tax indemnifications upon the sale of a subsidiary that previously filed a separate tax return, meaning that the acquiring entity may not be directly liable for the acquiree's tax obligations upon acquisition, see Section 2.8.

11.4 Accounting for Uncertainty in Income Taxes in Business Combinations

Uncertain tax positions related to a business combination and subsequent changes to those positions require special consideration under ASC 805 during the initial measurement period and after a business combination.

ASC 805-740

Other Presentation Matters

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 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.
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).

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.

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.

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, 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.

### 11.4.1 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 are related 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 FASB 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 Section 11.4 for additional guidance.)

**Example 11-25**

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 FASB 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 FASB 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 11-26**

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 FASB 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 FASB 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.

**11.5 Valuation Allowances**

In accordance with the guidance in ASC 740-10 and ASC 805-740, an acquirer recognizes DTAs and DTLs associated with the assets acquired and the liabilities assumed in a business combination. The acquirer also assesses whether a valuation allowance is required against some or all of the acquired DTAs when it is not more likely than not that such DTAs will be realized. This is generally done as part of purchase accounting. The business combination may also cause a change in judgment about the realizability of the acquirer’s DTAs.

Special consideration is required of a reporting entity when it is accounting for changes in a valuation allowance as of or after a business combination under ASC 805-740. The reporting entity should carefully consider the reason for the change in the valuation allowance, the DTAs to which the change in valuation allowance relates (i.e., whether they are the acquiree’s or the acquirer’s), and whether the information that caused the change in judgment existed before the acquisition date.
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. 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.

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. 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.

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]).

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 pasts 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.

Other Presentation Matters

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).

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.

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.

Related Implementation Guidance and Illustrations

- 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].
11.5.1 Accounting for Changes in the Acquirer’s and Acquiree’s Valuation Allowances as of and After the 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:

<table>
<thead>
<tr>
<th>Changes in Valuation Allowance as a Result of Facts and Circumstances That:</th>
<th>Existed as of the Acquisition Date</th>
<th>Occurred After the Acquisition Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation allowance on the acquiring entity’s DTAs that existed as of the acquisition date</td>
<td>Generally, 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 business combination accounting. Accordingly, all changes to an acquirer’s valuation allowance 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]).</td>
<td>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).</td>
</tr>
<tr>
<td>Valuation allowance on the acquired entity’s DTAs that existed as of the acquisition date</td>
<td>Generally, record as an adjustment to income tax expense (see ASC 805-740-45-2).</td>
<td>Generally, record as an adjustment to income tax expense (see ASC 805-740-45-2).</td>
</tr>
</tbody>
</table>

Under ASC 805, a valuation allowance established against acquired DTAs is recorded as part of acquisition accounting (i.e., establishing the valuation allowance would generally result in an increase to goodwill). By contrast, under ASC 805-740-30-3, a change in the acquirer’s valuation allowance as a result of the business combination is recognized as a component of income tax expense (i.e., it is accounted for separately from the business combination accounting). In addition, the impact of a change in a valuation allowance related to acquired DTAs as a result of facts and circumstances that occurred after the acquisition date is recognized as a component of income tax expense separately from the business combination.

Although a change in judgment related to an acquiring entity’s valuation allowance may appear to be inextricably linked to the business combination (e.g., the addition of an extra source of income to support realizability of DTAs), the impact should generally be recorded to income tax expense or benefit in the period of the change in judgment. For example, 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.)
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).

### 11.5.2 Assessing the Need for a Valuation Allowance as of and After the Acquisition Date

It may be complex for a reporting entity to determine whether DTAs — whether those of the acquiree or those of the acquirer — are more likely than not to be realized when the entity undertakes an acquisition. ASC 740-10-30-18 indicates that the future reversal of existing taxable temporary differences is one of four possible sources of taxable income that may be available to an entity for realizing a tax benefit for deductible temporary differences and carryforwards under the tax law. In some cases, acquired DTLs may represent a source of taxable income that supports the realizability of some or all of the benefit of either (1) the acquired DTAs or (2) the acquirer's DTAs but is not sufficient to support both. In this circumstance, the guidance in ASC 805 and ASC 740 is not clear about whether the acquired DTLs should be first considered a source of taxable income in the evaluation of realizability of the acquired DTAs or the acquirer's existing DTAs.

There are two acceptable methods that entities can use to determine how the source of taxable income from the future reversal of acquired DTLs should be allocated in the evaluation of the realizability of the acquired DTAs and the acquirer's existing DTAs. The method an acquirer selects is an accounting policy decision that should be applied consistently. The acquirer should also provide appropriate disclosures, including information about benefits or expenses recognized for changes in its valuation allowance made in accordance with ASC 805-740-50-1.

- **Method 1: Assess acquired DTAs first** — The acquirer first considers the acquired DTLs to be a source of taxable income for realization of the acquired DTAs. ASC 805-20-30-1 states that the “acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.” Allocating the source of taxable income from the acquiree's DTLs first to the realization of the acquiree's DTAs is consistent with this principle. Any net residual source of taxable income from the acquiree's DTLs remaining after the acquiree's DTAs are taken into account would be considered a potential source of taxable income for the realization of the benefit of the acquirer's existing DTAs. Any change in the acquirer's valuation allowance is recognized in income tax expense.

- **Method 2: Assess on the basis of tax law ordering** — Allocation of the source of taxable income from the acquiree's DTLs is based on the tax law in the given jurisdiction. To determine whether the acquiree's DTAs or the acquirer's DTAs will be used to reduce taxable income that results from the reversal of the DTLs, the acquirer schedules the reversal of all temporary differences of both the acquirer and the acquiree on the basis of the applicable tax law. If such scheduling does not result in a determination, the acquirer should develop a systematic, rational, and consistent method for scheduling the reversal of the temporary differences. Under this method, a net DTL could be recorded through purchase accounting, and the entity could simultaneously recognize an income tax benefit for the release of the acquirer's valuation allowance. The net DTL that is reflected in the acquisition accounting will commonly result in an increase of an asset (generally goodwill).

Under this method, it is assumed that the fair value measurement principle is not applied to DTAs and DTLs and that scheduling of the combined group's DTLs and DTAs is a normal part of that valuation analysis by an acquirer. It is also assumed that immediately after the business combination, the valuation allowance determination is performed by using the combined group's postacquisition positive and negative evidence (i.e., not solely the acquiree's positive and negative evidence).
Example 11-27

This example illustrates the application of each method in a valuation allowance assessment.

Assume the following:

- AC purchased TC in a nontaxable transaction.
- AC will file a consolidated tax return that will include TC.
- Before the acquisition, AC has a $1,000 NOL DTA with a $1,000 valuation allowance.
- After the application of acquisition accounting, TC has a $600 NOL DTA and a $600 DTL.
- Other than the $600 DTL, there are no other sources of taxable income for realizing the benefit of the consolidated group's DTAs.
- In accordance with tax law, the oldest available NOLs must be used first. There are no other limitations on the use of attributes.

The following table shows the years when the NOL carryforwards will expire:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>AC</td>
<td>1,000</td>
<td>400</td>
<td>600</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>TC</td>
<td>600</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following table shows the years when the DTL will reverse:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>TC</td>
<td>(600)</td>
<td>(150)</td>
<td>(150)</td>
<td>(150)</td>
<td>(150)</td>
</tr>
</tbody>
</table>

Application of Method 1

TC records a DTA of $600 and a DTL of $600 as part of the acquisition accounting. There is no impact on AC's deferred tax balances. AC's final consolidated financial statements will reflect a $1,600 DTA, a $600 DTL, and a $1,000 valuation allowance.

Application of Method 2

Per tax law, AC's older NOL DTAs must be used first; however, a portion of AC's NOL DTAs will expire in 20X1 and 20X2 before the full reversal of the DTL. The $300 of taxable income that will result from reversal of the acquired DTL in 20X1 and 20X2 will be allocated as a source of income to support the realizability of AC's NOL DTA. The $300 of taxable income that will result from reversal of the acquired DTL in 20X3 and 20X4 will be allocated as a source of income to support the realizability of TC's NOL DTA.

The purchase price allocation for TC will therefore include a $600 DTA, a $600 DTL, and a $300 valuation allowance as part of the acquisition accounting. AC will reverse $300 of valuation allowance and record a corresponding income tax benefit of $300. AC's final consolidated financial statements will reflect a $1,600 DTA, a $600 DTL, and a $1,000 valuation allowance.

11.6 Share-Based Payments

Changing Lanes

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance also contains two practical expedients under which nonpublic entities can use the simplified method to estimate the expected term of an award and make a one-time election to switch from fair value measurement to intrinsic value measurement for liability-classified awards. For PBEs,
the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods therein. 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.

Because ASU 2016-09 is effective for all entities, the guidance in this Roadmap is written as if adoption has occurred. For guidance before the adoption of ASU 2016-09, see Deloitte's *A Roadmap to Accounting for Share-Based Payment Awards*.

In a business combination, share-based payment awards held by employees of the acquiree are often exchanged for share-based payment awards of the acquirer. ASC 805 refers to the new awards as “replacement awards.” This exchange may or not be required as part of the acquisition or as part of the acquiree’s stock compensation plan. When the exchange is required as part of the acquisition, the acquirer must analyze the terms of both the preexisting and the replacement awards to determine what portion of the replacement awards is related to past service and therefore part of the consideration transferred in the business combination. The portion of replacement awards that is related to future services should be recognized as compensation cost in the postcombination period. Additional complexities arise when the terms of the replacement awards are different from those of the original rewards. See Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards* for additional discussion about the accounting for equity awards issued in connection with a business combination.

Similarly, ASC 805-740 includes specific income tax accounting guidance related to these types of awards. Because a portion of the fair value of the replacement award may be considered part of the consideration transferred in the business combination, initial and subsequent accounting for the income tax effects of the awards may be complex.

**ASC 805-740**

**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.

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

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 exchange of goods or services and therefore included in consideration transferred in the business combination.

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.
11.6.1 Tax Benefits of Tax-Deductible Share-Based Payment Awards Exchanged in a Business Combination

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.

11.6.1.1 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., NQSOs), an acquirer should record a DTA as of the acquisition date for the tax benefit of the fair-value-based measure of the acquirer’s replacement award included in the consideration transferred.

11.6.1.2 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.

11.6.1.3 Income Tax Accounting Upon Exercise of the Share-Based Payment Awards

ASC 805-740-45-5 states, in part, that “the deduction reported on a tax return for a replacement award classified as equity may be different from the fair-value-based measure of the award. The tax effect of that difference shall be recognized as income tax expense or benefit in the income statement of the acquirer.”

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 11-28 (below) and Example 11-29, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits received from tax-deductible share-based payment awards that are exchanged in a business combination after the effective date of FASB Statement 141(R).

**Example 11-28**

The par value of the common stock issued and cash received for the option’s exercise price are not considered in this example.

Assume the following:
- Company A has a calendar year-end and therefore adopted FASB Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., NQSOs).
- Company A’s applicable tax rate is 25 percent.

Company A issues replacement awards of $110 (fair-value-based measure) on the acquisition date in exchange for Company B’s awards of $100 (fair-value-based measure) on the acquisition date. The exercise price of the replacement awards issued by A is $15. No postcombination services are required for the replacement awards, and B’s employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to precombination service is the fair-value-based measure of B’s awards ($100) on the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination service is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to precombination service ($100). Because no postcombination service is required for the replacement awards, A immediately recognizes $10 as compensation cost in its postcombination financial statements. See the following journal entries.

**Journal Entry: June 30, 20X1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Compensation cost</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>110</td>
</tr>
</tbody>
</table>

To record the portions of the fair-value-based measure of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

**Journal Entry: June 30, 20X1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>27.5</td>
<td>25</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>25</td>
</tr>
<tr>
<td>Income tax provision</td>
<td></td>
<td>2.5</td>
</tr>
</tbody>
</table>

To record the associated income tax effects of the fair-value-based measure of the portions of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).
Example 11-28 (continued)

On September 30, 20X1, all replacement awards issued by A are exercised when the market price of A's shares is $150. Given the exercise of the replacement awards, A will realize a tax deduction of $135 ($150 market price of A's shares less the $15 exercise price). The tax benefit of the tax deduction is $33.75 ($135 × 25% tax rate). Therefore, an excess tax benefit of $6.25 (tax benefit of the tax deduction of $33.75 less the previously recorded DTA of $27.5) is recorded to current income tax expense. See the following journal entry.

**Journal Entry: September 30, 20X1**

| Account                  | Amount  
|--------------------------|---------
| Taxes payable            | 33.75   
| Deferred tax expense     | 27.5    
| Current tax expense      |         
| DTA                      |         

**To record the income tax effects of the award upon exercise.**

---

Example 11-29

The par value of the common stock issued and cash received for the option's exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted FASB Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., NQSOs).
- Company A's applicable tax rate is 25 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 × [4 years/5 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.
Example 11-29 (continued)

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

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>APIC</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>2.5</td>
<td></td>
</tr>
</tbody>
</table>

To record the compensation cost and the associated income tax effects for the six-month period from the date of the acquisition until December 31, 20X1.

**Journal Entries: June 30, 20X1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>APIC</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Goodwill</td>
<td>20</td>
<td></td>
</tr>
</tbody>
</table>

To record the portion of the fair-value-based measure of the replacement award attributable to precombination services (i.e., consideration transferred) and the associated income tax effects.

On June 30, 20X2, all replacement awards issued by A vest and are exercised when the market price of A's shares is $150. Given the exercise of the replacement awards, A will realize a tax deduction of $135 ($150 market price of A's shares less the $15 exercise price). The tax benefit of the tax deduction is $33.75 ($135 × 40% tax rate). Therefore, an excess tax benefit of $8.75 (tax benefit of the tax deduction of $33.75 less the previously recorded DTA of $25 [$20 + $2.5 + $2.5]) is recorded to current income tax expense. See the following journal entries.

**Journal Entries: June 30, 20X2**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>APIC</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>2.5</td>
<td></td>
</tr>
</tbody>
</table>

To record the compensation cost and the associated income tax effects for the six-month period ended June 30, 20X2.

**Journal Entry: June 30, 20X2**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
<td>33.75</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Current tax expense</td>
<td>33.75</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>25</td>
<td></td>
</tr>
</tbody>
</table>

To record the income tax effects of the award upon exercise.
11.6.2 Settlement of Share-Based Payment Awards Held by the Acquiree’s Employees

As described above, in a business combination, the acquiring company often issues replacement share-based payment awards to the acquiree’s employees. 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:

Example 11-30

On December 1, 20X1, Company A enters into an agreement to acquire Company B, in which A offers 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 agrees 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 agrees to the cash-settlement provision because it wants 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 is made at A’s discretion, the accelerated unrecognized compensation cost of B’s awards will 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-settles 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-settles the awards within two-and-a-half months of the end of B’s taxable period ending December 1, 20X1. The income tax deduction for the cash-settled awards reduces taxable income and creates an NOL carryforward in B’s income tax return for the short period ended December 1, 20X1. This NOL carryforward is available to reduce A’s postcombination taxable income.

Because the cash settlement of B’s awards is deductible for tax purposes in B’s precombination consolidated tax return and payment does not occur until December 6, 20X1, A’s tax-basis acquisition accounting balance sheet will 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.
Example 11-30 (continued)

- **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.

### 11.7 Other Considerations

Entities should be mindful of other tax considerations that are not directly related to or within the scope of the accounting literature on business combinations, including those that address deconsolidation, a planned sale or disposal of a business (either of which would trigger discontinued operations presentation in the financial statements), the election of an acquiree to apply pushdown accounting, and other reorganizations or mergers in contemplation of an IPO or related transaction.

#### 11.7.1 Deconsolidation

Although this chapter focuses on business combinations, entities must also evaluate special considerations when accounting for transactions that cause deconsolidation of subsidiaries. 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.

#### 11.7.1.1 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.
11.7.1.1  **Asset Sale**

When the net assets of a subsidiary are sold, the parent will present the gain or loss on the net assets (excluding deferred taxes) in pretax income and will present the reversal of any DTAs or DTLs associated with the assets sold (the inside basis differences\(^{12}\)) and any tax associated with the gain or loss on sale in income tax expense (or benefit).

11.7.1.1.2  **Stock Sale**

As with an asset sale, when the shares of a subsidiary are sold, the parent will present the gain or loss on the net assets in pretax income. One acceptable approach to accounting for the reversal of deferred taxes (the inside basis differences\(^{13}\)) is to include the reversal in the computation of the pretax gain or loss on the sale of the subsidiary; under this approach, the only amount that would be included in income tax expense (or benefit) would be the tax associated with the gain or loss on the sale of the shares (the outside basis difference\(^{14}\)). 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 Section 3.4.17.2 for a discussion of outside basis differences in situations in which the subsidiary is presented as a discontinued operation.

11.7.1.2  **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 differences\(^{15}\)) 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.

11.7.1.2.1  **Asset Sale**

In an asset sale, the tax bases of the assets and liabilities being sold will not be transferred to the buyer. Therefore, the deferred taxes related to the assets and liabilities (the inside basis differences\(^{16}\)) being sold should not be presented as held for sale; rather, they should be presented along with the consolidated entity’s other deferred taxes.

11.7.1.2.2  **Stock Sale**

In a stock sale, the tax bases of the assets and liabilities being sold generally are carried over to the buyer. Therefore, the deferred taxes related to the assets and liabilities (the inside basis differences\(^{17}\))

\(^{12}\) See Section 11.3.1 for the meaning of “inside” and “outside” basis differences.

\(^{13}\) See footnote 12.

\(^{14}\) See footnote 12.

\(^{15}\) See footnote 12.

\(^{16}\) See footnote 12.

\(^{17}\) See footnote 12.
being sold should be presented as held for sale and not with the consolidated entity's other deferred taxes.

11.7.2 Discontinued Operations
When an entity contemplates sale or disposition of a portion of its business, this might cause the portion of the business to be presented as discontinued operations. In this scenario, specific accounting considerations apply. Guidance on discontinued operations is presented in other sections of this Roadmap:

- See Section 3.4.17.2 for a discussion of recognition of a DTA related to a subsidiary presented as a discontinued operation.
- See Section 7.2 for interim reporting implications of intraperiod tax allocation for discontinued operations.

11.7.3 Pushdown Accounting Considerations
As previously noted, when an entity obtains control of a business, a new basis of accounting is established in the acquirer’s financial statements for the assets acquired and liabilities assumed. Sometimes the acquiree will prepare separate financial statements after its acquisition. Use of the acquirer's basis of accounting in the preparation of an acquiree’s separate financial statements is called pushdown accounting.

In November 2014, the FASB issued ASU 2014-17, which became effective upon issuance. This ASU gives an acquiree the option to apply pushdown accounting in its separate financial statements when it has undergone a change in control. See Appendix A of Deloitte’s A Roadmap to Accounting for Business Combinations for additional discussion regarding pushdown accounting.

11.7.3.1 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, to the extent the reporting entity's functional currency differs from the currency in which an acquiree files its tax return, 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 11-31

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 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:

#### Conversion Rate as of Date of Acquisition: 1 euro = 1 USD

<table>
<thead>
<tr>
<th>Description</th>
<th>Statutory Financial Statements — Local GAAP</th>
<th>Stat-to-GAAP Adjustment</th>
<th>GAAP — Local Currency</th>
<th>GAAP — Reporting Currency</th>
<th>GAAP — Local Currency</th>
<th>GAAP — Reporting Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangibles</td>
<td>—</td>
<td>€ 10,000</td>
<td>€ 10,000</td>
<td>$10,000</td>
<td>€ 9,000</td>
<td>$10,800</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>€ 2,500</td>
<td>€ 2,500</td>
<td>$2,500</td>
<td>€ 2,500</td>
<td>$3,000</td>
</tr>
<tr>
<td>DTL</td>
<td>—</td>
<td>€ (2,500)</td>
<td>€ (2,500)**</td>
<td>$ (2,500)</td>
<td>€ (2,250)</td>
<td>(2,700)</td>
</tr>
</tbody>
</table>

* 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 11-32

Assume the same facts as in Example 11-31 above, except that A has NOL 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>GAAP — Local Currency</th>
<th>Tax — Local Currency</th>
<th>Difference</th>
<th>DTA/(DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL carryforward</td>
<td>—</td>
<td>€ 10,000</td>
<td>€ 10,000</td>
<td>€ 2,500</td>
</tr>
</tbody>
</table>
Example 11-32 (continued)

Parent’s books, for A’s original business combination journal entries, at the end of year 1 (in thousands) are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>GAAP — Local Currency</th>
<th>Tax — Local Currency</th>
<th>Difference</th>
<th>DTA/(DTL) — Local Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangibles</td>
<td>€ 9,000*</td>
<td>—</td>
<td>€ 9,000</td>
<td>€ (2,250) [b]</td>
</tr>
<tr>
<td>Goodwill</td>
<td>€ 2,500</td>
<td>—</td>
<td>€ 2,500</td>
<td>—</td>
</tr>
</tbody>
</table>

* 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 journal entries are actually or notionally pushed down, A’s net DTA to be assessed for realizability should be the same.

11.7.4 Other Forms of Mergers

11.7.4.1 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). See Appendix B of Deloitte’s *A Roadmap to Accounting for Business Combinations* for further discussion of the accounting for common-control transactions.

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 11-33**

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 $210. (Assume that the tax rate is 21 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 journal entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>12,000</td>
</tr>
</tbody>
</table>

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 journal entry:

<table>
<thead>
<tr>
<th>Investment in the assets of LP</th>
<th>2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>10,800</td>
</tr>
<tr>
<td>Noncontrolling interest in LP</td>
<td>800</td>
</tr>
<tr>
<td>Cash</td>
<td>12,000</td>
</tr>
</tbody>
</table>
Example 11-33 (continued)

If it is assumed that Newco is subject to a 21 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 $126 ([($1,200 book basis – $600 tax basis] × 21%), with an offset to equity, as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>126</td>
</tr>
<tr>
<td>DTL</td>
<td>126</td>
</tr>
</tbody>
</table>

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 × 20% capital gains rate). F1 and F2 would also eliminate the portion of their collective DTL that was effectively contributed to Newco (($2,000 book basis – $1,000 tax basis] × 60% × 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 $2,268 (($12,000 tax basis – $1,200 book basis] × 21%), 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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>2,268</td>
</tr>
<tr>
<td>DTL</td>
<td>126</td>
</tr>
<tr>
<td>Equity</td>
<td>2,394</td>
</tr>
</tbody>
</table>

11.7.4.2 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.18 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.19

18 See Section 8.3 for guidance on acceptable methods of allocating income taxes to members of a group and Section 8.2.4 for a discussion of the allocation of income taxes to single member LLCs.
19 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.
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 Overton, associate chief accountant in the SEC’s Division of Corporation Finance, at the 2001 AICPA Conference on Current SEC Developments. Ms. Overton discussed a fact pattern in which the staff believed that certain operations that would be left behind upon a spin-off (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.”

11.7.4.3 Change in Tax Status as a Result of a Common-Control Merger

A common-control merger occurs when two legal entities that are controlled by the same parent company are merged into a single entity. Such a transaction is not a business combination because there was not a change in control of the entities involved (i.e., they are controlled by the same entity before and after the merger). The accounting for a change in an entity's taxable status through a common-control merger may differ from the method described in Section 11.7.4.2. 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. Such a measurement would be consistent with the method described in Section 11.7.4.2.

Although the transaction was between parties under common control, 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 Section 14.7.1.

11.8 Asset Acquisitions

As described in Section 11.1, an entity may acquire a group of assets that do not meet the definition of a business under ASC 805. Acquisitions of this nature are considered “asset acquisitions” and do not follow the measurement principles of a business combination under ASC 805. For financial reporting purposes, such transactions are generally recognized under a cost accumulation model. However, the tax bases of assets acquired could be different from the cost bases for a variety of reasons. As a result, temporary differences arise. The accounting for these differences differs from the accounting for a business combination described throughout this chapter. The primary difference is that no goodwill is recorded in an asset acquisition. Instead, the cost basis of an asset may be adjusted to account for recognition of deferred taxes.

ASC 740-10-25-51 prohibits immediate income statement recognition when the amount paid for an asset accounted for as an asset acquisition differs from the tax basis in that asset. Instead, a simultaneous equations method is used to determine the measurement of the asset and a related DTL or DTA in such a manner that there is no income statement impact (i.e., the financial reporting measurement of the asset and the DTA or DTL taken together equal the consideration transferred for the asset in such a way that there is an effect on earnings).

ASC 740-10-55-171 through 55-182 provide illustrative examples of how an entity can apply the simultaneous equations method when accounting for asset acquisitions that are not accounted for as business combinations.

See Example 25 in ASC 740-10-55-170 through 55-182 in Appendix A.
ASC 740-10 (continued)

25-51 The tax effect of asset purchases that are not business combinations in which the amount paid differs from the tax basis of the asset shall not result in immediate income statement recognition. The simultaneous equations method shall be used to record the assigned value of the asset and the related deferred tax asset or liability. (See Example 25, Cases A and B [paragraphs 740-10-55-171 through 55-182] for illustrations of the simultaneous equations method.) For purposes of applying this requirement, the following applies:

   a. An acquired financial asset shall be recorded at fair value, an acquired asset held for disposal shall be recorded at fair value less cost to sell, and deferred tax assets shall be recorded at the amount required by this Topic.

   b. An excess of the amounts assigned to the acquired assets over the consideration paid shall be allocated pro rata to reduce the values assigned to noncurrent assets acquired (except financial assets, assets held for disposal, and deferred tax assets). If the allocation reduces the noncurrent assets to zero, the remainder shall be classified as a deferred credit. (See Example 25, Cases C and D [paragraphs 740-10-55-183 through 55-191] for illustrations of transactions that result in a deferred credit.) The deferred credit is not a temporary difference under this Subtopic.

   c. A reduction in the valuation allowance of the acquiring entity that is directly attributable to the asset acquisition shall be accounted for in accordance with paragraph 805-740-3. 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.

Pending Content (Transition Guidance: ASC 740-10-65-8)

25-54 An entity shall determine whether a step up in the tax basis of goodwill relates to the business combination in which the book goodwill was originally recognized or whether it relates to a separate transaction. In situations in which the tax basis step up relates to the business combination in which the book goodwill was originally recognized, 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. In situations in which the tax basis step up relates to a separate transaction, a deferred tax asset would be recorded for the entire amount of the newly created tax goodwill in accordance with this Subtopic. Factors that may indicate that the step up in tax basis relates to a separate transaction include, but are not limited to, the following:

   a. A significant lapse in time between the transactions has occurred.

   b. The tax basis in the newly created goodwill is not the direct result of settlement of liabilities recorded in connection with the acquisition.

   c. The step up in tax basis is based on a valuation of the goodwill or the business that was performed as of a date after the business combination.

   d. The transaction resulting in the step up in tax basis requires more than a simple tax election.

   e. The entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step up in tax basis.

   f. The transaction resulting in the step up in tax basis was not contemplated at the time of the business combination.
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.

Pending Content (Transition Guidance: ASC 740-10-65-7)


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 — SEC Staff Guidance

S25-1 See paragraph 740-10-599-3, 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.

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.
Chapter 12 — Other Investments and Special Situations

12.1 Introduction
This chapter provides income tax accounting and disclosure guidance related to noncontrolling interests, equity method investments (including specific exceptions in ASC 740 related to corporate joint ventures and changes in ownership of investees), qualified affordable housing project (QAHP) investments, regulated entities, and distinguishing a change in estimate from a correction of an error. The book-versus-tax-differences chapter of this Roadmap (Chapter 3) provides helpful guidance on the respective definitions of inside and outside basis differences (see Section 3.3.1) and the recognition criteria for deferred taxes.

12.2 Noncontrolling Interests
ASC 810-10-20 defines a noncontrolling interest as the “portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent.” Consequently, noncontrolling interests are presented only in the consolidated financial statements of a parent whose holdings include a controlling interest in one or more subsidiaries it partially owns. The objective of accounting for noncontrolling interests is to present users of the consolidated financial statements with a clear depiction of the portion of a subsidiary's net assets, net income, and net comprehensive income that is attributable to equity holders other than the parent.

12.2.1 Accounting for the Tax Effects of Transactions With Noncontrolling Shareholders
A parent accounts for changes in its ownership interest in a subsidiary over which 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 12-1

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% × $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.

<table>
<thead>
<tr>
<th>Entity</th>
<th>Original Carrying Amount</th>
<th>Original Ownership Interest</th>
<th>Carrying Amount January 1, 20Y0</th>
<th>Ownership Interest January 1, 20Y0</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ 80,000,000</td>
<td>80%</td>
<td>$ 70,000,000</td>
<td>70%</td>
</tr>
<tr>
<td>B</td>
<td>20,000,000</td>
<td>20</td>
<td>20,000,000</td>
<td>20</td>
</tr>
<tr>
<td>C</td>
<td>—</td>
<td>—</td>
<td>10,000,000</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>$ 100,000,000</td>
<td>100%</td>
<td>$ 100,000,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

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 $2,812,500, which is computed as follows: ($20 million selling price − [$70 million tax basis × 12.5% portion sold]) × 25% tax rate. The amount comprises the following direct and indirect tax effects:

1. The direct tax effect of the sale is $2.5 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) and is computed as follows: ($20 million selling price − [$80 million book basis × 12.5% portion sold]) × 25% 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 $312,500. This amount is associated with the preexisting taxable temporary difference (i.e., the undistributed earnings of the subsidiary) of the interest sold and is computed as follows: ([$80 million book basis − $70 million tax basis] × 12.5% portion sold) × 25% 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 312,500

APIC 2,500,000

Current tax payable 2,812,500
Example 12-1 (continued)

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.

12.2.2 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 recognize income taxes only 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 12-2

Entity X has a 90 percent controlling interest in Partnership Y (an LLC). 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 25 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before income tax expense ($100,000 + $50,000)</td>
<td>$ 150,000</td>
</tr>
<tr>
<td>Income tax expense (($100,000 + ($50,000 × 90%)) × 25%)</td>
<td>($36,250)</td>
</tr>
<tr>
<td>Consolidated net income</td>
<td>113,750</td>
</tr>
<tr>
<td>Less: net income attributable to noncontrolling interests ($50,000 × 10%)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Net income attributable to controlling interest</td>
<td>$ 108,750</td>
</tr>
</tbody>
</table>

In this example, ASC 810 does not affect how X determines income tax expense under ASC 740, since X recognizes income tax expense only 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 24.2 percent ($36,250/$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.
12.3 **Equity Method Investee Considerations**

When an investor owns less than 50 percent of the voting capital but is able to exercise significant influence, it generally applies the equity method of accounting unless an exception applies (i.e., the investor elects the fair value option under ASC 825-10, or specialized industry accounting requires carrying the investment at fair value).

In general, under the equity method of accounting, an investor initially recognizes its investment in an investee (including a joint venture) at cost, in accordance with ASC 805-50-30. In addition, an investor that applies the equity method of accounting should comply with the requirements of ASC 323-10-35-4, which states, in part:

> Under the equity method, an investor shall recognize its share of the earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements rather than in the period in which an investee declares a dividend. An investor shall adjust the carrying amount of an investment for its share of the earnings or losses of the investee after the date of investment and shall report the recognized earnings or losses in income. An investor's share of the earnings or losses of an investee shall be based on the shares of common stock and in-substance common stock held by that investor.

12.3.1 **Deferred Tax Consequences of an Investment in an Equity Method Investment (a 50-Percent-or-Less-Owned Investee)**

For income tax accounting purposes, investors in an equity method investment should recognize the deferred tax consequences for an outside basis difference unless an exception applies.

See Section 3.4 for guidance on the definition of an outside basis difference. See Section 3.4.1 for guidance on the definition of foreign and domestic investments. Also see Section 3.4.17.1 for considerations related to VIEs.

12.3.1.1 **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.

12.3.1.2 **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 Section 3.4.4.
12.3.1.3 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.

12.3.2 Tax Effects of Investor Basis Differences Related to Equity Method Investments

In certain situations, there may be a difference between the cost of an equity method investment and the investor’s share of the investee’s individual assets and liabilities. 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. Differences of this nature 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. 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 Section 3.3.1 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 12-3**

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.

Company A will need to work with Q’s employees, Q’s general partner/managing member, or all of those individuals to obtain the information necessary to accurately account for the pass-through entity’s tax positions in accordance with ASC 740.
12.3.3 Change in Investment From a Subsidiary to an Equity Method Investee

If, in accordance with ASC 323, a parent divests of a portion of a subsidiary 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 “[i]f 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.” ASC 740-30-25-15 clarifies the meaning of 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 when the parent accounts for a disposition through a sale or another transaction that reduces the investment. Example 12-4 below illustrates this concept.

Example 12-4

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 X’s 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, 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 accrue a DTL only 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 12-4 illustrate a change in the consolidation of a foreign subsidiary, but the concepts are also applicable to domestic subsidiaries. Also, see Section 11.3.6.3 for further discussion of the tax consequences of business combinations achieved in stages.

### Changing Lanes

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB's Simplification Initiative). The ASU amends the guidance in ASC 740-30-25-15 on situations in which an investment in common stock of a subsidiary changes so that it is no longer considered a subsidiary (e.g., the extent of ownership in the investment changes so that it becomes an equity method investment). If the parent entity did not previously recognize income taxes on its undistributed earnings because of the exception in ASC 740-30-25-18(a) (i.e., because of an assertion of indefinite reinvestment), the previous requirement under U.S. GAAP that no deferred taxes be recognized on that portion of the basis difference until it becomes apparent that such undistributed earnings will be remitted (i.e., deferred taxes are not automatically recognized) applied. This represented an exception to the general principle for accounting for outside basis differences of equity method investments.

The FASB noted that “this exception increases the cost and complexity of applying Topic 740” because it essentially required an entity to bifurcate its outside basis difference in the investment and account for the components separately. The original outside basis difference that existed when the subsidiary became an equity method investment was “frozen”; however, subsequent changes in the outside basis difference would be recognized separately. The FASB removed the exception in ASC 740-30-25-15 that restricted recognition of a DTL on the portion of the outside basis difference that existed before the subsidiary became an equity method investment. Accordingly, an entity will need to recognize current tax expense to recognize a DTL related to the equity method investment when the subsidiary becomes an equity method investment. This guidance creates consistency with current U.S. GAAP, under which an equity method investor cannot assert indefinite reinvestment of earnings to avoid recording deferred taxes on its outside basis differences.

Entities should apply these amendments by using a modified retrospective approach, which would require recognizing deferred taxes as of the beginning of the period of adoption, with a cumulative-effect adjustment to retained earnings. For further information about ASU 2019-12, see Appendix B.

### 12.3.4 Accounting for an ITC Received From an Investment in a Partnership Accounted for Under the Equity Method

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

Under the deferral method, the ITC would result in (1) a reduction to income taxes payable (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) and (2) either a reduction to the carrying value of the related asset or a deferred credit. The tax benefit of the ITC is reflected in net income as a reduction to depreciation expense over the productive life of the related property.\(^1\)

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1 Note that there is an alternative view under which the benefit would be recorded in the income tax provision in accordance with paragraph 3 of Opinion 4.
Under the flow-through method, the ITC would result in (1) a reduction to income taxes payable for the year in which the credit arises (or an increase in a DTA if the credit is carried forward to future years, subject to assessment for realization) and (2) a reduction to income tax expense.

The accounting for ITCs was originally addressed in Opinion 2 (codified in ASC 740-10-25-46), which discusses direct investments in acquired depreciable property that generate ITCs. Since that guidance was introduced, however, the types of vehicles through which entities take advantage of ITCs have evolved. For example, entities often invest in partnerships whose operations include investments in assets that qualify for ITCs, which can then be passed through directly to the investors.

While ASC 740 addresses the accounting by an entity that directly owns an asset that generates an ITC, it does not explicitly address the accounting by a reporting entity that is an investor in a flow-through entity that owns the asset that generates the credit that is then passed through to the investor. In the latter case, the reporting entity must first consider whether it is required under ASC 810 (including the VIE subsections of ASC 810-10) to consolidate the flow-through entity in which it has invested. If consolidation of the investee is not required, the reporting entity would most often account for the investment by using the equity method.

There are two acceptable approaches ("Approach 1" and "Approach 2") on how a reporting entity that accounts for its investment in a flow-through entity under the equity method should account for the tax benefits received in the form of ITCs. The approach an entity selects is an accounting policy election that should be applied consistently. (See Section 3.5.9 for a discussion of the accounting for temporary differences related to ITCs.)

### 12.3.4.1 Approach 1 — Account for ITCs as an Income Tax Benefit

Under Approach 1, the investor would account for the tax benefits received in the form of ITCs as an income tax benefit. This method is consistent with accounting for the tax benefits under the flow-through method. It is also consistent with ASC 323-740-55-8 (formerly Exhibit 94-1A of EITF Issue 94-1), which contains an example of the application of the equity method to a QAHP investment that does not qualify for the proportional amortization method. In that example, the tax credits are recorded in the income tax provision in the year that they are received.

### 12.3.4.2 Approach 2 — Apply a Model Similar to the Deferral Method

Approach 2 is premised on the guidance originally contained in paragraph 3 of Opinion 4 on an ITC that was passed through to a lessee under an operating lease for leased property. More specifically, paragraph 3 of Opinion 4 provided an example in which the asset generating the ITC was not carried on the lessee's balance sheet; rather, the ITC was passed through to the lessee in a manner similar to the way it would be passed through to an investor in a flow-through entity. In the example, the Interpretation indicated that the “lessee should account for the credit by whichever method is used for purchased property” and then provided clarification on how to apply the deferral method if that method is selected, suggesting that the lessee could use either the deferral method or the flow-through method even in a situation in which the underlying asset that generated the credit was not actually reflected in the reporting entity’s financial statements.

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2. See also paragraph 11 of Opinion 2.
Under Approach 2, the tax benefits from the ITCs would be deferred and amortized over the useful life of the related assets, resulting in a cost reduction that would be reflected as an adjustment in the equity method earnings (i.e., “above the line”). That is, the deferral method would yield an increase in the equity method earnings because less depreciation would flow through to the investor.  

**12.3.5 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.

**12.4 QAHP Investments**

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**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.

**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 the qualified affordable housing projects.

**Scope and Scope Exceptions**

**Overall Guidance**

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 323-10-15, with specific transaction qualifications noted in the other Subsections of this Section.

**15-2** The Qualified Affordable Housing Project Investments Subsections follow the same Scope and Scope Exceptions as outlined in the General Subsection of this Subtopic, see Section 323-10-15, with specific transaction qualifications noted below.

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3 Alternatively, under the deferral method, instead of reducing the cost basis of the qualifying asset or assets, an entity could recognize a deferred credit. In this scenario, the recovery of the deferred credit would result in a reduction to the income tax provision over the life of the qualifying asset or assets.
### ASC 323-740 (continued)

#### 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.

#### 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 (described in paragraphs 323-740-35-2 and 323-740-45-2) provided all of the following conditions 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.

**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.

**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.

**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.
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, 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 proportional amortization method, shall be applied.

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.

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.

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.

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).

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.
ASC 323-740 (continued)

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.

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.

35-2 Under the proportional amortization method, the investor amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits allocated to the investor. The amortization amount shall be calculated as follows:
   a. The initial investment balance less any expected residual value of the investment, multiplied by
   b. The percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment.

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.

35-4 As a practical expedient, an investor is permitted to amortize the initial cost of the investment in proportion to only the tax credits allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from applying the requirement in paragraph 323-740-35-2.

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.

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.
### ASC 323-740 (continued)

**Other Presentation Matters**

45-1 This guidance addresses the income statement presentation of the affordable housing tax credit when an investment in a qualified affordable housing project through a limited liability entity is accounted for using the proportional amortization method.

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.

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.

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.

**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].

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In January 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 QAHP investments 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 QAHP investments qualified for use of the effective yield method. The amended criteria are now used for determining whether QAHP investments qualify for use of the proportional amortization method. Upon adoption, retrospective application was required; however, an entity that used the effective yield method to account for its QAHP 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.

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance removes the reference to the cost method in ASC 970-323 and supersedes ASC 325-20 (cost accounting guidance); however, ASC 323-740-25-2A (added by the ASU) states that “[a]ccounting for an investment in a qualified affordable housing project using the cost method may be appropriate.” For PBEs, the amendments in the ASU became effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, the amendments in the ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted.
12.4.1 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 VIE subsections of ASC 810-10) to consolidate a QAHP investee. If consolidation of the QAHP investee is required, the proportional amortization method cannot be used.

If the QAHP investee 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.

Questions have arisen regarding whether a company needs to reevaluate whether the project yields an overall benefit (the criterion in ASC 323-740-25-1(b) above) when a change in tax rate is enacted (e.g., the corporate rate reduction signed into U.S. tax law on December 22, 2017). Although a change in tax rates may affect whether the criteria in ASC 323-740-25-1 are met after the initial investment, we do not believe that the change in tax rate represents either a change in the nature of the investment or a change in the relationship with the investee, as those terms are contemplated in ASC 323-740-25-1C. Therefore, an entity is not required to reassess whether it is still appropriate to apply the proportional amortization method solely because of the change in tax rates.

However, when the total expected tax benefit (tax credits and other tax benefits received) changes, amortization of the investment must be revised to ensure that cumulative amortization over the life of the investment equals the initial carrying amount (less any residual value). The change in corporate tax rate mentioned above will generally reduce the benefit of “other” tax benefits (i.e., tax benefits other than credits) to be allocated to a QAHP investor in the future (i.e., the pass-through losses in the future will now benefit the investor at a 21 percent, instead of a 35 percent, tax rate). If an investor has not elected to use the practical expedient, the proportion of benefits already allocated to the investor will increase in relation to the total expected tax credits and other tax benefits. As a result, we believe that there are two acceptable approaches for adjusting amortization.


4 For information regarding the determination of whether an investor has the ability to exercise significant influence over an entity that invests in QAHPs, see Section 3.4.2 of Deloitte’s A Roadmap to Accounting for Equity Method Investments and Joint Ventures.
Chapter 12 — Other Investments and Special Situations

Under the first approach, the investor would record a cumulative catch-up adjustment to the carrying amount of the investment on the basis of the amount of tax credits and other tax benefits that have been allocated to the investor in relation to the revised amount of total expected tax benefits. This approach is consistent with the guidance in ASC 323-740, which requires that the initial cost of the investment be amortized in proportion to the tax credits and other benefits that have been allocated to the investor.

Under the second approach, the investor would adjust amortization prospectively. This treatment is consistent with accounting for a change in estimate that does not affect the carrying amount of an asset or liability but alters the subsequent accounting for existing or future assets or liabilities under ASC 250.

An investor should consider whether it has, in effect, made a policy election in prior periods when adjusting amortization to take into account changes in expected tax benefits that are due to factors other than changes in tax rates. If so, using a different approach to account for the change in tax rate would be a change in accounting principle that would need to be assessed for preferability.

In addition, QAHP investors are required to assess their investment for impairment when the occurrence of an event or a change in circumstances indicates that it is more likely than not that the carrying amount of the investment will not be realized. ASC 323-740-35-6 states that the “impairment loss shall be measured as the amount by which the carrying amount of an investment exceeds its fair value.” Fair value should take into account discounting of the future tax benefits expected to be received. Therefore, if a significant portion of the investor’s yield was tied to such benefits, the investor may have needed to test its investment for impairment. More specifically, the investor would have needed to compare the carrying amount of the investment, after any cumulative catch-up is considered, with the undiscounted amount of the remaining expected tax credits and other tax benefits in the evaluation of whether it is more likely than not that the carrying amount will not be realized.

ASC 323-740 does not specify where in the income statement an impairment charge related to a QAHP investment should be recorded. Under the proportional amortization method, the amortization of the cost of the investment is netted against the tax benefits received within the income tax expense line. An impairment is a recognition of the fact that the unamortized cost of acquiring the benefits exceeds the remaining expected benefits, but it does not change the nature of the initial investment as an investment in tax credits and other tax benefits. Accordingly, we believe that the impairment would be recorded as a component of income tax expense.

12.4.1.1 Before the Adoption of ASU 2016-01

As for a limited liability investment in a QAHP that is not accounted for 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.” ASC 323-740-55-8 includes an example of the application of the equity method to an investment in a QAHP that does not qualify for the proportional amortization method. For additional information on the accounting for ITCs as an income tax benefit (when received from an investment in a partnership accounted for under the equity method), see Section 12.3.4. 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 323-30-599-1 for more information. If the equity method is not required, the cost method would generally be used.
**Changing Lanes**

In December 2019, the FASB issued **ASU 2019-12**, which modifies ASC 740 to simplify the accounting for income taxes (as part of the FASB's Simplification Initiative). The ASU makes improvements to the Codification topics on income taxes related to investments in QAHPs accounted for under the equity method.

ASC 323-740-55-8 includes an illustrative example of the accounting for an investment in a QAHP under the equity method. The example previously indicated that the investment became impaired in year 9 and that impairment was measured on the basis of the remaining tax credits allocable to the investor; however, the impairment assessment (specifically, the year in which the impairment occurs) was incorrect on the basis of the revised facts that were used when the example was amended in ASU 2014-01. ASU 2019-12 corrects the error in the illustrative example. For further information about ASU 2019-12, see **Appendix B**.

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.

### 12.4.1.2 After the Adoption of ASU 2016-01

ASU 2016-01 removes the reference to the cost method in ASC 970-323 and supersedes ASC 325-20. However, ASC 323-740-25-2A (added by the ASU) states that “[a]ccounting 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.”

In addition, the proportional amortization method applies only to investments in QAHPs through limited liability entities and should not be analogized to investments in other projects for which substantially all of the benefits come from tax benefits. This restriction is similar to the SEC staff's view described in ASC 323-740-S99-2 that it would be inappropriate to extend the prior effective yield method of accounting to analogous situations.
12.4.2 Applicability of the Proportional Amortization Method to a QAHP Investment That Generates Other Tax Credits in Addition to Affordable Housing Credits

Another criterion in ASC 323-740-25-1 for applying the proportional amortization method is that substantially all of the projected benefits of the QAHP investment 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, paragraph BC10 of ASU 2014-01 states, in part:

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 QAHP investments, it is unclear whether a QAHP investment 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 QAHP investment 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, we believe that if 45 percent of the projected benefits of a QAHP investment are attributable to QAHP credits and tax benefits from operating losses of the investment and the remaining 55 percent are associated with other tax credits, it would be difficult to conclude that the investment is within the scope of ASC 323-740. Alternatively, we believe that if 90 percent of the projected benefits of a QAHP investment 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, it would generally be appropriate to conclude that the investment is within the scope of ASC 323-740.

12.4.3 Recognizing Deferred Taxes When the Proportional Amortization Method Is Used to Account for an Investment in a QAHP

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 Background Information and Basis for Conclusions of ASU 2014-01, the EITF 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 12-5, 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 12-5, 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 EITF'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 12-6, 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 12-6), 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 that these results are less reflective of the overall economics of the investment and, again, inconsistent with the overall objectives of ASU 2014-01.

12.4.3.1 Illustrative Examples

In each of the illustrative 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 9 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 ETR is 25 percent.
Example 12-5
Book Basis

Amortization
(B)

Tax Basis

$

$

Net
Benefit
(K)

Deductible
Temporary
Difference
(L)

DTA at
25%
(M)

Deferred
Tax Benefit Net Benefit
(Expense)
(Expense)
(N)
(O)

459

1

$ 200,000

17,391

$ 182,609

$ 200,000

8,000

$ 192,000

2

182,609

17,391

165,217

192,000

8,000

184,000

18,000

2,000

20,000

17,391

2,609

18,783

4,696

2,348

4,957

3

165,217

17,391

147,826

184,000

8,000

176,000

18,000

2,000

20,000

17,391

2,609

28,174

7,043

2,348

4,957

4

147,826

17,391

130,435

176,000

8,000

168,000

18,000

2,000

20,000

17,391

2,609

37,565

9,391

2,348

4,957

5

130,435

17,391

113,043

168,000

8,000

160,000

18,000

2,000

20,000

17,391

2,609

46,957

11,739

2,348

4,957

6

113,043

17,391

95,652

160,000

8,000

152,000

18,000

2,000

20,000

17,391

2,609

56,348

14,087

2,348

4,957

7

95,652

17,391

78,261

152,000

8,000

144,000

18,000

2,000

20,000

17,391

2,609

65,739

16,435

2,348

4,957

8

78,261

17,391

60,870

144,000

8,000

136,000

18,000

2,000

20,000

17,391

2,609

75,130

18,783

2,348

4,957

9

60,870

17,391

43,478

136,000

8,000

128,000

18,000

2,000

20,000

17,391

2,609

84,522

21,130

2,348

4,957

10

43,478

17,391

26,087

128,000

8,000

120,000

18,000

2,000

20,000

17,391

2,609

93,913

23,478

2,348

4,957

11

26,087

1,739

24,348

120,000

8,000

112,000

—

2,000

2,000

1,739

261

87,652

21,913

(1,565)

(1,304)

12

24,348

1,739

22,609

112,000

8,000

104,000

—

2,000

2,000

1,739

261

81,391

20,348

(1,565)

(1,304)

13

22,609

1,739

20,870

104,000

8,000

96,000

—

2,000

2,000

1,739

261

75,130

18,783

(1,565)

(1,304)

14

20,870

1,739

19,130

96,000

8,000

88,000

—

2,000

2,000

1,739

261

68,870

17,217

(1,565)

(1,304)

15

19,130

1,739

17,391

88,000

8,000

80,000

—

2,000

2,000

1,739

261

62,609

15,652

(1,565)

(1,304)

16

17,391

1,739

15,652

80,000

8,000

72,000

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2,000

2,000

1,739

261

56,348

14,087

(1,565)

(1,304)

17

15,652

1,739

13,913

72,000

8,000

64,000

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2,000

2,000

1,739

261

50,087

12,522

(1,565)

(1,304)

18

13,913

1,739

12,174

64,000

8,000

56,000

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2,000

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1,739

261

43,826

10,957

(1,565)

(1,304)

19

12,174

1,739

10,435

56,000

8,000

48,000

—

2,000

2,000

1,739

261

37,565

9,391

(1,565)

(1,304)

20

10,435

1,739

8,696

48,000

8,000

40,000

—

2,000

2,000

1,739

261

31,304

7,826

(1,565)

(1,304)

21

8,696

1,739

6,957

40,000

8,000

32,000

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2,000

2,000

1,739

261

25,043

6,261

(1,565)

(1,304)

22

6,957

1,739

5,217

32,000

8,000

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18,783

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23

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3,478

24,000

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16,000

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2,000

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261

12,522

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3,478

1,739

1,739

16,000

8,000

8,000

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2,000

1,739

261

6,261

1,565

(1,565)

(1,304)

25

1,739

1,739

—

8,000

8,000

—

—

2,000

2,000

1,739

261

—

—

(1,565)

$ 180,000

$ 50,000

$ 230,000

200,000

$ 30,000

$

$ 200,000

Ending
(F)

Less:
Amortization
(J)

Net Benefit — Including Deferred Taxes

Beginning
(A)

$ 200,000

Beginning Depreciation
(D)
(E)

Other Tax
Benefits
(Taxed
Tax Credits at 25%)
(G)
(H)

Total
Credits
and
Other Tax
Benefits
(I)

Year

$

Ending
(C)

Net Benefit — Excluding Deferred Taxes

18,000

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 $230,000 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 straight-line method over 25 years.
F = End-of-year tax basis of investment, net of tax depreciation in Column E.

$

2,000

20,000

$

$

17,391

$

2,609

$

9,391

$

2,348

$

G = 8.5 percent annual tax credit on $200,000 tax basis of underlying initial investment.
H = Column E × 25 percent tax rate.
I = Column G + Column H.
J = Column B.
K = Column I – Column J.
L = Column F − Column C.
M = Column L × 25 percent tax rate.
N = Change in DTA in Column M for the year.
O = Column N + Column K.

2,348

$

4,957

(1,304)
$

30,000


### Example 12-6

<table>
<thead>
<tr>
<th>Year</th>
<th>Book Basis Ending (A)</th>
<th>Other Tax Benefits</th>
<th>Total Credits and Other Tax Benefits</th>
<th>Net Benefit</th>
<th>Deductible Temporary Difference</th>
<th>DTA at 25%</th>
<th>Deferred Tax Benefit (Expense)</th>
<th>Net Benefit — Including Deferred Taxes</th>
<th>Net Benefit — Excluding Deferred Taxes</th>
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</table>

### Notes

- **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 x (total tax benefits received during the year in Column G = total anticipated tax benefits over the life of the investment of $180,000 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 straight-line method over 25 years.
- **F**: End-of-year tax basis of investment, net of tax depreciation in Column E.
- **G**: 8.5 percent annual tax credit on $200,000 tax basis of underlying initial investment.
- **H**: Column E x 25 percent tax rate.
- **I**: Column G + Column H.
- **J**: Column B.
- **K**: Column I - Column J.
- **L**: Column F - Column C.
- **M**: Column L x 25 percent tax rate.
- **N**: Change in DTA in Column M for the year.
- **O**: Column N + Column K.
12.5 Regulated Entities

ASC 980-740

Income Taxes Applicable to Regulated Entities

25-1 For regulated entities that meet the criteria for application of paragraph 980-10-15-2, this Subtopic specifically:
   a. Prohibits net-of-tax accounting and reporting
   b. Requires recognition of a deferred tax liability for tax benefits that are flowed through to customers when temporary differences originate and for the equity component of the allowance for funds used during construction
   c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

25-2 If, as a result of an action by a regulator, it is probable that the future increase or decrease in taxes payable for (b) and (c) in the preceding paragraph will be recovered from or returned to customers through future rates, an asset or liability shall be recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs 980-340-25-1 and 980-405-25-1. That asset or liability also shall be a temporary difference for which a deferred tax liability or asset shall be recognized.

25-3 Example 1 (see paragraph 980-740-55-8) illustrates recognition of an asset for the probable revenue to recover future income taxes.

25-4 Example 2 (see paragraph 980-740-55-13) illustrates adjustment of a deferred tax liability when the liability represents amounts already collected from customers.

12.5.1 Regulated Entities Subject to ASC 980

Regulated entities preparing financial statements under U.S. GAAP would apply ASC 740 when determining the tax amounts to record. In addition, ASC 980-740 relies on the general standards of accounting for the effects of regulation in ASC 980 and, in a manner consistent with those standards, requires recognition of (1) an asset when a DTL is recognized if it is probable that future revenue will be provided for the payment of those DTLs and (2) a liability when a DTA is recognized if it is probable that a future reduction in revenue will result when that DTA is realized.

ASC 980-740-25-1 prohibits net-of-tax accounting on the basis that commingling assets and liabilities with their related tax effects confuses the relationship among the various classifications in financial statements. Therefore, in accordance with ASC 980-740-25-1, regulated entities should adjust the reported net-of-tax amount of construction in progress and plant in service to the pretax amount.
12.6 Special Situations

12.6.1 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 GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.” In determining whether the change is a correction of an error, an entity should consider whether the information was or should have been “reasonably knowable” or “readily accessible” from the entity’s books and records in a prior reporting period and whether the application of information at that time would have resulted in different reporting. The determination of when information was or should have been reasonably knowable or readily accessible will depend on the entity’s particular facts and circumstances.

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

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

An entity must often use judgment in discerning whether a change in a prior-year tax provision results from a correction of an error or a change in estimate. The sections below list examples of changes in accounting estimate and error corrections.
The following are examples of changes that should be accounted for as changes in accounting estimate:

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

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

- Intentionally misstating a tax accrual.
- Discovering a mathematical error in a prior-year income tax provision.
- Oversight or misuse of facts or failure to use information that was reasonably knowable and readily accessible as of the balance sheet date.
- Misapplying a rule or requirement or the provisions of U.S. GAAP. One example is a situation in which an entity fails to record a DTA, a DTL, a tax benefit, or a liability for UTBs that should have been recognized in accordance with ASC 740 on the basis of the facts and circumstances that existed as of the reporting date that were reasonably knowable when the financial statements were issued.
- Adjusting an amount for new information that would have been readily accessible from the entity’s books and records as of the prior reporting period. In assessing whether information was or should have been “readily accessible,” an entity should consider the nature, complexity, relevance, and frequency of occurrence of the item.
Chapter 13 — Presentation of Income Taxes

13.1 Background
This chapter provides interpretive guidance on presentation matters discussed in ASC 740-10-45, the Other Presentation Matters section of the Income Taxes: Overall subtopic. Matters discussed in the Other Presentation sections of other subtopics in ASC 740 are included in other chapters within this Roadmap. The ASC 200 topics of the Codification also comprise 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.

13.2 Statement of Financial Position Classification of Income Tax Accounts

<table>
<thead>
<tr>
<th>ASC 740-10</th>
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</thead>
<tbody>
<tr>
<td><strong>45-1</strong> This Section provides guidance on statement of financial position and income statement classification and presentation matters applicable to all of the following:</td>
</tr>
<tr>
<td>a. Statement of financial position classification of income tax accounts</td>
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<tr>
<td>b. Income statement presentation of certain measurement changes to income tax accounts</td>
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<td>c. Income statement classification of interest and penalties</td>
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<td>d. Presentation matters related to investment tax credits under the deferral method.</td>
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<th>Pending Content (Transition Guidance: ASC 220-10-65-4)</th>
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<tr>
<td><strong>45-1</strong> This Section provides guidance on statement of financial position, income statement and statement of shareholder equity classification, and presentation matters applicable to all the following:</td>
</tr>
<tr>
<td>a. Statement of financial position classification of income tax accounts</td>
</tr>
<tr>
<td>b. Income statement presentation of certain measurement changes to income tax accounts</td>
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<td>d. Presentation matters related to investment tax credits under the deferral method.</td>
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<tr>
<td>e. Statement of shareholder equity reclassification of certain income tax effects from accumulated other comprehensive income.</td>
</tr>
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| 45-2 See Subtopic 740-20 for guidance on the intraperiod allocation of total income tax expense (or benefit). |

**Statement of Financial Position Classification of Income Tax Accounts**

| 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. |
**Chapter 13 — Presentation of Income Taxes**

**ASC 740-10 (continued)**

**Deferred Tax Accounts**

45-4 In a classified statement of financial position, an entity shall classify deferred tax liabilities and assets as noncurrent amounts.

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 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.

45-7 Paragraph superseded by Accounting Standards Update No. 2015-17.

45-8 Paragraph superseded by Accounting Standards Update No. 2015-17.

45-9 Paragraph superseded by Accounting Standards Update No. 2015-17.

45-10 Paragraph superseded by Accounting Standards Update No. 2015-17.

**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.

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.

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.

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. 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.

In November 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 old guidance, which required 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 PBEs, 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.

For other balance sheet items, such as income taxes payable/receivable, ASC 210-10 provides guidance on the classification in the statement of financial position. Typically, income taxes payable would be presented as a current liability because it would be expected to be settled within a relatively short period, usually 12 months (ASC 210-10-45-9).

For public companies, ASC 210-10-S99-1(20) and ASC 210-10-S99-1(26) indicate that the SEC prescribed certain balance sheet captions in SEC Regulation S-X, Rule 5-02, related to income taxes, as follows:

- “Other current liabilities. State separately, in the balance sheet or in a note thereto, any item in excess of 5 percent of total current liabilities. Such items may include, but are not limited to, accrued payrolls, accrued interest, taxes, indicating the current portion of deferred income taxes, and the current portion of long-term debt. Remaining items may be shown in one amount.”

- “Deferred credits. State separately in the balance sheet amounts for (a) deferred income taxes, (b) deferred tax credits, and (c) material items of deferred income.”

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 SEC 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. See Chapter 14 for more information.

See below for further guidance on circumstances in which a UTB liability should be recorded as a current liability.

### 13.2.1 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. 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 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. [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...
Chapter 13 — Presentation of Income Taxes

deduction. In this example, 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.

13.2.2 Balance Sheet Classification of the Liability for UTBs

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.” ASC 740-10-45-12 states that 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.”

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 reclassify a liability from noncurrent to current only 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. See Section 14.4.1 for more information on the disclosure requirements related to UTBs.

13.2.3 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 tax jurisdiction related to a UTB in its current-year tax return and for which the entity records a UTB of $40 (20 percent tax rate × $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 tax jurisdiction for which the entity has recognized a $200 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 an NOL 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 uncertain tax position of $200 is not sustained, the entity may use its $1,000 NOL carryforward to offset such a position, thus resulting in a $40 reduction to the existing NOL carryforward DTA of $200. That is, the entity would present a net DTA of $160.

### 13.2.4 Balance Sheet Presentation of UTBs Resulting From Transfer Pricing Arrangements

Another common example of a UTB that may affect two separate jurisdictions is related to transfer pricing. See Section 4.6.3 for a detailed discussion of the application of transfer pricing arrangements under ASC 740.

In some cases, if two governments follow the Organisation for Economic Co-operation and Development’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 that were 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 include only 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.

For more information on UTBs related to transfer pricing arrangements, see Section 4.6.3.

### 13.3 Income Statement

#### 13.3.1 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 retroactively 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 separately from the UTB in the tabular rollforward required by ASC 740-10-50-15A.

13.3.2 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. An entity has 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.

13.3.3 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 also indicated that it believes that 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. Further, we believe that companies should present interest income in a manner consistent with the policy election related to interest expense on UTBs. See Section 14.4.4.1 for more information regarding disclosures related to interest income.
13.3.4 Presentation of Professional Fees

Entities often incur costs for professional services (e.g., attorney and accountant fees) related to the implementation of tax strategies,\(^1\) 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.

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\(^1\) If a tax-planning strategy is identified to support realization of DTAs, the entity should consider the cost of implementing the strategy (inclusive of professional fees) when measuring the incremental benefit such a strategy would provide.
Chapter 14 — Disclosure of Income Taxes

14.1 Overview
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 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** contains guidance on required disclosures in separate or carve-out financial statements (including abbreviated separate or carve-out financial statements).
- **Chapter 11** provides guidance on required disclosures for the effects of a business combination on an entity's valuation allowance.
- **Chapter 12** offers guidance on required disclosures for noncontrolling interests, equity method investments, and QAHP investments, including specific exceptions in ASC 740 related to corporate joint ventures and changes in ownership of investees.

14.2 Balance Sheet

**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.

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).

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 Section 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.
ASC 740-10 (continued)

<table>
<thead>
<tr>
<th>50-5</th>
<th>An entity's temporary difference and carryforward information requires additional disclosure. The additional disclosure differs for public and nonpublic entities.</th>
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</table>

**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).

**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.

### Changing Lanes

In March 2019, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. If it is approved, PBEs would be required to disclose the tax-effected amounts of federal or national, state, and foreign NOL and tax credit carryforwards along with the valuation allowance associated with such amounts. It would also require PBEs to explain any valuation allowance recognized or released during the year, along with the corresponding amount. Board members believed that these requirements would provide decision-useful information.

While the Board believed that PBEs should be required to provide the tax-effected amounts of federal or national, state, and foreign DTAs related to NOL and tax credit carryforwards, on the basis of feedback received from nonpublic entities, the Board proposed that nonpublic entities disclose the total amounts of federal or national, state, and foreign tax credits and other federal or national, state, and foreign carryforwards (on a not-tax-effected basis) separately for (1) those carryforwards that expire and (2) those that do not, along with their expiration dates (or range of expiration dates).

The proposed ASU would require the guidance to be applied prospectively, and the Board will determine an effective date and whether to permit early adoption after it considers feedback from stakeholders. For further information about the status of this project, see Appendix C.

### 14.2.1 Deferred Taxes

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).”
14.2.1.1 Required Level of Detail

When disclosing the tax effect of each type of temporary difference or carryforward as required by ASC 740-10-50-6, 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., PP&E) 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.

14.2.1.2 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

Neither the ASC master glossary nor SEC Regulation S-X defines “significant,” as used in ASC 740-10-50-6. 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.

14.2.2 Other Balance Sheet Disclosure Considerations

14.2.2.1 Disclosure of Temporary Difference or Carryforward That Clearly Will Never Be Realized

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 FASB 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. 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.
14.2.2.2 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.

Changing Lanes

As discussed in Section 14.2, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. If approved, the proposed ASU would remove the existing requirement in ASC 740-30-50-2(b) to disclose the “cumulative amount of each type of temporary difference” when a “deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures.”

For more information about the status of this project, including the proposed ASU’s transition and effective dates, see Appendix C.

14.3 Income Statement

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-9</strong> 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:</td>
</tr>
<tr>
<td>a. Current tax expense (or benefit)</td>
</tr>
<tr>
<td>b. Deferred tax expense (or benefit) (exclusive of the effects of other components listed below)</td>
</tr>
<tr>
<td>c. Investment tax credits</td>
</tr>
<tr>
<td>d. Government grants (to the extent recognized as a reduction of income tax expense)</td>
</tr>
<tr>
<td>e. The benefits of operating loss carryforwards</td>
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<tr>
<td>f. Tax expense that results from allocating certain tax benefits directly to contributed capital</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td><strong>50-10</strong> 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.</td>
</tr>
<tr>
<td><strong>50-11</strong> 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.</td>
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</tbody>
</table>
### ASC 740-10 (continued)

#### 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.

#### 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.

<table>
<thead>
<tr>
<th>Related Implementation Guidance and Illustrations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Income-Tax-Related Disclosures [ASC 740-10-55-79].</td>
</tr>
<tr>
<td>• Example 29: Disclosure Related to Components of Income Taxes Attributable to Continuing Operations [ASC 740-10-55-212].</td>
</tr>
</tbody>
</table>

### 14.3.1 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.

Thus, 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. See ASC 740-10-50-12 and 50-13 above.

The disclosure requirement addressed by ASC 740-10-50-12 and 50-13 is often referred to as the “rate reconciliation” disclosure requirement. 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 depending on the reporting entity’s facts and circumstances. However, the SEC staff frequently comments on rate reconciliation disclosures that are not clear and transparent. A reporting entity should evaluate its reconciling items to ensure that they clearly communicate to financial statement users the events and circumstances affecting the reporting entity’s ETR.
Changing Lanes

As discussed in Section 14.2, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. If approved, the proposed ASU would amend the requirement in ASC 740-10-50-12 that a PBE disclose the income tax rate reconciliation in a manner consistent with SEC Regulation S-X, Rule 4-08(h). As amended, ASC 740-10-50-12 would continue to require a PBE to “disclose a reconciliation . . . of reported total income tax expense (or benefit) from continuing operations” to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the statutory federal or national income tax rate. However, the amendments would modify the requirement to disaggregate and separately present components in the rate reconciliation that are greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with the requirement in SEC Regulation S-X, Rule 4-08(h).

During deliberations of the proposed ASU, some Board members questioned whether 5 percent was an appropriate threshold given the decrease in the U.S. statutory rate as a result of the Tax Cuts and Jobs Act (the “Act”). Thus, the Board has asked stakeholders for feedback on an appropriate threshold.

For more information about the status of this project, including the proposed ASU’s transition and effective dates, see Appendix C.

14.3.1.1 Evaluating Significance of Reconciling Items in the Rate Reconciliation

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.

SEC Regulation S-X, Rule 4-08(h)(2), 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 SEC Regulation S-X, 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.
14.3.1.2 Appropriate Federal Statutory Rate for Use in the Rate Reconciliation of a Foreign Reporting Entity

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. SEC Regulation S-X, 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 (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 SEC Regulation S-X, 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.

14.3.1.3 Computing the “Foreign Rate Differential” in the Rate Reconciliation

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.

We believe that a line in the rate reconciliation described as the foreign rate differential should generally include only the effects on an entity's ETR 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.

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1 This would apply to (or include) a tax inversion.
14.3.2 Other Income Statement Disclosure Considerations

ASC 740-10-50-9 requires an entity to disclose significant components of income tax expense or benefit that are attributable to continuing operations for each year presented in the financial statements. ASC 740-10-50-9(g) requires an entity to disclose 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.

14.3.2.1 Disclosure of the Components of Deferred Tax Expense

One of the components required to be disclosed in ASC 740-10-50-9 is deferred tax expense (or benefit). In many circumstances, certain changes between the beginning-of-year and end-of-year deferred tax balances do not affect the total deferred tax expense or benefit. 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).

14.3.2.2 Disclosure of the Tax Effect of a Change in Tax Law, Rate, or Tax Status

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 earnings per share (EPS) disclosures required by ASC 260 are not informative or are misleading.
14.4 UTB-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.

[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.

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].

14.4.1 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 Section 13.2.3 for an example of a UTB recorded as a reduction in a DTA.)
Changing Lanes

As discussed in Section 14.2, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. If approved, the proposed ASU would require PBEs to provide a breakdown (i.e., a mapping) of the amount of total UTBs shown in the reconciliation of the total amounts of UTBs by the respective balance-sheet lines on which such UTBs are recorded.

For more information about the status of this project, including the proposed ASU’s transition and effective dates, see Appendix C.

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.

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).

14.4.1.1 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 does not recognize any tax benefit for a significant position taken in the second quarter (and therefore recognizes 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 is not related 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 14-1

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 21 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 $210 ($1,000 × 21%). The public entity would include only 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 $790 in the amount of UTBs that, if recognized, would affect the ETR.

14.4.1.2 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.
14.4.1.3 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 UBPs 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).

14.4.1.4 Disclosure of Fully Reserved DTAs in the Reconciliation of UBPs

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 14-2**

A public entity has a $1 million NOL carryforward. Assume a 25 percent tax rate. The entity records a $250,000 DTA, for which management applies a $250,000 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 $225,000, which represents 90 percent of the benefit. In addition, the entity would include a UTB of $25,000 in the tabular disclosure under ASC 740-10-50-15A(a).

14.4.1.5 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 UBPs 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 UBPs related to settlements with tax authorities.

**Example 14-3**

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 UBPs from prior periods (line 1) and a decrease of $800 in UBPs related to settlements (line 2). A “current taxes payable” for the settlement amount of $800 should be recorded until that amount is paid to the tax authority.
14.4.1.6 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 disclosure 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.

Management of entities subject to SEC reporting requirements should consider Form 10-Q’s disclosure requirements, which include providing disclosures about significant changes from the most recent fiscal year in estimates used in preparation of the financial statements.

14.4.1.7 Presentation in the Tabular Reconciliation of a Federal Benefit Associated With Unrecognized State and Local Income Tax Positions

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).

14.4.2 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).

14.4.2.1 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 14-4 below illustrates a situation involving such UTBs.

Example 14-4

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 10 years. The entity has a 25 percent applicable tax rate. The entity would recognize a $2,250 ($9,000 × 25%) DTA for repair cost not allowable in the current period ($1,000 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.
14.4.3 Disclosure of UTBs That Could Significantly Change Within 12 Months of the Reporting Date

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.”

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 generally 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 14-5**

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 14-6**

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 14-7

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 recognizes 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 believe that it is reasonably possible that a more accelerated reversal of the UTB will result 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.

Changing Lanes

As discussed in Section 14.2, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. The proposed ASU would also remove the existing requirement in ASC 740-10-50-15(d) to disclose the details of tax “positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease” in the next 12 months.

For more information about the status of this project, including the proposed ASU’s transition and effective dates, see Appendix C.

14.4.3.1 Disclosure of Expiration of Statute of Limitations

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.

14.4.3.2 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 14-8

A calendar-year-end entity is 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 recognizes a liability for the UTBs associated with those tax positions. The entity believes that the tax authority will complete its audit of the 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.

14.4.3.3 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.

14.4.4 Separate Disclosure of Interest Income, Interest Expense, and Penalties

ASC 740-10-50-15(c) states that entities must disclose “[t]he 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.” Interest income, interest expense, and penalties should be disclosed separately. Accordingly, 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.
14.4.4.1 **Interest Income on UTBs**

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. 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense (benefit)</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Tax expense (benefit) recognized for UTBs in the income statement</td>
<td>XXX</td>
</tr>
<tr>
<td>Interest expense, gross of related tax effects</td>
<td>XXX</td>
</tr>
<tr>
<td>Interest income, gross of related tax effects</td>
<td>XXX</td>
</tr>
<tr>
<td>Penalties, gross of related tax effects</td>
<td>XXX</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>XXX</td>
</tr>
<tr>
<td>Tax benefits charged or credited to APIC</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total tax provision</strong></td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

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.

14.4.5 **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.

14.4.6 Disclosing the Effects of Income Tax Uncertainties in a Leveraged Lease Entered Into Before the Adoption of ASC 842

On the effective date of ASC 842, leases previously classified as leveraged leases under ASC 840 will be subject to the guidance in ASC 842-50. The legacy accounting requirements are grandfathered in for leases that were entered into and accounted for as leveraged leases before the effective date of ASC 842. A leveraged lease modified on or after the effective date of ASC 842 would be accounted for as a new lease under the lessor model in ASC 842. Entities are not permitted to account for any new or subsequently amended lease arrangements as leveraged leases after the effective date of ASC 842. For additional information on the impact of ASC 842 on leveraged lease accounting, see Section 9.5.2 of Deloitte’s A Roadmap to Applying the New Leasing Standard.

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.”

The tax effects of 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.

Lessor 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 leveraged 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.
14.5 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.

14.5.1 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.

14.6 Disclosure of the Components of Income (or Loss) Before Income Tax Expense (or Benefit) as Either Foreign or Domestic

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).

SEC Regulation S-X, 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.

Changing Lanes

As discussed in Section 14.2, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. If approved, it would require all entities to disclose (1) the pretax “[i]ncome (or loss) from continuing operations . . . disaggregated between domestic and foreign” amounts,\(^3\) (2) the “[i]ncome tax expense (or benefit) from continuing operations disaggregated among federal, state, and foreign” amounts,\(^4\) and (3) the “[i]ncome taxes paid disaggregated among federal, state, and foreign” amounts.

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\(^2\) 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.

\(^3\) Represents an existing disclosure requirement for PBEs under SEC Regulation S-X, Rule 4-08(h).

\(^4\) See footnote 3.
The proposed ASU also contains clarifications related to the following:

- **Jurisdiction of domicile income tax on foreign earnings** — Such income tax should be classified as income tax for the jurisdiction of domicile (e.g., U.S. federal tax on GILTI resulting from foreign earnings is classified as domestic for a U.S.-domiciled company).

- **Preconsolidation basis** — The amount of pretax income (or loss) from continuing operations indicated in the disaggregation should be presented “before intra-entity eliminations.” When deliberating the proposed guidance, some Board members expressed concern that diversity in practice could result because “before intra-entity eliminations” is not defined in U.S. GAAP. Accordingly, the FASB included Question 4 in the proposed ASU’s questions for respondents to determine whether clarification is needed.

For more information about the status of this project, including the proposed ASU’s transition and effective dates, see Appendix C.

### 14.6.1 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 United States (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 an 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.

### 14.6.2 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.
14.6.2.1 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 SEC Regulation S-X, 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 14-9

Assume the following facts:

- Company P is an SEC registrant and is domiciled and operates in the United States, which has a 21 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.
- Companies 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, which S licenses to third parties.
- None of the amounts paid qualify for capitalization.
- For the year 20X5, P records $200 of development expense before reimbursement by S. Company S reimburses P for 50 percent of the costs. Accordingly, P recognizes a net development expense of $100 under the cost-sharing arrangement, and S records $100 of development expense.
- Company P increases its income tax expense by $21 for the cost-sharing expense reimbursement 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's pretax income would reflect the $100 net development cost expense in the disclosure of domestic income or loss and would similarly include $100 of development expense in the disclosure of foreign income or loss. That is, the cost-sharing arrangement has the effect of moving $100 of expense from domestic to foreign. This disclosure corresponds to an applicable amount of domestic and foreign tax expense and benefit, respectively, which is also recognized and disclosed in 20X5.

14.6.2.2 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 inventory 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 inventory is sold outside the consolidated group.
Consider the following example:

**Example 14-10**

Assume the same facts as those in Example 14-9, 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 $21 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.

### 14.7 Pro Forma Financial Statements

#### 14.7.1 Change in Tax Status to Taxable: Pro Forma 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:

- If necessary adjustments include more than adjustments for taxes, limit pro forma presentation to latest fiscal year and interim period.
- 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 of the FRM 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 the option in paragraph 3410.1(b) of the FRM 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 Section 14.3.2 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.

14.8 Statement of Cash Flows

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. See Appendix E for a sample of this required disclosure.

Changing Lanes

As discussed in Section 14.2, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. If approved, the proposed ASU would amend ASC 230-10-50-2 to add an interim requirement to disclose income taxes paid for all interim periods presented.

For more information about the status of this project, including the proposed ASU’s transition and effective dates, see Appendix C.
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 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.

Implementation Guidance

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.

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 if the taxpayer takes the dispute to the court of last resort.

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.
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. 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.

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.

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

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.

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. 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).

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.

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).
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.

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.

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. 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.

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. 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.
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.

55-26 Local (including franchise) taxes based on income are within the scope of this Topic. 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. 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.

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.

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.

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.
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.

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.

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.

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, 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.

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. 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.
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. 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

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.
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.

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.

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.

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.
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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.

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.

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.

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). 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.
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.

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.

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.

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. 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.

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.
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.

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.

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. 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.

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.

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.

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.
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.

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. 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.

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.

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.

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. 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.

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.

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.
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.

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.

**Excise Tax on Withdrawal of Excess Pension Plan Assets**

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.

**Other Direct Payments to Taxing Authorities**

Example 26 (see paragraph 740-10-55-202) illustrates a transaction directly with a governmental taxing authority.

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

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

**Income Tax Related Disclosures**

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

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.

**Illustrations**

*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.

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.

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.
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.

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.

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.

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.

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.
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.

**Example 4: Valuation Allowance and Tax-Planning Strategies**

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.

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.

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. 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.

**Example 5: Highly Certain Tax Positions**

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.

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.

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.

**Example 6: Measurement With Information About the Approach to Settlement**

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.

<table>
<thead>
<tr>
<th>Possible Estimated Outcome</th>
<th>Individual Probability of Occurring (%)</th>
<th>Cumulative Probability of Occurring (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 100</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>80</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>60</td>
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<td>10</td>
<td>85</td>
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<tr>
<td>20</td>
<td>10</td>
<td>95</td>
</tr>
<tr>
<td>—</td>
<td>5</td>
<td>100</td>
</tr>
</tbody>
</table>

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.

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.

<table>
<thead>
<tr>
<th>Possible Estimated Outcome</th>
<th>Individual Probability of Occurring (%)</th>
<th>Cumulative Probability of Occurring (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 100</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>75</td>
<td>50</td>
<td>75</td>
</tr>
<tr>
<td>50</td>
<td>25</td>
<td>100</td>
</tr>
</tbody>
</table>

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.

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. |

**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). |

| 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. |

**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. |

| 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. |
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.

Example 11: Information Becomes Available Before Issuance of Financial Statements

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).

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.

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.

Example 12: Basic Deferred Tax Recognition

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).

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.
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.

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.

**Example 13: Valuation Allowance for Deferred Tax Assets**

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.

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.

Assume that pretax financial income and taxable income for Year 4 turn out to be as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial loss</td>
<td>$(50)</td>
</tr>
<tr>
<td>Reversing deductible temporary differences</td>
<td>$(300)</td>
</tr>
<tr>
<td>Loss carryforward for tax purposes</td>
<td>$(350)</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss carryforward from Year 4 for tax purposes (see above)</td>
<td>$350</td>
</tr>
<tr>
<td>Unreversed deductible temporary differences ($900 – $300)</td>
<td>$600</td>
</tr>
<tr>
<td>Total</td>
<td>$950</td>
</tr>
</tbody>
</table>

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.

**Example 14: Phased-In Change in Tax Rates**

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.

The tax rate that is used to measure the deferred tax liability for the $2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of those temporary differences is on taxes payable for Years 1–3, Years 4–6, or Year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in Years 4–6. If tax losses are expected in Years 4–6, however, the tax rate is:

a. 35 percent if realization of a tax benefit for those tax losses in Years 4–6 will be by loss carryback to Years 1–3
b. 45 percent if realization of a tax benefit for those tax losses in Years 4–6 will be by loss carryforward to Year 7 and thereafter.

**Example 15: Change in Tax Rates**

This Example illustrates the guidance in paragraph 740-10-55-23 for determination of the tax rate for measurement of a deferred tax asset for deductible temporary differences when there is a change in tax rates. This Example has the following assumptions:

a. Enacted tax rates are 30 percent for Years 1–3 and 40 percent for Year 4 and thereafter.
b. At the end of Year 3 (the current year), an entity has $900 of deductible temporary differences, which are expected to result in tax deductions of approximately $300 on the future tax returns for each of Years 4–6.

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.
Further assume for this Example both of the following:

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

b. Taxable income and taxes payable in each of Years 1–3 were $300 and $90, respectively.

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.

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.

**Example 16: Graduated Tax Rates**

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.

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.

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.

**Example 17: Determining Whether a Tax Is an Income Tax**

The guidance in paragraph 740-10-55-26 addressing when a tax is an income tax is illustrated using the following historical example.
### ASC 740-10 — Implementation Guidance and Illustrations (continued)

**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.

#### Pending Content (Transition Guidance: ASC 740-10-65-8)

55-140 A state's franchise tax on each corporation is 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 is a term defined by the tax statute for federal taxable income.

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.

#### Pending Content (Transition Guidance: ASC 740-10-65-8)

55-141 In this Example, the amount of franchise tax equal to the tax on the corporation's net taxable earned surplus is an income tax.

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.

#### Pending Content (Transition Guidance: ASC 740-10-65-8)

55-142 Deferred tax assets and liabilities are required to be recognized under this Subtopic for the temporary differences that exist as of the date of the statement of financial position using the tax rate to be applied to the corporation's net taxable earned surplus (4.5 percent).

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.

#### Pending Content (Transition Guidance: ASC 740-10-65-8)

55-143 The portion of the total computed franchise tax that exceeds the amount equal to the tax on the corporation's net taxable earned surplus should not be presented as a component of income tax expense during any period in which the total computed franchise tax exceeds the amount equal to the tax on the corporation's net taxable earned surplus.

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% (0.25% 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. 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.
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. This Example intentionally is not comprehensive (for example, it excludes state and local taxes).

55-147 This Example has the following assumptions:
   a. Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for 2005: $21,000
   b. Expected qualified production activities income for 2005: $50,000
   c. Net operating loss carryforwards at December 31, 2004, which expire in 2005: $20,000
   d. Expected W-2 wages for 2005: $10,000
   e. Assumed statutory income tax rate: 35%
   f. Qualified production activities deduction: 3% of the lesser of qualified production activities income or taxable income (after deducting the net operating loss carryforwards); limited to 50% of W-2 wages: $30.

55-148 Based on these assumptions, the entity would not recognize a valuation allowance for the net operating loss carryforwards at December 31, 2004, because expected taxable income in 2005 (after deducting the qualified production activities deduction) exceeds the net operating loss carryforwards, as follows.

### Analysis to compute the qualified production activities deduction

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected taxable income (excluding the qualified production activities</td>
<td>$ 21,000</td>
</tr>
<tr>
<td>deduction and net operating loss carryforwards) for the year 2005</td>
<td></td>
</tr>
<tr>
<td>Less net operating loss carryforwards&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Expected taxable income (after deducting the net operating loss carryforwards)</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Qualified production activities deduction</td>
<td>$ 30</td>
</tr>
</tbody>
</table>

<sup>(a)</sup> The Act requires that net operating loss carryforwards be deducted from the taxable income in determining the qualified production activities deduction. Therefore, the qualified production activities deduction will not result in a need for a valuation allowance for an entity’s deferred tax asset for net operating loss carryforwards. However, certain types of tax credit carryforwards are not deducted in determining the qualified production activities deduction and, therefore, could require a valuation allowance.

### Analysis to determine the effect of the qualified production activities deduction on the need for a valuation allowance for deferred tax assets for the net operating loss carryforwards

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected taxable income after deducting the qualified production activities deduction</td>
<td>$ 20,970</td>
</tr>
<tr>
<td>Net operating loss carryforwards</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Expected taxable income exceeds the net operating loss carryforwards</td>
<td>$ 970</td>
</tr>
</tbody>
</table>
Example 19: Recognizing Tax Benefits of Operating Loss

55-149 This Example illustrates the guidance in paragraphs 740-10-55-35 through 55-36 for recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year. This Example has the following assumptions:

a. The enacted tax rate is 40 percent for all years.
b. An operating loss occurs in Year 5.
c. The only difference between financial and taxable income results from use of accelerated depreciation for tax purposes. Differences that arise between the reported amount and the tax basis of depreciable assets in Years 1–7 will result in taxable amounts before the end of the loss carryforward period from Year 5.
d. Financial income, taxable income, and taxes currently payable or refundable are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Years 2–4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income (loss)</td>
<td>$ 2,000</td>
<td>$ 5,000</td>
<td>$(8,000)</td>
<td>$ 2,200</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Depreciation differences</td>
<td>(800)</td>
<td>(2,200)</td>
<td>(800)</td>
<td>(700)</td>
<td>(600)</td>
</tr>
<tr>
<td>Loss carryback</td>
<td>—</td>
<td>—</td>
<td>2,800</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Loss carryforward</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>6,000</td>
<td>4,500</td>
</tr>
<tr>
<td>Taxable income (loss)</td>
<td>$ 1,200</td>
<td>$ 2,800</td>
<td>$(6,000)</td>
<td>$ (4,500)</td>
<td>$ 1,900</td>
</tr>
<tr>
<td>Taxes payable (refundable)</td>
<td>$ 480</td>
<td>$ 1,120</td>
<td>$(1,120)</td>
<td>—</td>
<td>$ 760</td>
</tr>
</tbody>
</table>

e. At the end of Year 5, profits are not expected in Years 6 and 7 and later years, and it is concluded that a valuation allowance is necessary to the extent realization of the deferred tax asset for the operating loss carryforward depends on taxable income (exclusive of reversing temporary differences) in future years.

55-150 The deferred tax liability for the taxable temporary differences is calculated at the end of each year as follows.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Years 2–4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unreversed differences:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning amount</td>
<td>$ —</td>
<td>$ 800</td>
<td>$ 3,000</td>
<td>$ 3,800</td>
<td>$ 4,500</td>
</tr>
<tr>
<td>Additional amount</td>
<td>800</td>
<td>2,200</td>
<td>800</td>
<td>700</td>
<td>600</td>
</tr>
<tr>
<td>Total</td>
<td>$ 800</td>
<td>$ 3,000</td>
<td>$ 3,800</td>
<td>$ 4,500</td>
<td>$ 5,100</td>
</tr>
<tr>
<td>Deferred tax liability (40 percent)</td>
<td>$ 320</td>
<td>$ 1,200</td>
<td>$ 1,520</td>
<td>$ 1,180</td>
<td>$ 2,040</td>
</tr>
</tbody>
</table>

55-151 The deferred tax asset and related valuation allowance for the loss carryforward are calculated at the end of each year as follows.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Years 2–4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss carryforward for tax purposes</td>
<td>$ —</td>
<td>$ —</td>
<td>$ 6,000</td>
<td>$ 4,500</td>
<td>$ —</td>
</tr>
<tr>
<td>Deferred tax asset (40 percent)</td>
<td>$ —</td>
<td>$ —</td>
<td>$ 2,400</td>
<td>$ 1,800</td>
<td>$ —</td>
</tr>
<tr>
<td>Valuation allowance equal to the amount by which the deferred tax asset exceeds the deferred tax liability</td>
<td>—</td>
<td>—</td>
<td>(880)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Net deferred tax asset</td>
<td>$ —</td>
<td>$ —</td>
<td>$ 1,520</td>
<td>$ 1,800</td>
<td>$ —</td>
</tr>
</tbody>
</table>
ASC 740-10 — Implementation Guidance and Illustrations (continued)

Total tax expense for each period is as follows.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Years 2–4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(benefit):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in deferred</td>
<td>$320</td>
<td>$880</td>
<td>$320</td>
<td>$280</td>
<td>$240</td>
</tr>
<tr>
<td>tax liability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Increase) decrease</td>
<td>—</td>
<td>—</td>
<td>(1,520)</td>
<td>(280)</td>
<td>1,800</td>
</tr>
<tr>
<td>in net deferred tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>asset</td>
<td>320</td>
<td>880</td>
<td>(1,200)</td>
<td>—</td>
<td>2,040</td>
</tr>
<tr>
<td>Currently payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(refundable)</td>
<td>480</td>
<td>1,120</td>
<td>(1,120)</td>
<td>—</td>
<td>760</td>
</tr>
<tr>
<td>Total tax expense</td>
<td>$800</td>
<td>$2,000</td>
<td>(2,320)</td>
<td>—</td>
<td>$2,800</td>
</tr>
<tr>
<td>(benefit)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

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.

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.

Example 20: Interaction of Loss Carryforwards and Temporary Differences

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:

a. The financial loss and the loss reported on the tax return for an entity's first year of operations are the same.

b. 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)

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:

a. The financial loss and the loss reported on the tax return for an entity's first year of operations are the same.

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

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

<table>
<thead>
<tr>
<th></th>
<th>Financial Income</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1: Income (loss) from operations</td>
<td>$ (4,000)</td>
<td>$ (4,000)</td>
</tr>
<tr>
<td>Year 2: Income (loss) from operations</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>Taxable gain on sale</td>
<td>$</td>
<td>2,500</td>
</tr>
<tr>
<td>Taxable income before loss carryforward</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>Loss carryforward from Year 1</td>
<td>(4,000)</td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ —</td>
<td></td>
</tr>
</tbody>
</table>

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.

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.

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 | $ 60 |
| **Total** | **$ 90** |

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.

**Example 22: Multiple Tax-Planning Strategies Available**

55-163 This Example illustrates the guidance in paragraphs 740-10-55-39 through 55-48 relating to tax-planning strategies. An entity might identify several qualifying tax-planning strategies that would either reduce or eliminate the need for a valuation allowance for a deferred tax asset. For example, assume that an entity’s required valuation allowance would be reduced $5,000 based on Strategy A, $7,000 based on Strategy B, and $12,000 based on both strategies. The entity may not recognize the effect of one of those strategies in the current year and postpone recognition of the effect of the other strategy to a later year.

55-164 The entity should recognize the effect of both tax-planning strategies and reduce the valuation allowance by $12,000 at the end of the current year. Paragraph 740-10-30-19 provides guidance on tax-planning strategies and establishes the requirement that strategies meeting the criteria set forth in that paragraph shall be considered in determining the required valuation allowance.

**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.
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.

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:

- **a.** Netting gains and losses and application of the corridor amortization approach described in paragraph 715-60-35-29
- **b.** Recognition of additional subsidies through amortization of prior service costs that include effects of the subsidy
- **c.** 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.

**Example 24: Built-In Gains of S Corporation**

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:

- **a.** 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.

<table>
<thead>
<tr>
<th></th>
<th>Fair Market Value</th>
<th>Tax Basis</th>
<th>Reported Amount</th>
<th>Temporary Differences</th>
<th>Topic 740 Built-In Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities</td>
<td>$90</td>
<td>$100</td>
<td>$80</td>
<td>$(20)</td>
<td>$(10)</td>
</tr>
<tr>
<td>Inventory, (first-in first-out [FIFO])</td>
<td>100</td>
<td>50</td>
<td>100</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Depreciable assets</td>
<td>95</td>
<td>80</td>
<td>90</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$285</td>
<td>$230</td>
<td>$270</td>
<td>$40</td>
<td>$50</td>
</tr>
</tbody>
</table>

- **b.** The entity has no tax loss or credit carryforwards available to offset the built-in gains.
- **c.** 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).
- **d.** 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.
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:

a. 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.

<table>
<thead>
<tr>
<th></th>
<th>Fair Market Value</th>
<th>Tax Basis</th>
<th>Reported Amount</th>
<th>Temporary Differences</th>
<th>Topic 740 Built-In Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities</td>
<td>$90</td>
<td>$100</td>
<td>$80</td>
<td>$(20)</td>
<td>$(10)</td>
</tr>
<tr>
<td>Inventory, (first-in first-out [FIFO])</td>
<td>100</td>
<td>50</td>
<td>100</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Depreciable assets</td>
<td>95</td>
<td>80</td>
<td>90</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td><strong>$285</strong></td>
<td><strong>$230</strong></td>
<td><strong>$270</strong></td>
<td><strong>$40</strong></td>
<td><strong>$50</strong></td>
</tr>
</tbody>
</table>

b. The entity has no tax loss or credit carryforwards available to offset the built-in gains.

c. 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).

d. 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.

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.

**Example 25: Purchase Transactions That Are Not Accounted for as Business Combinations**

Paragraph 740-10-25-51 addresses the accounting when an asset is acquired outside of a business combination and the tax basis of the asset differs from the amount paid. The following Cases illustrate the required accounting for purchase transactions that are not accounted for as business combinations in the following circumstances:

a. The amount paid is less than the tax basis of the asset (Case A).

b. The amount paid is more than the tax basis of the asset (Case B).

c. The transaction results in a deferred credit (Case C).

d. A deferred credit is created by a financial asset (Case D).

e. Subparagraph not used.

f. The result is a purchase of future tax benefits (Case F).

**Case A: Amount Paid Is Less Than Tax Basis of Asset**

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).
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.

In accordance with paragraph 740-10-25-51, the amounts assigned to the equipment and the related deferred tax asset should be determined using the simultaneous equations method as follows (where FBB is Final Book Basis, CPP is Cash Purchase Price, and DTA is Deferred Tax Asset):

- **Equation A** (determine the final book basis of the equipment):
  \[ FBB - \left(\text{Tax Rate} \times (FBB - \text{Tax Basis})\right) = CPP \]
- **Equation B** (determine the amount assigned to the deferred tax asset):
  \[ (\text{Tax Basis} - FBB) \times \text{Tax Rate} = DTA. \]

In this Case, the following variables are known:
- a. Tax Basis = $150
- b. Tax Rate = 35 percent
- c. CPP = $100.

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

- **Equation A**: FBB = $73
- **Equation B**: DTA = $27.

Accordingly, the entity would record the following journal entry.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>73</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>27</td>
</tr>
<tr>
<td>Cash</td>
<td>100</td>
</tr>
</tbody>
</table>

Case B: Amount Paid Is More Than Tax Basis of Asset

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).

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.
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):

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

Equation B (determine the amount assigned to the DTL):

\[ (FBB - \text{Tax Basis}) \times \text{Tax Rate} = DTL. \]

In this Case, the following variables are known:

a. Tax Basis = $0
b. Tax Rate = 35 percent
c. CPP = $1,000,000.

The unknown variables (FBB and DTL) are solved as follows:

Equation A: FBB = $1,538,462
Equation B: DTL = $538,462.

Accordingly, the entity would record the following journal entry.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FCC license</td>
<td>$1,538,462</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>$538,462</td>
</tr>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Case C: Transaction Results In Deferred Credit

This Case provides an illustration of a transaction that results in a deferred credit.

Entity A buys a machine for $50 with a tax basis of $200. The tax rate is 35 percent.

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):

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

Equation B (determine the amount assigned to the DTA):

\[ (\text{Tax Basis} - FBB) \times \text{Tax Rate} = DTA. \]

In this Case, the following variables are known:

a. Tax Basis = $200
b. Tax Rate = 35 percent
c. CPP = $50.
The unknown variables (FBB and DTA) are solved as follows:

Equation A: FBB = $(31). However, because the FBB cannot be less than zero, the FBB is recorded at zero.

Equation B: DTA = $70.

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.

<table>
<thead>
<tr>
<th>Machine</th>
<th>$ —</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset</td>
<td>70</td>
</tr>
<tr>
<td>Deferred credit</td>
<td>$ 20</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

Case D: Deferred Credit Created by Financial Asset

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.

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 × .35) | 105 |
| Deferred credit             | $ 55  |
| Cash                        | $ 250 |

Case E: Simultaneous Equations Method and Reduction in Preexisting Valuation Allowance

Paragraph not used.

Paragraph not used.

Paragraph not used.

Paragraph not used.

Paragraph not used.

Paragraph not used.

Case F: Purchase of Future Tax Benefits

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Deferred credit</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

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).
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. 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.)

55-204 In this Example, the tax effects of transactions directly with a taxing authority are recorded directly in income as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset</td>
<td>$350,000</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>$320,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

55-205 Paragraph superseded by Accounting Standards Update No. 2015-17.

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

55-207 Paragraph superseded by Accounting Standards Update No. 2015-17.

55-208 Paragraph superseded by Accounting Standards Update No. 2015-17.

55-209 Paragraph superseded by Accounting Standards Update No. 2015-17.

55-210 Paragraph superseded by Accounting Standards Update No. 2015-17.

55-211 Paragraph superseded by Accounting Standards Update No. 2015-17.

Example 29: Disclosure Related to Components of Income Taxes Attributable to Continuing Operations

55-212 Paragraph 740-10-55-79 provides guidance on satisfying the required disclosure of the significant components of income taxes and identifies three acceptable approaches illustrated in this Example:

a. The gross method (Case A)
b. The net method (Case B)
c. The statutory tax rate reconciliation method (Case C).
Cases A, B, and C share the following assumptions:

a. An entity has $1,588 of taxable income and $100 of investment tax credits for the current year. The $100 deferred tax asset for $295 of operating loss carryforwards was fully reserved at the beginning of the current year.

b. Pretax financial income from continuing operations is $5,000.

c. Income tax expense from continuing operations is $1,500.

d. Effective tax rate is 30%.

e. Statutory tax rate is 34%.

Case A: Gross Method

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.

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Deferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax expense before application of investment tax credits and operating loss carryforwards</td>
<td>$ 540</td>
<td>$ 1,160</td>
</tr>
<tr>
<td>Investment tax credits</td>
<td>(100)</td>
<td>—</td>
</tr>
<tr>
<td>Tax benefit of operating loss carryforwards</td>
<td>(100)</td>
<td>—</td>
</tr>
<tr>
<td>Tax expense from continuing operations</td>
<td>$ 340</td>
<td>$ 1,160</td>
</tr>
</tbody>
</table>

Case B: Net Method

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.

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense (net of $100 investment tax credits and $100 tax benefit of operating loss carryforwards)</td>
<td>$ 340</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>1,160</td>
</tr>
<tr>
<td>Tax expense from continuing operations</td>
<td>$ 1,500</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
<th>20X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense</td>
<td>$ 340</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td></td>
<td>1,160</td>
<td></td>
</tr>
<tr>
<td>Tax expense from continuing operations</td>
<td>$ 1,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax expense at statutory rate</td>
<td></td>
<td>$ 1,700</td>
<td></td>
</tr>
<tr>
<td>Benefit of investment tax credits</td>
<td>(100)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefit of operating loss carryforwards</td>
<td>(100)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax expense from continuing operations</td>
<td>$ 1,500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
<th>20X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at January 1</td>
<td>$ 370,000</td>
<td>$ 380,000</td>
<td>$ 415,000</td>
</tr>
<tr>
<td>Additions based on tax positions related to the current year</td>
<td>10,000</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Additions for tax positions of prior years</td>
<td>30,000</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Reductions for tax positions of prior years</td>
<td>(60,000)</td>
<td>(20,000)</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Settlements</td>
<td>(40,000)</td>
<td>(5,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Balance at December 31</td>
<td>$ 310,000</td>
<td>$ 370,000</td>
<td>$ 380,000</td>
</tr>
</tbody>
</table>

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.
Example 31: Disclosure Relating to Realizability Estimates of Deferred Tax Asset

This Example illustrates the guidance in paragraph 275-10-50-8 for disclosure relating to the realizability estimates of a deferred tax asset.

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.

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.

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.

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.

Example 32: Definition of a Tax Position

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.
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.

Example 34: Definition of a Tax Position

55-225 Entity N, a tax-exempt not-for-profit entity, enters into transactions that may be subject to income tax on unrelated business income. Tax positions to consider include but are not limited to:

a. Entity N's characterization of its activities as related or unrelated to its exempt purpose
b. Entity N's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income
c. The allocation of Entity N's expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities.

Even if Entity N were not subject to income taxes on unrelated business income, it still has a tax position of whether it qualifies as a tax-exempt not-for-profit entity.

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.

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.

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.
Example 38: Financial Statements of a Group of Related Entities

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.

Illustrations

Example 1: Allocation to Continuing Operations

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.

The adjustments include the tax effects of:

a. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years
b. Changes in tax laws or rates
c. Changes in tax status
d. Tax-deductible dividends paid to shareholders.

The allocation of income tax expense between pretax income from continuing operations and other items shall include deferred taxes.
This Example illustrates allocation of current and deferred tax expense. The assumptions are as follows:

a. 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.

b. 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.

<table>
<thead>
<tr>
<th>Future Years</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracting operations</td>
<td>$ —</td>
<td>$ —</td>
<td>$ 500</td>
<td>$ 500</td>
</tr>
<tr>
<td>Other operations</td>
<td>$(100)</td>
<td>$(100)</td>
<td>$(200)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(100)</td>
<td>$(100)</td>
<td>$(500)</td>
<td>$(300)</td>
</tr>
<tr>
<td>Enacted tax rate for future years</td>
<td>40%</td>
<td>40%</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability (asset)</td>
<td>$(40)</td>
<td>$(40)</td>
<td>$150</td>
<td>$(70)</td>
</tr>
</tbody>
</table>

c. 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.

d. 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.

e. For Year 2, the entity has $50 of pretax reported income from continuing operations and $200 of pretax reported income from discontinued operations.

f. Determination of the entity's deferred tax asset and liability at the end of Year 2 is as follows.

<table>
<thead>
<tr>
<th>Future Years</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discontinued operations</td>
<td>$700</td>
<td>$ —</td>
<td>$700</td>
</tr>
<tr>
<td>Continuing operations</td>
<td>$(200)</td>
<td>$(100)</td>
<td>$(300)</td>
</tr>
<tr>
<td>Total</td>
<td>$500</td>
<td>$(100)</td>
<td>$(400)</td>
</tr>
<tr>
<td>Enacted tax rate for future years</td>
<td>40%</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability (asset) — net</td>
<td>$200</td>
<td>$(30)</td>
<td>$170</td>
</tr>
</tbody>
</table>

55-5 Total deferred tax expense for Year 2 is $100 ($170 – $70). The deferred tax benefit of the deductible temporary differences related to the entity's continuing operations during Year 2 is determined as follows.

- Deferred tax asset related to the entity's continuing operations at the end of Year 2 (40 percent of $200 and 30 percent of $100) = $110
- Deferred tax asset related to the entity's continuing operations at the beginning of Year 2 (40 percent of $200) = $80
- Deferred tax benefit for Year 2 = $(30)
**ASC 740-20 — Implementation Guidance and Illustrations (continued)**

55-6 The deferred tax expense for taxable temporary differences related to the entity's discontinued operations during Year 2 is determined as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax liability at the end of Year 2 (40 percent of $700)</td>
<td>$280</td>
</tr>
<tr>
<td>Deferred tax liability at the end of Year 1 (30 percent of $500)</td>
<td>(150)</td>
</tr>
<tr>
<td>Deferred tax expense for Year 2</td>
<td>$130</td>
</tr>
</tbody>
</table>

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

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

**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.

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:

a. Loss from continuing operations with an extraordinary gain (Case A)
b. Income from continuing operations with a loss from discontinued operations (Case B).

Case A: Loss From Continuing Operations With a Gain on Discontinued Operations

55-10 This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

a. The entity's pretax financial income and taxable income are the same.
b. The entity's ordinary loss from continuing operations is $500.
c. The entity also has a gain on discontinued operations of $900 that is a capital gain for tax purposes.
d. 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).
Case A: Loss From Continuing Operations With a Gain on Discontinued Operations (Tax Benefit Realizable)

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:

a. The entity's pretax financial income and taxable income are the same.
b. The entity's ordinary loss from continuing operations is $500.
c. The entity also has a gain on discontinued operations of $900 that is a capital gain for tax purposes.
d. 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).
e. The entity has determined that the deferred tax asset that would have resulted from the loss from continuing operations if the gain on discontinued operations had not occurred would be expected to be realized (that is, a valuation allowance would not have been needed).

55-11 Income tax expense is allocated between the pretax loss from operations and the gain on discontinued operations as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total income tax expense</td>
<td>$ 120</td>
</tr>
<tr>
<td>Tax benefit allocated to the loss from operations</td>
<td>(150)</td>
</tr>
<tr>
<td>Incremental tax expense allocated to the gain on discontinued operations</td>
<td>$ 270</td>
</tr>
</tbody>
</table>

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.
Case A1: Loss From Continuing Operations With a Gain on Discontinued Operations (Tax Benefit Not Realizable)

55-12A This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are the same as in Case A except that the entity has determined that the deferred tax asset that would have resulted from the loss from continuing operations if the gain on discontinued operations had not occurred would not be expected to be realized (that is, a valuation allowance would have been needed).

55-12B Income tax expense is allocated between the pretax loss from operations and the gain on discontinued operations as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total income tax expense</td>
<td>$120</td>
</tr>
<tr>
<td>Tax benefit allocated to the loss from operations</td>
<td>—</td>
</tr>
<tr>
<td>Incremental tax expense allocated to the gain on discontinued operations</td>
<td>$120</td>
</tr>
</tbody>
</table>

55-12C 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. However, the guidance in paragraph 740-20-45-7 requires that an entity 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. The entity has determined that, absent the capital gain from discontinued operations, a valuation allowance would have been needed on the deferred tax asset resulting from the $500 loss from continuing operations. Thus, zero tax benefit is allocated to continuing operations. The $120 incremental income tax expense related to the gain on discontinued operations is the difference between $120 of total tax expense and the zero tax benefit allocated to continuing operations.

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. See paragraph 740-20-45-7 for the exception to the general requirement when an entity has a loss from continuing operations.
Example 3: Allocation of the Benefit of a Tax Credit Carryforward

55-15 This Example illustrates the guidance in paragraphs 740-20-45-7 through 45-8 for allocation of the tax benefit of a tax credit carryforward that is recognized as a deferred tax asset in the current year. The assumptions are as follows:

a. The entity's pretax financial income and taxable income are the same.
b. Pretax financial income for the year comprises $300 from continuing operations and $400 from a gain on discontinued operations.
c. 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.
d. 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.

55-16 Income tax expense or benefit is allocated between pretax income from continuing operations and the gain on discontinued operations as follows.

<table>
<thead>
<tr>
<th>Total income tax benefit</th>
<th>$ (50)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax expense (benefit) allocated to income from continuing operations:</td>
<td></td>
</tr>
<tr>
<td>Tax (before tax credits) on $300 of taxable income at 40 percent</td>
<td>$ 120</td>
</tr>
<tr>
<td>Tax credits</td>
<td>(330)</td>
</tr>
<tr>
<td>Tax expense allocated to the gain on discontinued operations</td>
<td>$ 160</td>
</tr>
</tbody>
</table>

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.

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.

<table>
<thead>
<tr>
<th>Foreign Currency</th>
<th>Exchange Rate</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unremitted earnings, beginning of year</td>
<td>1,000</td>
<td>FC1 = $1.20</td>
</tr>
<tr>
<td>Earnings for the year</td>
<td>600</td>
<td>FC1 = $1.10</td>
</tr>
<tr>
<td>Unremitted earnings, end of year</td>
<td>1,600</td>
<td>FC1 = $1.00</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th></th>
<th>Net Investment</th>
<th>Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, beginning of year</td>
<td>$ 1,200</td>
<td>$ 240</td>
</tr>
<tr>
<td>Earnings and related taxes</td>
<td>660</td>
<td>132</td>
</tr>
<tr>
<td>Transaction adjustment and related taxes</td>
<td>(260)</td>
<td>(52)</td>
</tr>
<tr>
<td>Balances, end of year</td>
<td>$ 1,600</td>
<td>$ 320</td>
</tr>
</tbody>
</table>

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.

---

**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:

a. Ordinary income in all interim periods (Case A)

b. Ordinary income and losses in interim periods (Case B)

c. Changes in estimates (Case C).
ASC 740-270 — Implementation Guidance and Illustrations (continued)

55-3 Cases A and B share all of the following assumptions:

a. 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.

b. Computation of the estimated annual effective tax rate applicable to ordinary income is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax at statutory rate ($100,000 at 50%)</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Less anticipated tax credits</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net tax to be provided</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Estimated annual effective tax rate ($40,000 ÷ $100,000)</td>
<td>40%</td>
</tr>
</tbody>
</table>

c. 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.

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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Reporting Period</th>
<th>Year-to-Date</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Year-to-Date</th>
<th>Less Previously Provided</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
<td>40%</td>
<td>$ 8,000</td>
<td>—</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>40,000</td>
<td>40%</td>
<td>16,000</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>60,000</td>
<td>40%</td>
<td>24,000</td>
<td>16,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>100,000</td>
<td>40%</td>
<td>40,000</td>
<td>24,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$ 40,000</td>
</tr>
</tbody>
</table>

Case B: Ordinary Income and Losses in Interim Periods

55-5 The following Cases illustrate ordinary income and losses in interim periods:

a. Year-to-date ordinary income (Case B1)

b. Year-to-date ordinary losses, realization more likely than not (Case B2)

c. Year-to-date ordinary losses, realization not more likely than not (Case B3).
### 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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax (or Benefit)</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 40,000</td>
<td>$ 40,000</td>
<td>40%</td>
<td>$ 16,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>40,000</td>
<td>80,000</td>
<td>40%</td>
<td>32,000</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(20,000)</td>
<td>60,000</td>
<td>40%</td>
<td>24,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>100,000</td>
<td>40%</td>
<td>40,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax (or Benefit)</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>First quarter</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>40%</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>10,000</td>
<td>(10,000)</td>
<td>40%</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>15,000</td>
<td>5,000</td>
<td>40%</td>
<td>2,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>95,000</td>
<td>100,000</td>
<td>40%</td>
<td>40,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Reporting Period</th>
<th>Year-to-Date</th>
<th>Ordinary Income (Loss)</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax (or Benefit)</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$ (20,000)</td>
<td>$ (20,000)</td>
<td>— (a)</td>
<td>—</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>Second quarter</td>
<td>10,000</td>
<td>(10,000)</td>
<td>— (a)</td>
<td>—</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>Third quarter</td>
<td>15,000</td>
<td>5,000</td>
<td>40%</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>95,000</td>
<td>100,000</td>
<td>40%</td>
<td>40,000</td>
<td>2,000</td>
<td>38,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
<td>$40,000</td>
<td></td>
<td>$40,000</td>
</tr>
</tbody>
</table>

(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.

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.

<table>
<thead>
<tr>
<th>Estimated, end of</th>
<th>First Quarter</th>
<th>Second Quarter</th>
<th>Third Quarter</th>
<th>Actual Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated ordinary income for the fiscal year</td>
<td>$100,000</td>
<td>$80,000</td>
<td>$80,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Tax at 50% statutory rate</td>
<td>$50,000</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less anticipated credits</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(10,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net tax to be provided</td>
<td>$45,000</td>
<td>$35,000</td>
<td>$30,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Estimated annual effective tax rate</td>
<td>45%</td>
<td>43.75%</td>
<td>37.5%</td>
<td>40%</td>
</tr>
</tbody>
</table>
### 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

#### Cases A, B, and C share the following assumptions.

- **a.** 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.
- **b.** 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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Reporting Period</th>
<th>Year-to-Date</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax Benefit at Statutory Rate ($100,000 at 50%)</th>
<th>Tax Credits</th>
<th>Net Tax Benefit</th>
<th>Estimated Annual Effective Tax Rate ($60,000 + $100,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$ 25,000</td>
<td>$ 25,000</td>
<td>45%</td>
<td>$ (50,000)</td>
<td>(10,000)</td>
<td>$ (60,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Second quarter</td>
<td>5,000</td>
<td>30,000</td>
<td>43.75%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Third quarter</td>
<td>25,000</td>
<td>55,000</td>
<td>37.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>45,000</td>
<td>100,000</td>
<td>40%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**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.
Case A: Realization of the Tax Benefit of the Loss Is More Likely Than Not

55-14 The following Cases illustrate when realization of the tax benefit of the loss is more likely than not:

a. Ordinary losses in all interim periods (Case A1)
b. Ordinary income and losses in interim periods (Case A2).

Case A1: Ordinary Losses in All Interim Periods

55-15 The entity has ordinary losses in all interim periods. The full tax benefit of the anticipated ordinary loss and the anticipated tax credits will be realized by carryback. Quarterly tax computations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Loss</th>
<th>Estimated Year-to-Date</th>
<th>Tax Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td>Annual Effective Tax Rate</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ (20,000)</td>
<td>$ (20,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(20,000)</td>
<td>(40,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(20,000)</td>
<td>(60,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>(40,000)</td>
<td>(100,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$ (100,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Estimated Year-to-Date</th>
<th>Tax (or Benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td>Annual Effective Tax Rate</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
<td>60%</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(80,000)</td>
<td>(60,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(80,000)</td>
<td>(140,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>(100,000)</td>
<td>60%</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$ (100,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(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:

$$ \text{Year-to-date ordinary loss times the statutory rate} $$

($140,000 at 50\%) \quad $ (70,000)

Estimated tax credits for the year \quad (10,000)

Year-to-date benefit limited to \quad $ (80,000)
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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Year-to-Date</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Year-to-Date</th>
<th>Less Previously Provided</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$20,000</td>
<td>$20,000</td>
<td>60%</td>
<td>$12,000</td>
<td>—</td>
<td>$12,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(80,000)</td>
<td>(60,000)</td>
<td>60%</td>
<td>(36,000)</td>
<td>12,000</td>
<td>(48,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(80,000)</td>
<td>(140,000)</td>
<td>60%</td>
<td>(84,000)</td>
<td>(36,000)</td>
<td>(48,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>(100,000)</td>
<td>60%</td>
<td>(60,000)</td>
<td>(84,000)</td>
<td>24,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$(100,000)</td>
<td></td>
<td></td>
<td></td>
<td>$(60,000)</td>
<td></td>
</tr>
</tbody>
</table>

(a) Footnote superseded by Accounting Standards Update No. 2019-12.

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.

Case C: Partial Realization of the Tax Benefit of the Loss Is More Likely Than Not

55-18 The following Cases illustrate when partial realization of the tax benefit of the loss is more likely than not:

a. Ordinary losses in all interim periods (Case C1)
b. Ordinary income and losses in interim periods (Case C2).

Case C1: Ordinary Losses in All Interim Periods

55-19 The entity has an ordinary loss in all interim periods. It is more likely than not that the tax benefit of the loss in excess of $40,000 of prior income available to be offset by carryback ($20,000 of tax at the 50 percent statutory rate) will not be realized. Therefore the estimated annual effective tax rate is 20 percent ($20,000 benefit more likely than not to be realized divided by $100,000 estimated fiscal year ordinary loss). Quarterly tax computations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Loss</th>
<th>Year-to-Date</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Year-to-Date</th>
<th>Less Previously Provided</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$ (20,000)</td>
<td>(20,000)</td>
<td>20%</td>
<td>$ (4,000)</td>
<td>—</td>
<td>$ (4,000)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(20,000)</td>
<td>(40,000)</td>
<td>20%</td>
<td>(8,000)</td>
<td>(4,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(20,000)</td>
<td>(60,000)</td>
<td>20%</td>
<td>(12,000)</td>
<td>(8,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>(40,000)</td>
<td>(100,000)</td>
<td>20%</td>
<td>(20,000)</td>
<td>(12,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$(100,000)</td>
<td></td>
<td></td>
<td></td>
<td>$(20,000)</td>
<td></td>
</tr>
</tbody>
</table>
Case C2: Ordinary Income and Losses in Interim Periods

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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Year-to-Date</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Computed</th>
<th>Limited to</th>
<th>Less Previously Provided</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$20,000</td>
<td>$20,000</td>
<td>20%</td>
<td>$4,000</td>
<td>$</td>
<td>4,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>$(80,000)</td>
<td>$(60,000)</td>
<td>20%</td>
<td>$(12,000)</td>
<td>4,000</td>
<td>(16,000)</td>
<td>$(16,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>$(80,000)</td>
<td>$(140,000)</td>
<td>20%</td>
<td>$(28,000)</td>
<td>$(20,000)</td>
<td>(12,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>100,000</td>
<td>20%</td>
<td>20,000</td>
<td>(20,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$(100,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$20,000</td>
<td>$(20,000)</td>
</tr>
</tbody>
</table>

Case D: Reversal of Net Deferred Tax Credits

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.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated fiscal year ordinary loss</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>The tax benefit to be recognized is the lesser of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax effect of the loss carryforward ($100,000 at 50% statutory rate)</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Amount of the net deferred tax liabilities that would otherwise have been settled during the carry-forward period</td>
<td>$24,000</td>
<td></td>
</tr>
<tr>
<td>Estimated annual effective tax rate ($24,000 ÷ $100,000)</td>
<td>24%</td>
<td></td>
</tr>
</tbody>
</table>
ASC 740-270 — Implementation Guidance and Illustrations (continued)

55-22 Quarterly tax computations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Loss</th>
<th>Tax Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
</tr>
<tr>
<td>First quarter</td>
<td>(20,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(20,000)</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(20,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>(40,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>(100,000)</td>
<td></td>
</tr>
</tbody>
</table>

55-23 Note that changes in the timing of the loss by quarter would not change this computation.

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

55-24 The following Cases illustrate accounting for income taxes applicable to unusual or infrequently occurring items when ordinary income is expected for the fiscal year:

a. Realization of the tax benefit is more likely than not at date of occurrence (Case A)

b. Realization of the tax benefit not more likely than not at date of occurrence (Case B).

55-25 Cases A and B illustrate the computation of the tax (or benefit) applicable to unusual or infrequently occurring items when ordinary income is anticipated for the fiscal year. These Cases are based on the assumptions and computations presented in paragraph 740-270-55-3 and Example 1, Cases A and B (see paragraphs 740-270-55-4 through 55-8), plus additional information supplied in Cases A and B of this Example. The computation of the tax (or benefit) applicable to the ordinary income is not affected by the occurrence of an unusual or infrequently occurring item; therefore, each Case refers to one or more of the illustrations of that computation in Example 1, Cases A and B (see paragraphs 740-270-55-4 through 55-8), and does not reproduce the computation and the assumptions. The income statement display for tax (or benefit) applicable to unusual or infrequently occurring items is illustrated in Example 7 (see paragraph 740-270-55-52).
Case A: Realization of the Tax Benefit Is More Likely Than Not at Date of Occurrence

55-26 As explained in paragraph 740-270-55-25, this Case is based on the computations of tax applicable to ordinary income that are illustrated in Example 1, Case A (see paragraph 740-270-55-4). In addition, the entity experiences a tax-deductible unusual or infrequently occurring loss of $50,000 (tax benefit $25,000) in the second quarter. Because the loss can be carried back, it is more likely than not that the tax benefit will be realized at the time of occurrence. Quarterly tax provisions are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Unusual or Infrequently Occurring</th>
<th>Tax (or Benefit) Applicable to</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$20,000</td>
<td>$8,000</td>
<td></td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>$(50,000)</td>
<td>8,000 $(25,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td></td>
<td>16,000 $(25,000)</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td>$(50,000)</td>
<td>$40,000 $(25,000)</td>
</tr>
</tbody>
</table>

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.
Case B: Realization of the Tax Benefit Not More Likely Than Not at Date of Occurrence

55-28 As explained in paragraph 740-270-55-25, this Case is based on the computations of tax applicable to ordinary income that are illustrated in Example 1, Cases A and B1 (see paragraphs 740-270-55-4 through 55-6). In addition, the entity experiences a tax-deductible unusual or infrequently occurring loss of $50,000 (potential benefit $25,000) in the second quarter. The loss cannot be carried back, and available evidence indicates that a valuation allowance is needed for all of the deferred tax asset. As a result, the tax benefit of the unusual or infrequently occurring loss is recognized only to the extent of offsetting ordinary income for the year to date. Quarterly tax provisions under two different assumptions for the occurrence of ordinary income are as follows.

<table>
<thead>
<tr>
<th>Assumptions and Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Unusual or Infrequently Occurring Loss</th>
<th>Tax (or Benefit) Applicable to</th>
<th>Reporting Period</th>
<th>Year-to-Date Ordinary Income</th>
<th>Year-to-Date Unusual or Infrequently Occurring Loss</th>
<th>Less Previously Provided</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income in all quarters:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 20,000</td>
<td>$ 8,000</td>
<td>$ 8,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>$ (50,000)</td>
<td>8,000</td>
<td>16,000</td>
<td>$ (16,000)</td>
<td></td>
<td>$ —</td>
<td>$(16,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>8,000</td>
<td>24,000</td>
<td>(24,000)</td>
<td>(16,000)</td>
<td></td>
<td>(8,000)</td>
<td></td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>16,000</td>
<td>40,000</td>
<td>(25,000)</td>
<td>(24,000)</td>
<td></td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$ 100,000</td>
<td>$ (50,000)</td>
<td>$ 40,000</td>
<td></td>
<td>$ (25,000)</td>
<td></td>
<td></td>
<td>$(25,000)</td>
</tr>
<tr>
<td>Income and loss quarters:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 40,000</td>
<td>$ 16,000</td>
<td>$ 16,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Second quarter</td>
<td>40,000</td>
<td>$ (50,000)</td>
<td>16,000</td>
<td>32,000</td>
<td>$ (25,000)</td>
<td></td>
<td>$ —</td>
<td>$(25,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(20,000)</td>
<td>(8,000)</td>
<td>24,000</td>
<td>(24,000)</td>
<td>(25,000)</td>
<td></td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>16,000</td>
<td>40,000</td>
<td>(25,000)</td>
<td>(24,000)</td>
<td></td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$ 100,000</td>
<td>$ (50,000)</td>
<td>$ 40,000</td>
<td></td>
<td>$ (25,000)</td>
<td></td>
<td></td>
<td>$(25,000)</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimate pretax income</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Tax at 50% statutory rate</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Less anticipated credit</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net tax to be provided</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Estimated annual effective tax rate</td>
<td>40%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>25,000</td>
<td>45,000</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Revised Ordinary Income From Continuing Operations</th>
<th>Loss From Operations</th>
<th>Provision for Loss on Disposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$ 25,000</td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td>Second quarter</td>
<td>35,000</td>
<td>(10,000)</td>
<td></td>
</tr>
<tr>
<td>Third quarter</td>
<td>50,000</td>
<td>(10,000)</td>
<td>$ 55,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>50,000(\text{I})</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$ 160,000</td>
<td>(25,000)</td>
<td>$ 55,000</td>
</tr>
</tbody>
</table>

\(\text{(a)}\) Estimated.
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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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated ordinary income from continuing operations</td>
<td>$160,000</td>
</tr>
<tr>
<td>Tax at 50% statutory rate</td>
<td>$80,000</td>
</tr>
<tr>
<td>Less anticipated tax credits applicable to continuing operations</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Net tax to be provided</td>
<td>$72,000</td>
</tr>
<tr>
<td>Estimated annual effective tax rate</td>
<td>45%</td>
</tr>
</tbody>
</table>

55-33 Quarterly computations of tax applicable to ordinary income from continuing operations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax</th>
<th>Less Previously Provided</th>
<th>Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td>(A)</td>
<td>Year-to-Date</td>
<td>(B)</td>
</tr>
<tr>
<td>First quarter</td>
<td>$25,000</td>
<td>$25,000</td>
<td>45%</td>
<td>$11,250</td>
<td>$11,250</td>
</tr>
<tr>
<td>Second quarter</td>
<td>35,000</td>
<td>60,000</td>
<td>45%</td>
<td>27,000</td>
<td>11,250</td>
</tr>
<tr>
<td>Third quarter</td>
<td>50,000</td>
<td>110,000</td>
<td>45%</td>
<td>49,500</td>
<td>27,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>50,000</td>
<td>160,000</td>
<td>45%</td>
<td>72,000</td>
<td>49,500</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$160,000</td>
<td>$160,000</td>
<td>45%</td>
<td>$72,000</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Tax Applicable to Ordinary Income</th>
<th>Tax Benefit Applicable to Division X</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Previously Reported (A)</td>
<td>Recomputed (Above) (B)</td>
</tr>
<tr>
<td>First quarter</td>
<td>$8,000</td>
<td>$11,250</td>
</tr>
<tr>
<td>Second quarter</td>
<td>10,000</td>
<td>15,750</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th></th>
<th>Loss From Operations Division X</th>
<th>Provision for Loss on Disposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated annual income from continuing operations</td>
<td>$160,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Loss from Division X operations</td>
<td>(25,000)</td>
<td></td>
</tr>
<tr>
<td>Provision for loss on disposal of Division X</td>
<td></td>
<td>(55,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$135,000</td>
<td>$105,000</td>
</tr>
<tr>
<td>Tax at 50% statutory rate</td>
<td>$67,500</td>
<td>$52,500</td>
</tr>
<tr>
<td>Anticipated credits from continuing operations</td>
<td>(8,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Tax credits of Division X and recapture of previously recognized tax credits resulting from discontinuance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes on income after effect of Division X losses</td>
<td>59,500</td>
<td>44,500</td>
</tr>
<tr>
<td>Taxes on income before effect of Division X losses — see computation above</td>
<td>72,000</td>
<td>72,000</td>
</tr>
<tr>
<td>Tax benefit applicable to the losses of Division X</td>
<td>(12,500)</td>
<td>(27,500)</td>
</tr>
<tr>
<td>Amounts previously recognized — see computation above</td>
<td>(9,000)</td>
<td></td>
</tr>
<tr>
<td>Tax benefit recognized in third quarter</td>
<td>(3,500)</td>
<td>(27,500)</td>
</tr>
</tbody>
</table>

The resulting revised quarterly tax provisions are summarized as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Pretax Income (Loss)</th>
<th>Tax (or Benefit) Applicable to</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$25,000</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>35,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>50,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$160,000</td>
<td>(25,000)</td>
</tr>
</tbody>
</table>
**Example 5: Accounting for Income Taxes Applicable to Ordinary Income if an Entity Is Subject to Tax in Multiple Jurisdictions**

55-37 The following Cases illustrate the guidance in paragraph 740-270-30-36 for accounting for income taxes applicable to ordinary income if an entity is subject to tax in multiple jurisdictions:

- a. Ordinary income in all jurisdictions (Case A)
- b. Ordinary loss in a jurisdiction; realization of the tax benefit not more likely than not (Case B)
- c. Ordinary income or tax cannot be estimated in one jurisdiction (Case C).

55-38 Cases A, B, and C assume that an entity operates through separate corporate entities in two countries. Applicable tax rates are 50 percent in the United States and 20 percent in Country A. The entity has no unusual or infrequently occurring items during the fiscal year and anticipates no tax credits or events that do not have tax consequences. (The effect of foreign tax credits and the necessity of providing tax on undistributed earnings are ignored because of the wide range of tax planning alternatives available.) For the full fiscal year the entity anticipates ordinary income of $60,000 in the United States and $40,000 in Country A. The entity is able to make a reliable estimate of its Country A ordinary income and tax for the fiscal year in dollars. Computation of the overall estimated annual effective tax rate in Cases B and C is based on additional assumptions stated in those Cases.

**Case A: Ordinary Income in All Jurisdictions**

55-39 Computation of the overall estimated annual effective tax rate is as follows.

<table>
<thead>
<tr>
<th>Anticipated ordinary income for the fiscal year:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>In the United States</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>In Country A</td>
<td>40,000</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Anticipated tax for the fiscal year:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>In the United States ($60,000 at 50% statutory rate)</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>In Country A ($40,000 at 20% statutory rate)</td>
<td>8,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 38,000</td>
</tr>
</tbody>
</table>

**Overall estimated annual effective tax rate**

($38,000 ÷ $100,000) = 38%
## ASC 740-270 — Implementation Guidance and Illustrations (continued)

### 55-40 Quarterly tax computations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Tax</th>
<th>Overall Estimated Annual Effective Tax Rate</th>
<th>Year-to-Date Reporting Period</th>
<th>Less Previously Reported</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>United States</td>
<td>Country A</td>
<td>Total</td>
<td>Year-to-Date</td>
<td></td>
</tr>
<tr>
<td>First quarter</td>
<td>$5,000</td>
<td>$15,000</td>
<td>$20,000</td>
<td>$20,000</td>
<td>38%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Second quarter</td>
<td>10,000</td>
<td>10,000</td>
<td>20,000</td>
<td>40,000</td>
<td>38%</td>
</tr>
<tr>
<td>Third quarter</td>
<td>10,000</td>
<td>10,000</td>
<td>20,000</td>
<td>60,000</td>
<td>38%</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>35,000</td>
<td>5,000</td>
<td>40,000</td>
<td>100,000</td>
<td>38%</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$60,000</td>
<td>$40,000</td>
<td>$100,000</td>
<td></td>
<td>38%</td>
</tr>
</tbody>
</table>

### 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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (or Loss)</th>
<th>Tax (or Benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$5,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Third quarter</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>35,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Foreign Currency (FC) Amounts</th>
<th>Translated Amounts in Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ordinary Income in FC period</td>
<td>Tax (at 40% rate)</td>
</tr>
<tr>
<td>First quarter</td>
<td>FC 10,000</td>
<td>$12,500</td>
</tr>
<tr>
<td>Second quarter</td>
<td>5,000</td>
<td>8,750</td>
</tr>
<tr>
<td>Third quarter</td>
<td>30,000</td>
<td>27,500</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>15,000</td>
<td>16,250</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>FC 60,000</td>
<td>$65,000</td>
</tr>
</tbody>
</table>

55-43 Quarterly tax provisions are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter</td>
<td>$5,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Third quarter</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>35,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>
**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).

**Pending Content (Transition Guidance: ASC 740-10-65-8)**

55-44 The following Example illustrates 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 when legislation is effective in a future interim period.

- Subparagraph superseded by Accounting Standards Update No. 2019-12.
- Subparagraph superseded by Accounting Standards Update No. 2019-12.

**Case A: Legislation Effective in a Future Interim Period**

55-45 The assumed facts applicable to this Case follow.

**Pending Content (Transition Guidance: ASC 740-10-65-8)**

*Editor’s Note: Paragraph 740-270-55-45 will be amended upon transition, together with its heading: Legislation Effective in a Future Interim Period*

55-45 The assumed facts applicable to this Example 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax at statutory rate ($100,000 at 50%)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less anticipated tax credits</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net tax to be provided</td>
<td>$40,000</td>
</tr>
<tr>
<td>Estimated annual effective tax rate ($40,000 ÷ $100,000)</td>
<td>40%</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax at statutory rate ($100,000 at 50%)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less anticipated tax credits</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Net tax to be provided</td>
<td>$38,000</td>
</tr>
<tr>
<td>Estimated annual effective tax rate ($38,000 ÷ $100,000)</td>
<td>38%</td>
</tr>
</tbody>
</table>
The effect of the new legislation shall not be reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting Period</td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td>Year-to-Date</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
<td>40%</td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>40,000</td>
<td>40%</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>60,000</td>
<td>38%</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>100,000</td>
<td>38%</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$100,000</td>
<td></td>
<td>38%</td>
</tr>
</tbody>
</table>

Pending Content (Transition Guidance: ASC 740-10-65-8)

The effect of the new legislation shall be reflected in the computation of the annual effective tax rate beginning in the first interim period that includes the enactment date of the new legislation. Accordingly, quarterly tax computations are as follows.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting Period</td>
<td>Reporting Period</td>
<td>Year-to-Date</td>
<td>Year-to-Date</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
<td>40%</td>
</tr>
<tr>
<td>Second quarter</td>
<td>20,000</td>
<td>40,000</td>
<td>38%</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20,000</td>
<td>60,000</td>
<td>38%</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>100,000</td>
<td>38%</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$(100,000)</td>
<td></td>
<td>38%</td>
</tr>
</tbody>
</table>

Case B: Effective Date of New Legislation

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.

Pending Content (Transition Guidance: ASC 740-10-65-8)

Editor’s note: Paragraph 740-270-55-50 will be superseded upon transition, together with its heading:

Case B: Effective Date of New Legislation

Paragraph superseded by Accounting Standards Update No. 2019-12.
ASC 740-270 — Implementation Guidance and Illustrations (continued)

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 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.

Pending Content (Transition Guidance: ASC 740-10-65-8)

55-51 Paragraph superseded by Accounting Standards Update No. 2019-12.

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales(^{(a)})</td>
<td>$ XXXX</td>
</tr>
<tr>
<td>Other income(^{(a)})</td>
<td>XXX</td>
</tr>
</tbody>
</table>

Costs and expenses:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales(^{(a)})</td>
<td>$ XXXX</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses(^{(a)})</td>
<td>XXX</td>
</tr>
<tr>
<td>Interest expense(^{(a)})</td>
<td>XXX</td>
</tr>
<tr>
<td>Other deductions(^{(a)})</td>
<td>XX</td>
</tr>
<tr>
<td>Unusual items</td>
<td>XXX</td>
</tr>
<tr>
<td>Infrequently occurring items</td>
<td>XXX</td>
</tr>
</tbody>
</table>

Income (loss) from continuing operations before income taxes and other items listed below | XXXX |

Provision for income taxes (benefit)\(^{(b)}\) | XXXX |

Income (loss) from continuing operations before other items listed below | XXXX |

Discontinued operations:

Income (loss) from operations of discontinued Component X
(less applicable income taxes of $XXXX) | XXXX |

Net income (loss) | $ XXXX |

\(^{(a)}\) Components of ordinary income (loss).

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

Illustrations

Example 1: Nontaxable Business Combination

55-2 This Example illustrates the guidance in paragraphs 805-740-25-2 through 25-3 and 805-740-30-1 relating to the recognition and measurement of a deferred tax liability and deferred tax asset in a nontaxable business combination. The assumptions are as follows:

a. The enacted tax rate is 40 percent for all future years, and amortization of goodwill is not deductible for tax purposes.

b. A wholly owned entity is acquired for $20,000, and the entity has no leveraged leases.

c. The tax basis of the net assets acquired (other than goodwill) is $5,000, and the recognized value is $12,000. Future recovery of the assets and settlement of the liabilities at their assigned values will result in $20,000 of taxable amounts and $13,000 of deductible amounts that can be offset against each other. Therefore, no valuation allowance is necessary.

55-3 The amounts recorded to account for the business combination transaction are as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognized value of the net assets (other than goodwill) acquired</td>
<td>$ 12,000</td>
</tr>
<tr>
<td>Deferred tax liability for $20,000 of taxable temporary differences</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Deferred tax asset for $13,000 of deductible temporary differences</td>
<td>5,200</td>
</tr>
<tr>
<td>Goodwill</td>
<td>10,800</td>
</tr>
<tr>
<td>Consideration paid for the acquiree</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

Example 2: Valuation Allowance at Acquisition Date Subsequently Reduced

55-4 This Example illustrates the guidance in paragraphs 805-740-25-3 and 805-740-45-2 relating to the recognition of a deferred tax asset and the related valuation allowance for acquired deductible temporary differences at the date of a nontaxable business combination and in subsequent periods when the tax law limits the use of an acquired entity's deductible temporary differences and carryforwards to subsequent taxable income of the acquired entity in a consolidated tax return. The assumptions are as follows:

a. The enacted tax rate is 40 percent for all future years.

b. The purchase price is $20,000, and the assigned value of the net assets acquired is also $20,000.

c. The tax basis of the net assets acquired is $60,000. The $40,000 ($60,000 – $20,000) of deductible temporary differences at the combination date is primarily attributable to an allowance for loan losses. Provisions in the tax law limit the use of those future tax deductions to subsequent taxable income of the acquired entity.

d. The acquired entity's actual pretax results for the two preceding years and the expected results for the year of the business combination are as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$(15,000)</td>
</tr>
<tr>
<td>Year 2</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Year 3 to the combination date</td>
<td>$(5,000)</td>
</tr>
<tr>
<td>Expected results for the remainder of Year 3</td>
<td>$(5,000)</td>
</tr>
</tbody>
</table>

e. Based on assessments of all evidence available at the date of the business combination in Year 3 and at the end of Year 3, management concludes that a valuation allowance is needed at both dates for the entire amount of the deferred tax asset related to the acquired deductible temporary differences.
The acquired entity's pretax financial income and taxable income for Year 3 (after the business combination) and Year 4 are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income</td>
<td>$15,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Reversals of acquired deductible temporary differences</td>
<td>(15,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th></th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income</td>
<td>$15,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Income tax expense (benefit):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred</td>
<td></td>
<td>(6,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$15,000</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

**Example 3: Acquirer's Taxable Temporary Differences Eliminate Need for Acquiree Valuation Allowance**

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:

a. The enacted tax rate is 40 percent for all future years.

b. 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.

c. The acquiring entity has temporary differences that will result in $30,000 of net taxable amounts in future years.

d. 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.
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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned value of the identified net assets acquired</td>
<td>$12,000</td>
</tr>
<tr>
<td>Deferred tax liability recognized for the acquired entity's taxable temporary differences ($7,000 at 40 percent)</td>
<td>(2,800)</td>
</tr>
<tr>
<td>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)</td>
<td>2,800</td>
</tr>
<tr>
<td>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)</td>
<td>3,600</td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,400</td>
</tr>
<tr>
<td>Purchase price of the acquired entity</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

**Example 4: Tax Deductible Goodwill Exceeds Financial Reporting Goodwill**

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:

- a. 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.
- b. The tax rate is 40 percent for all years.

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. 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.

\[ \frac{\text{Tax Rate}}{[1 - \text{Tax Rate}]} \times \text{Preliminary Temporary Difference} = \text{Deferred Tax Asset} \]

In this Example, the following variables are known:

- Tax rate = 40 percent
- Preliminary Temporary Difference = $300 ($900 − $600)

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

Goodwill for financial reporting would be established at the acquisition date at $400 ($600 less the $200 credit adjustment).
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 following is a tabular presentation of this Example.

<table>
<thead>
<tr>
<th></th>
<th>19X2</th>
<th>19X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial reporting basis</td>
<td>CFC 350 × 1.5</td>
<td>CFC 525</td>
</tr>
<tr>
<td>Tax basis</td>
<td>CFC 100 × 1.25</td>
<td>CFC 125</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>CFC 250</td>
<td>CFC 400</td>
</tr>
<tr>
<td>Tax rate</td>
<td>× .40</td>
<td>× .40</td>
</tr>
<tr>
<td>Deferred tax liability, end of year</td>
<td>CFC 100</td>
<td>CFC 160</td>
</tr>
<tr>
<td>Deferred tax liability (restated), beginning of year</td>
<td>CFC 100 × 1.5</td>
<td>CFC 150</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td></td>
<td>CFC 10</td>
</tr>
</tbody>
</table>

Example 1: Application of Accounting Guidance to a Limited Partnership Investment in a Qualified Affordable Housing Project

55-1 This Section is an integral part of the requirements of this Subtopic.

Illustrations

55-2 This Example illustrates the application of the cost, equity, and proportional amortization methods of accounting for a limited liability investment in a qualified affordable housing project.

55-3 The following are the terms for this Example.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of investment</td>
<td>January 1, 20X1</td>
</tr>
<tr>
<td>Purchase Price of Investment</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
**ASC 323-740 — Implementation Guidance and Illustrations (continued)**

55-4 This Example has the following assumptions:

- a. All cash flows (except initial investment) occur at the end of each year.
- b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
- c. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
- d. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.
- e. The annual tax credit allocation (equal to 4 percent of the project’s original cost) will be received for a period of 10 years.
- f. The investor’s tax rate is 40 percent.
- g. The project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.
- h. The project’s taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the $100,000 investment.
- j. It is assumed that all requirements are met to retain allocable tax credits 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. 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.
An analysis of the proportional amortization method follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment (1)</th>
<th>Amortization of Investment (2)</th>
<th>Tax Credits (3)</th>
<th>Net Losses/Tax Depreciation (4)</th>
<th>Other Tax Benefits From Tax Depreciation (5)</th>
<th>Tax Credits and Other Tax Benefits (6)</th>
<th>Tax Credits and Other Tax Benefits, Net of Amortization (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$90,909</td>
<td>$9,091</td>
<td>$8,000</td>
<td>$7,273</td>
<td>$2,909</td>
<td>$10,909</td>
<td>$1,818</td>
</tr>
<tr>
<td>2</td>
<td>81,818</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>3</td>
<td>72,727</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>4</td>
<td>63,636</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>5</td>
<td>54,545</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>6</td>
<td>45,454</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>7</td>
<td>36,363</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>8</td>
<td>27,272</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>9</td>
<td>18,181</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>10</td>
<td>9,090</td>
<td>9,091</td>
<td>8,000</td>
<td>7,273</td>
<td>2,909</td>
<td>10,909</td>
<td>1,818</td>
</tr>
<tr>
<td>11</td>
<td>6,666</td>
<td>2,424</td>
<td>—</td>
<td>7,273</td>
<td>2,909</td>
<td>2,909</td>
<td>485</td>
</tr>
<tr>
<td>12</td>
<td>4,242</td>
<td>2,424</td>
<td>—</td>
<td>7,273</td>
<td>2,909</td>
<td>2,909</td>
<td>485</td>
</tr>
<tr>
<td>13</td>
<td>1,818</td>
<td>2,424</td>
<td>—</td>
<td>7,273</td>
<td>2,909</td>
<td>2,909</td>
<td>485</td>
</tr>
<tr>
<td>14</td>
<td>—</td>
<td>1,818</td>
<td>—</td>
<td>5,451</td>
<td>2,183</td>
<td>2,183</td>
<td>365</td>
</tr>
<tr>
<td>15</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
<td>$80,000</td>
<td>$100,000</td>
<td>$40,000</td>
<td>$120,000</td>
<td>$20,000</td>
<td>—</td>
</tr>
</tbody>
</table>

(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 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).

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment (1)</th>
<th>Amortization of Investment (2)</th>
<th>Tax Depreciation (3)</th>
<th>Tax Credits (4)</th>
<th>Current Tax Benefit (5)</th>
<th>Deferred Tax Benefit (Expense) (6)</th>
<th>Impact on Net Income (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$90,000</td>
<td>$10,000</td>
<td>$7,273</td>
<td>$8,000</td>
<td>$10,909</td>
<td>$1,091</td>
<td>$2,000</td>
</tr>
<tr>
<td>2</td>
<td>80,000</td>
<td>10,000</td>
<td>7,273</td>
<td>8,000</td>
<td>10,909</td>
<td>1,091</td>
<td>2,000</td>
</tr>
<tr>
<td>3</td>
<td>70,000</td>
<td>10,000</td>
<td>7,273</td>
<td>8,000</td>
<td>10,909</td>
<td>1,091</td>
<td>2,000</td>
</tr>
<tr>
<td>4</td>
<td>60,000</td>
<td>10,000</td>
<td>7,273</td>
<td>8,000</td>
<td>10,909</td>
<td>1,091</td>
<td>2,000</td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>10,000</td>
<td>7,273</td>
<td>8,000</td>
<td>10,909</td>
<td>1,091</td>
<td>2,000</td>
</tr>
<tr>
<td>6</td>
<td>40,000</td>
<td>10,000</td>
<td>7,273</td>
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</tr>
<tr>
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<td>30,000</td>
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</tr>
<tr>
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<td>20,000</td>
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<td>7,273</td>
<td>8,000</td>
<td>10,909</td>
<td>1,091</td>
<td>2,000</td>
</tr>
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<td>10,000</td>
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<td>7,273</td>
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<td>1,091</td>
<td>2,000</td>
</tr>
<tr>
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<td></td>
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<td>8,000</td>
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</tr>
<tr>
<td>11</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<td>(2,909)</td>
</tr>
<tr>
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<td></td>
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<td>(2,909)</td>
</tr>
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<td></td>
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</tr>
<tr>
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<td></td>
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<td></td>
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<td>(2,183)</td>
</tr>
<tr>
<td>15</td>
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<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$80,000</td>
<td>$120,000</td>
<td></td>
<td></td>
<td>$20,000</td>
</tr>
</tbody>
</table>

(1) End-of-year investment for a 5 percent limited liability 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.


(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).
A detailed analysis of the equity method follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment (1)</th>
<th>Book Loss (2)</th>
<th>Tax Loss (Depreciation) (3)</th>
<th>Tax Credits (4)</th>
<th>Current Tax Benefit (5)</th>
<th>Deferred Tax Benefit (Expense) (6)</th>
<th>Impact on Net Income (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$92,727</td>
<td>$7,273</td>
<td>$8,000</td>
<td>$10,909</td>
<td>$3,636</td>
<td></td>
<td>$3,636</td>
</tr>
<tr>
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<td>8,000</td>
<td>10,909</td>
<td>3,636</td>
<td>3,636</td>
</tr>
<tr>
<td>3</td>
<td>78,181</td>
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<td>7,273</td>
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<td>3,636</td>
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<td>10,909</td>
<td>3,636</td>
<td>3,636</td>
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<tr>
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<td>7,273</td>
<td>8,000</td>
<td>10,909</td>
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<td>3,636</td>
</tr>
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<td>7,273</td>
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<td>3,636</td>
</tr>
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<td>7,273</td>
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<td>3,636</td>
</tr>
<tr>
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<td>$0</td>
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</tr>
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</table>

(1) End-of-year investment for a 5 percent limited liability 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.


(6) The change in deferred taxes resulting from differences 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).
### Pending Content (Transition Guidance: ASC 740-10-65-8)

55-8 A detailed analysis of the equity method follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment (1)</th>
<th>Book Loss (2)</th>
<th>Tax Loss (Depreciation) (3)</th>
<th>Tax Credits (4)</th>
<th>Current Tax Benefit (5)</th>
<th>Deferred Tax Benefit (Expense) (6)</th>
<th>Impact on Net Income (7)</th>
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<td>$0</td>
<td>$20,000</td>
<td></td>
</tr>
</tbody>
</table>

(1) End-of-year investment for a 5 percent limited liability 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.


(6) The change in deferred taxes resulting from differences 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 the total future tax benefits at the end of Year 6 indicate that a net loss will be recognized over the remaining term of the investment indicating an other-than-temporary impairment. For purposes of this Example, in Year 6, impairment is measured as the excess of the carrying amount of the net investment over 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 in Year 6 ($24,362) is derived as follows: Investment at the end of Year 5 ($63,635) less the loss recognized in Year 6 ($7,273) before recognizing the impairment, the remaining tax credits allocable to the investor ($32,000), and the estimated residual value ($0).

55-9 This Example is but one method for recognition and measurement of impairment of an investment accounted for by the equity method. Inclusion of this method in this Example does not indicate that it is a preferred method.

55-10 Paragraph superseded by Accounting Standards Update No. 2014-01.
Appendix B — FASB Issues ASU on Simplifying the Accounting for Income Taxes

B.1 Background

In December 2019, the FASB issued ASU 2019-12, which modifies ASC 740 to simplify the accounting for income taxes. The changes were originally submitted by stakeholders in connection with the FASB’s initiative to reduce complexity in accounting standards (the Simplification Initiative). As the Board states in the ASU, “[t]he objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.”

B.2 Key Changes Made by the ASU

B.2.1 Hybrid Tax Regimes

ASU 2019-12 amends the requirements related to the accounting for hybrid tax regimes. Such regimes are tax jurisdictions that impose the greater of two taxes — one based on income or one based on items other than income. Although ASC 740 does not apply to taxes based on items other than income, ASC 740-10-15-4(a) originally specified that if there is a tax based on income that is greater than a franchise tax based on capital, only that excess is subject to the guidance in ASC 740. In feedback to the FASB, stakeholders indicated that the guidance on hybrid tax regimes increased the cost and complexity of applying ASC 740, particularly when the tax amount deemed to be a non-income tax was insignificant. Further, such guidance made it more difficult for entities to determine the appropriate tax rate to use when recording deferred taxes.

Accordingly, the FASB amended ASC 740-10-15-4(a) to state that an entity should include the amount of tax based on income in the tax provision and should record any incremental amount recorded as a tax not based on income. This amendment effectively reverses the order in which an entity determines the type of tax under current U.S. GAAP. In addition, the ASU amends the illustrative examples referred to and included in ASC 740-10-55-26 and ASC 740-10-55-139 through 55-144. The FASB notes that such amendments are consistent with the accounting for other incremental taxes, such as the BEAT. Moreover, in paragraph BC12 of the ASU, the FASB concluded that subjecting these taxes to the disclosure requirements in ASC 740 will result in greater transparency of franchise tax amounts.
B.2.2  Tax Basis Step-Up in Goodwill Obtained in a Transaction That Is Not a Business Combination

In a business combination that results in the recognition of goodwill in accordance with ASC 805, amounts assigned to goodwill may be different, for income tax purposes, from the amounts used for financial reporting. Under U.S. GAAP, a DTA is recognized when the tax basis of goodwill exceeds the book basis of goodwill. When the book basis of goodwill exceeds the tax basis of goodwill, however, ASC 805 prohibits recognition of a DTL.

After a business combination, certain transactions or events may increase the tax basis of the entity’s assets, including goodwill. The previous guidance in ASC 740-10-25-4 prohibited recognition of a DTA for a subsequent step-up in the tax basis of goodwill that is related to the portion of goodwill from a prior business combination for which a DTL was not initially recognized, except when “the newly deductible goodwill amount exceeds the remaining balance of book goodwill.”

Stakeholders noted that applying the guidance in U.S. GAAP did not necessarily result in outcomes that reflected the economics of the underlying transactions. For example, an entity may have sacrificed an NOL carryforward in exchange for tax basis in goodwill. From an economic perspective, such an entity would have exchanged one asset for another and yet may have been precluded from recognizing the asset received.

In response to stakeholder feedback, the FASB removed the previous guidance in ASC 740-10-25-54 that prohibited recognition of a DTA for a step-up in tax basis “except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill.” Instead, the amended guidance contains a model under which an entity can consider a list of factors in determining whether the step-up in tax basis is related to the business combination that caused the initial recognition of goodwill or to a separate transaction. If the step-up is related to the business combination in which the book goodwill was originally recognized, the entity would not record a DTA for the step-up in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill. If the step-up is related to a subsequent transaction, however, the entity would record a DTA. The Board decided that this revised guidance “better reflects the economic consequences of separate transactions because it results in the recognition of an asset instead of expense when the step up in tax basis results in a future tax benefit.”

In paragraph BC19 of ASU 2019-12, the Board acknowledged that entities will still need to apply judgment in making this determination.

B.2.3  Separate Financial Statements of Legal Entities Not Subject to Tax

ASC 740-10-30-27 requires that “[t]he consolidated amount of current and deferred tax expense for a group that files a consolidated tax return . . . be allocated among the members of the group when those members issue separate [company] financial statements.” However, ASC 740-10-30-27 does not state which entities would be considered “members” of the group in the determination of whether taxes should be allocated to a given entity. For example, the guidance does not specify whether taxes should be allocated to nontaxable entities (e.g., a disregarded single member LLC that passes income through to the owner of the entity for tax purposes and is not severally liable for the related taxes of its owner).

Because stakeholders had indicated that the original guidance was unclear, the FASB added ASC 740-10-30-27A, which clarifies that legal entities that are not subject to tax (e.g., certain partnerships and disregarded single member LLCs) are not required to include, in their separate financial statements, amounts of consolidated current and deferred taxes. An entity, however, may elect to allocate current and deferred tax expense from its consolidated parent entity in its stand-alone financial statements, as
Appendix B — FASB Issues ASU on Simplifying the Accounting for Income Taxes

long as the legal entity is not subject to tax and is disregarded by the taxing authority. In addition, the Board added ASC 740-10-50-17A, which requires that when a legal entity that is both not subject to tax and disregarded by the taxing authority elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements in accordance with ASC 740-10-30-27A, it must disclose that fact and provide the disclosures required by ASC 740-10-50-17.

Paragraph BC22 of ASU 2019-12 notes that one reason to allow such a policy election is that some entities (e.g., certain rate-regulated entities or entities with cost-plus revenue arrangements) may, for business reasons, want to include in their separate financial statements an allocation of the tax amounts incurred by the consolidating parent entity as a result of transactions generated by the entity not subject to tax.

**Connecting the Dots**

Under the aforementioned policy election, a single member LLC (a disregarded entity for tax) is permitted to include a tax provision in its separate financial statements, but a partnership (a regarded entity for tax) is not.

**B.2.4 Intraperiod Tax Allocation Exception to Incremental Approach**

Under U.S. GAAP, an entity should determine the tax effect of income from continuing operations without considering the tax effect of items that are not included in continuing operations, such as discontinued operations or OCI. Prior U.S. GAAP included an exception to this approach, as described in ASC 740-20-45-7 (before ASU 2019-12), which required that “all items . . . be considered in determining the amount of tax benefit that results from a loss from continuing operations.” This exception applied only when there was a current-period loss from continuing operations.

Stakeholders provided feedback on the difficulty of applying this exception, which they noted (1) was often overlooked, (2) provided little perceived benefit to users of financial statements, (3) was applied inconsistently in practice, and (4) often yielded counterintuitive results. On the basis of this feedback, the FASB removed the exception in ASC 740-20-45-7. While some respondents disagreed with the removal of this exception and believed that its removal may indeed increase costs for certain entities, the FASB noted that “overall, the scenarios in which removing the exception would decrease the cost of applying Topic 740 are likely more common than those scenarios in which removing the exception would increase costs.” In addition, the ASU amends the illustrative example in ASC 740-20-55-10 through 55-14 to conform with the removal of the exception in ASC 740-20-45-7.

**B.2.5 Ownership Changes in Investments — Changes From a Subsidiary to an Equity Method Investment**

ASC 740-30-25-15 previously provided guidance on situations in which an investment in common stock of a subsidiary changes so that it is no longer considered a subsidiary (e.g., the extent of ownership in the investment changes so that it becomes an equity method investment). Under prior U.S. GAAP, if the parent entity did not previously recognize income taxes on its undistributed earnings because of the exception in ASC 740-30-25-18(a) (i.e., because of an assertion of indefinite reinvestment), no deferred taxes were recognized on that portion of the basis difference until it became apparent that such undistributed earnings would be remitted (i.e., deferred taxes were not automatically recognized). This requirement represented an exception to the general principle related to the accounting for outside basis differences of equity method investments.

In paragraph BC31 of ASU 2019-12, the FASB states that the exception in ASC 740-30-25-15 increases “the cost and complexity of applying Topic 740” because it essentially required an entity to bifurcate its outside basis difference in the investment and account for the components separately. The original
outside basis difference that existed when the subsidiary became an equity method investment was “frozen”; however, subsequent changes in the outside basis difference were recognized separately. The FASB removed the exception in ASC 740-30-25-15, which restricted recognition of a DTL on the portion of the outside basis difference that existed before the subsidiary became an equity method investment. Under the new guidance, an entity will need to recognize a DTL related to the outside basis difference of an equity method investment when the subsidiary becomes an equity method investment. Accordingly, an entity “shall accrue in the current period income taxes on the temporary difference related to its remaining investment in common stock.” This guidance is now consistent with current U.S. GAAP, under which an equity method investor is prohibited from asserting indefinite reinvestment of earnings to avoid recording deferred taxes on its outside basis differences.

B.2.6 Ownership Changes in Investments — Changes From an Investment to a Subsidiary

ASC 740-30-25-16 provides guidance on situations in which a foreign equity method investment becomes a subsidiary. Prior guidance stated that the DTL previously recognized for a foreign investment could not be derecognized when the investment became a subsidiary unless dividends received from the subsidiary exceeded earnings from the subsidiary after the date it became a subsidiary. This was the case regardless of whether an exception under ASC 740-30-25-18(a) applied.

In a manner similar to its observations related to ASC 740-30-25-15 above, the FASB noted that this historical requirement increased the cost and complexity of applying ASC 740 because an entity essentially needed to bifurcate its outside basis difference in the subsidiary and account for the components separately. This complicated the accounting for investments and foreign subsidiaries and reduced comparability among entities (i.e., some of a reporting entity's subsidiaries may not have been eligible to apply the exception simply because of the nature of the investment before they became subsidiaries).

To decrease the complexity of applying ASC 740 and increase the usefulness of information for financial statement users, the FASB removed the exception in ASC 740-30-25-16 that "froze" the DTL on the outside basis difference that existed before the investment became a subsidiary. Accordingly, an entity may need to reverse a DTL if it asserts indefinite reinvestment of earnings of the subsidiary at the time of the ownership change. This treatment results in consistency among all of the entity's subsidiaries for which indefinite reinvestment is asserted.

B.2.7 Interim-Period Accounting for Enacted Changes in Tax Law

Stakeholder feedback indicated that the guidance on recognizing the income tax effects of an enacted change in tax law in an interim period was unclear. More specifically, the previous guidance in ASC 740-10 required that the tax effect of a change in tax law or rates on deferred tax accounts and taxes payable or refundable for prior years be recognized in the period that includes the enactment date. ASC 740-270-25-5, however, previously stated that the effect of a change in tax law or rates on taxes currently payable or refundable for the current year is recorded after the effective date and no earlier than the enactment date. Because the prior guidance in ASC 740-270-25-5 appeared inconsistent with that in ASC 740-10, diversity in practice developed.

As a result, to reduce the cost and complexity of applying ASC 740, the FASB amended ASC 740-270-25-5 to require that the effects of an enacted change in tax law on taxes currently payable or refundable for the current year be reflected in the computation of the AETR in the first interim period that includes the enactment date of the new legislation. In addition, the example in ASC 740-270-55-44 through 55-49 was also amended to reflect the change. This amendment superseded the example in ASC 740-270-55-50 and 55-51.
B.2.8  YTD Loss Limitation in Interim-Period Tax Accounting

Under the interim-period income tax model, an entity is generally required to calculate its best estimate of the AETR for the full fiscal year at the end of each interim reporting period and to use that rate to calculate income taxes on a YTD basis. ASC 740-270-30-28 provides additional guidance on situations in which an entity incurs a loss on a YTD basis that exceeds the anticipated loss for the year. In these situations, previous U.S. GAAP stipulated that the income tax benefit was limited to the income tax benefit that would exist on the basis of the YTD loss. This represented an exception to the general guidance in ASC 740-270. Stakeholders provided mixed feedback on the usefulness of the exception and the outcomes it yielded. However, the Board noted that application of this exception is complex and prone to errors.

The FASB determined that the elimination of this exception would reduce the time and cost associated with remediating errors while not adversely altering the information provided to stakeholders on an interim basis within an entity’s quarterly financial statements. Thus, the FASB removed the exception in ASC 740-270-30-28. In paragraph BC42 of ASU 2019-12, the Board acknowledges that removal of the exception may result in recognition of tax benefits in an interim period that exceed the tax benefits that would be received on the basis of the YTD loss. However, the FASB decided that the benefit to financial statement users of limiting the tax benefits would not outweigh the costs of the limitation.

B.3  Codification Improvements

ASU 2019-12 makes two minor improvements to the Codification topics discussed below.

B.3.1  Income Statement Presentation of Tax Benefits of Tax-Deductible Dividends

Once effective for a reporting entity, ASU 2016-09 will amend ASC 718-740-45-7 to state that “[t]he tax benefit of tax-deductible dividends on allocated and unallocated employee stock ownership plan shares shall be recognized in the income statement” (emphasis added). Paragraph BC44 of ASU 2019-12 notes that before the adoption of ASU 2016-09, ASC 718-740-45-7 stated that the relevant tax benefit “should be recognized in income taxes allocated to continuing operations” (emphasis added). Other Codification topics that address this issue use the language in ASC 718-740-45-7 before the adoption of ASU 2016-09. The FASB decided to change the phrase “recognized in the income statement” to “recognized in income taxes allocated to continuing operations” (i.e., the phrase that was used before the adoption of ASU 2016-09) to clarify where income tax benefits related to tax-deductible dividends should be presented in the income statement.

B.3.2  Impairment of Investment in QAHPs Accounted for Under the Equity Method

ASC 323-740-55-8 includes an example illustrating the accounting for an investment in a QAHP under the equity method. The example previously indicated that the investment becomes impaired in year 9 and that impairment is measured on the basis of the remaining tax credits allocable to the investor; however, the impairment assessment (specifically, the year in which the impairment occurs) is incorrect on the basis of the revised facts that were used when the example was amended in ASU 2014-01. The FASB initially suggested deleting ASC 323-740-55-8, noting that the example was not necessary because a more relevant and useful example already exists in this Codification topic. However, during the comment period, the FASB received feedback indicating that the example is used in the accounting for subsequent measurement of qualified affordable housing property investments under the equity method. Accordingly, the FASB reversed its initial decision and instead corrected the error in the calculation.


B.4 Transition and Effective Date

B.4.1 Transition and Related Disclosure

The transition method related to the amendments made by ASU 2019-12 depends on the nature of the guidance as follows:

- Guidance on the separate financial statements of legal entities that are not subject to tax should be applied on a retrospective basis for all periods presented.
- Guidance on ownership changes of foreign equity method investments or foreign subsidiaries should be applied on a modified retrospective basis, with a cumulative-effect adjustment recorded through retained earnings as of the beginning of the period of adoption.
- Guidance on hybrid tax regimes (i.e., franchise taxes that are partially based on income) can be adopted by using either a full retrospective approach for all periods presented or a modified retrospective approach, with a cumulative-effect adjustment recorded through retained earnings as of the beginning of the period of adoption.
- All amendments for which there is no specific application guidance should be applied on a prospective basis.

Upon transition, entities are required to disclose (1) the nature of and reason for the change in accounting principle, (2) the transition method selected for each topic applicable to the entity, and (3) a description of the impact of the adoption on the specific financial statement line items affected by the change in accounting principle. In paragraph BC57 of the ASU, the Board states that it would not be cost-beneficial “to require quantitative disclosures that would effectively require an entity to maintain two sets of accounting records solely to meet disclosure requirements that would not be required when preparing the entity’s basic financial statements.” Accordingly, no such quantitative disclosure requirement exists.

B.4.2 Effective Date

The amendments in ASU 2019-12 are effective for PBEs for fiscal years beginning after December 15, 2020, including interim periods therein. Early adoption of the standard is permitted, including adoption in interim or annual periods for which financial statements have not yet been issued.

For all other entities, the guidance is effective for fiscal years beginning after December 15, 2021, and for interim periods beginning after December 15, 2022. Early adoption for these entities is also permitted, including adoption in interim or annual periods for which financial statements have not yet been made available for issuance.

If an entity early adopts these amendments in an interim period, it should reflect any adjustments as of the beginning of the annual period that includes that interim period. In addition, an entity that elects to early adopt the standard is required to adopt all of the amendments in the same period (i.e., an entity cannot select which amendments to early adopt).
Appendix C — FASB Proposes Changes to Income Tax Disclosure Requirements

C.1 Background
In March 2019, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. The proposed guidance, which is part of the Board’s disclosure framework project, is intended to increase the relevance of income tax disclosures for financial statement users. Comments on the proposal were due by May 31, 2019.

The proposed ASU is a revised version of the FASB’s July 2016 exposure draft (the “initial ED”) on changes to the income tax disclosure requirements. The Board discussed stakeholder feedback on the initial ED in January 2017 and again in November 2018, when it also assessed whether updates would be needed as a result of the Tax Cuts and Jobs Act (the “Act”). For more information about the initial ED, see Deloitte’s July 29, 2016, Heads Up.

This appendix compares the requirements in the initial ED with those in the proposed ASU. The proposed ASU’s questions for respondents are reproduced in Section C.5 for reference, and certain of its sample disclosures related to operating loss and tax credit carryforwards are reproduced in Section C.6.

C.2 Key Changes Outlined in the Proposed ASU

C.2.1 Disaggregation
The initial ED would have required all entities to disclose the following disaggregated amounts:

- The amount of pretax income (or loss) “from continuing operations . . . disaggregated between domestic and foreign.”
- The amount of “income tax expense (or benefit) from continuing operations disaggregated between domestic and foreign.”
- The amount of income taxes paid, disaggregated by foreign and domestic amounts. A further disaggregation would be required for “any country that is significant to total income taxes paid.”

The proposed ASU retains the disaggregated presentation of the amount of income (or loss) from continuing operations, the amount of income tax expense (or benefit) from continuing operations, and the amount of income taxes paid, disaggregated by foreign and domestic amounts, but it removes the by-significant-country disaggregation requirement related to income taxes paid.

On the basis of stakeholder feedback regarding concerns about (1) potential diversity with respect to the classification of U.S. federal income tax on foreign earnings (e.g., U.S. tax on GILTI) and (2) current

---

1 Represents an existing disclosure requirement for PBEs under SEC Regulation S-X, Rule 4-08(h).
2 See footnote 1.
diversity in practice related to reporting income or loss from continuing operations disaggregated between foreign and domestic amounts, the proposed ASU also contains clarifications related to the following:

- **Jurisdiction of domicile income tax on foreign earnings** — Such income tax should be classified as income tax for the jurisdiction of domicile (e.g., U.S. federal tax on GILTI resulting from foreign earnings is classified as domestic for a U.S. domiciled company).

- **Preconsolidation basis** — The amount of pretax income (or loss) from continuing operations indicated in the disaggregation should be presented “before intra-entity eliminations.” When deliberating the proposed guidance, some Board members expressed concern that diversity in practice could result because “before intra-entity eliminations” is not defined in U.S. GAAP. Accordingly, the FASB included Question 4 in the proposed ASU’s questions for respondents to determine whether clarification is needed.

**Connecting the Dots**

In practice, some entities disaggregate elimination entries made in arriving at consolidated pretax income (loss) and push them back to the respective components, while others disregard such elimination entries and report the components before elimination entries. For more information, see Chapter 8.

### C.2.2 Indefinitely Reinvested Foreign Earnings

The Act introduced the concept of the “transition tax,” which requires U.S. shareholders to pay a tax on certain post-1986 undistributed and previously untaxed foreign E&P. The transition tax has significantly reduced the amount of untaxed foreign earnings held by entities with foreign operations because taxes have been (or will be) paid on most, if not all, post-1986 earnings. As a result, the proposed ASU removes the initial ED’s proposed requirement in ASC 740-30-50-3 that any change to an indefinite reinvestment assertion made during the year must be disclosed, including the circumstances that caused such a change and the amount of earnings to which the change in assertion was related.

Similarly, the proposed ASU would remove the existing requirement in ASC 740-30-50-2(b) to disclose the “cumulative amount of each type of temporary difference” when a “deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures.”

**Connecting the Dots**

Note that the proposed ASU would not eliminate the existing requirements in ASC 740-30-50-2(c) to (1) disclose the amount of unrecognized DTL related to investments in foreign subsidiaries and corporate joint ventures that are essentially permanent in duration or (2) provide a statement that determination of such DTL is not practicable.

Likewise, the proposed ASU removes the initial ED’s proposed requirement that entities disclose the aggregate of cash, cash equivalents, and marketable securities held by their foreign subsidiaries to help financial statement users predict the likelihood of future repatriations and the associated tax consequences related to foreign indefinitely reinvested earnings.
C.2.3 UTBs

The proposed ASU removes the initial ED's proposed requirement that entities disclose, in the tabular reconciliation of the total amount of UTBs required by proposed ASC 740-10-50-15A(a), settlements disaggregated by those that have been (or will be) settled in cash and those that have been (or will be) settled by using existing DTAs (e.g., settlement by using existing NOL or tax credit carryforwards). But the proposed ASU retains the initial ED's proposed requirement that PBEs provide a breakdown (i.e., a mapping) of the amount of total UTBs shown in the reconciliation of the total amounts of UTBs by the respective balance-sheet lines on which such UTBs are recorded. However, the proposed ASU removes the initial ED's proposed requirement to disclose a UTB that is not included in a balance-sheet line separately since it was unclear to which UTB the requirement would now be relevant.

The proposed ASU also retains the proposal to remove the existing requirement in ASC 740-10-50-15(d) to disclose the details of tax positions for which it is reasonably possible that the total amount of UTBs will significantly increase or decrease in the next 12 months.

C.2.4 Valuation Allowances

The proposed ASU retains the initial ED's proposed requirement that PBEs explain any valuation allowance recognized or released during the year, along with the corresponding amount.

C.2.5 Rate Reconciliation

The proposed ASU affirms the initial ED's proposed amendment to the requirement in ASC 740-10-50-12 that a PBE disclose the income tax rate reconciliation in a manner consistent with SEC Regulation S-X, Rule 4-08(h). If amended, ASC 740-10-50-12 would continue to require a PBE to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the statutory federal or national income tax rate. However, the amendment would modify the requirement to disaggregate and separately present components in the rate reconciliation that are greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with the requirement in SEC Regulation S-X, Rule 4-08(h).

During deliberations of the proposed ASU, some Board members questioned whether 5 percent was an appropriate threshold given the decrease to the U.S. statutory rate as a result of the Act. Thus, the FASB included Question 6 in the proposed ASU’s questions for respondents.

C.2.6 Operating Loss and Tax Credit Carryforwards

Currently, entities are required to disclose, for tax purposes, the amount and expiration dates of operating losses and tax credit carryforwards. Historically, there has been diversity in practice related to this disclosure requirement, which the initial ED sought to reduce by requiring a PBE to disclose the total amount of:

- “[F]ederal, state, and foreign [gross NOL and tax credit] carryforwards (not tax effected) by time period of expiration for each of the first five years after the reporting date and a total for any remaining years."
- “[D]eferred tax assets for federal, state, and foreign [NOL and tax credit] carryforwards (tax effected) before the valuation allowance.”
However, the proposed ASU removed the proposed requirement in the initial ED to report not-tax-effected amounts because the Board determined that disclosing such amounts of federal or national, state, and foreign gross NOL and tax credit carryforwards does not provide decision-useful information. The Board also concluded that disclosure of the tax-effected amounts of federal or national, state, and foreign NOL and tax credit carryforwards is useful, so it retained the initial ED's proposed requirement for such disclosure, with a modification to also disclose the valuation allowance associated with such amounts.

While the FASB voted to require PBEs to provide the tax-effected amounts of federal or national, state, and foreign DTAs related to NOL and tax credit carryforwards, on the basis of feedback received from nonpublic entities, the Board retained the initial ED's proposed requirement in ASC 740-10-50-8A that nonpublic entities disclose the total amounts of federal or national, state, and foreign tax credits and other federal or national, state, and foreign carryforwards (on a not-tax-effected basis) separately for (1) those carryforwards that expire and (2) those that do not, along with their expiration dates (or range of expiration dates).

Section C.6 contains illustrations of the above disclosure requirements from the proposed ASU.

C.2.7 Interim Disclosure Requirements
The initial ED did not propose changes to interim disclosure requirements. However, the proposed ASU would amend ASC 230-10-50-2 to add an interim requirement to disclose income taxes paid for all interim periods presented.

C.3 Other Changes
C.3.1 Change in Tax Law
The initial ED would have required an entity to disclose an enacted tax law change if it was probable that such a change would affect the entity in the future. Stakeholders expressed concerns that this language was potentially too broad, and the Board discussed the possibility of modifying the requirement to provide such disclosure if that change would have a "significant effect [on the entity] in a future period." However, the Board ultimately determined that the disclosure requirement was unnecessary and removed it (ASC 740-10-50-22 in the initial ED) from the proposed ASU.

C.3.2 Government Assistance
The initial ED would have required an entity to disclose certain information related to assistance received from a governmental unit that reduces the entity's income taxes. However, this proposed disclosure was removed from the proposed ASU.

C.4 Transition and Effective Date
The proposed ASU would require the guidance to be applied prospectively, and the Board will determine an effective date and whether to permit early adoption after it considers feedback from stakeholders.

3 Quoted text is from the handout for the November 14, 2018, FASB meeting.
C.5 Questions for Respondents

The proposed ASU’s questions for respondents are reproduced below.

**Question 1:** Would the amendments in this proposed Update that add or modify disclosure requirements result in more effective, decision-useful information about income taxes? Please explain why or why not. Would the proposed amendments result in the elimination of decision-useful information about income taxes? If yes, please explain why.

**Question 2:** Are the proposed disclosure requirements operable and auditable? If not, which aspects pose operability or auditability issues and why?

**Question 3:** Would any of the proposed disclosures impose significant incremental costs? If so, please describe the nature and extent of the additional costs.

**Question 4:** One of the proposed amendments would require entities to disclose pretax income (or loss) from continuing operations before intra-entity eliminations disaggregated between domestic and foreign, which initial feedback indicated would reduce diversity in practice. Would this proposed amendment be operable? Should the Board specify whether the disclosed amounts should be before or after intra-entity eliminations? Why or why not?

**Question 5:** Would a proposed amendment to require disaggregation of income tax expense (or benefit) from continuing operations by major tax jurisdiction be operable? Would such a proposed amendment result in decision-useful information about income taxes? Why or why not?

**Question 6:** The proposed amendments would modify the existing rate reconciliation requirement for public business entities to be consistent with SEC Regulation S-X 210.4-08(h). That regulation requires separate disclosure for any reconciling item that amounts to more than 5 percent of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate. Should the Board consider a threshold that is different than 5 percent? If so, please recommend a different threshold and give the basis for your recommendation.

**Question 7:** Are there any other disclosures that should be required by Topic 740 on the basis of the concepts in Chapter 8 of Concepts Statement 8, as a result of the Tax Cuts and Jobs Act, or for other reasons? Please explain why.

**Question 8:** Are there any disclosure requirements that should be removed on the basis of the concepts in Chapter 8, as a result of the Tax Cuts and Jobs Act, or for other reasons? Please explain why.

**Question 9:** The proposed amendments would replace the term *public entity* in Topic 740 with the term *public business entity* as defined in the Master Glossary of the Codification. Do you agree with the change in scope? If not, please describe why.

**Question 10:** Should the proposed disclosures be required only for the reporting year in which the requirements are effective and thereafter or should prior periods be restated in the year in which the requirements are effective? Please explain why.

**Question 11:** How much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Should early adoption be permitted? Please explain why.
C.6 Illustrative Examples of Disclosures Related to Operating Loss and Tax Credit Carryforwards

The illustrative examples below are reproduced from the proposed ASU.

<table>
<thead>
<tr>
<th>Expires During Fiscal Year</th>
<th>Deferred Tax Asset for Carryforwards Before Valuation Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Federal</td>
</tr>
<tr>
<td>20X2</td>
<td>$ 415</td>
</tr>
<tr>
<td>20X3</td>
<td>380</td>
</tr>
<tr>
<td>20X4</td>
<td>300</td>
</tr>
<tr>
<td>20X5</td>
<td>320</td>
</tr>
<tr>
<td>20X6</td>
<td>210</td>
</tr>
<tr>
<td>Thereafter</td>
<td>560</td>
</tr>
<tr>
<td>Indefinite carryforwards</td>
<td>370</td>
</tr>
<tr>
<td>Totals</td>
<td>4,800</td>
</tr>
</tbody>
</table>

Unrecognized tax benefits at December 31, 20X1: $ (2,000)

Total tax effect of carryforwards after unrecognized tax benefits: $ 2,800

Valuation allowance: —

Total tax effect of carryforwards after valuation allowance: $ 2,800

Realization of the deferred tax asset is dependent on generating sufficient taxable income to utilize the 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.

55-220A If Entity A is an entity other than a public business entity, illustrative disclosure for the entity follows.

The entity has $6.6 million, $6.0 million, and $5.4 million in federal, state, and foreign loss carryforwards (not tax effected), respectively, of which $1.8 million and $1.6 million in federal and state loss carryforwards, respectively, do not expire. The remaining loss carryforwards expire at various points between 20X2 and 20X9. The entity also has deferred tax assets of $1.2 million, $0.4 million, and $0.5 million for federal, state, and foreign credit carryforwards, respectively, which expire at various points between 20X2 and 20X7.

Realization of the deferred tax asset is dependent on generating sufficient taxable income to utilize the carryforwards. Although realization is not assured, management believes that 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.
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, ASC 740-20-20, ASC 740-30-20, ASC 740-270-20, ASC 718-740-20, ASC 805-740-20, ASC 830-740-20, ASC 323-740-20, and the ASC master glossary.

### ASC 740 Topics and Subtopics — Glossary

**Acquiree**
The business or businesses that the acquirer obtains control of in a business combination. 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.

**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.

**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. 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.

**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.

**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.

**Note:** The following definition is Pending Content; see Transition Guidance in 718-10-65-11.

The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single grantee or to a group of grantees. 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.
### ASC 740 Topics and Subtopics — Glossary (continued)

#### 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. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

**Note:** The following definition is Pending Content; see Transition Guidance in paragraph 805-10-65-4. Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.

#### Business Combination
A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity.

#### Carrybacks
Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.

#### 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.

#### Commencement Date of the Lease (Commencement Date)
**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1. The date on which a lessor makes an underlying asset available for use by a lessee. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

#### 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.

#### 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. 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. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

#### 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.
<table>
<thead>
<tr>
<th><strong>ASC 740 Topics and Subtopics — Glossary (continued)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract</strong></td>
</tr>
<tr>
<td><em>Note:</em> The following definition is Pending Content; see Transition Guidance in 606-10-65-1.</td>
</tr>
<tr>
<td>An agreement between two or more parties that creates enforceable rights and obligations.</td>
</tr>
<tr>
<td><strong>Contract Asset</strong></td>
</tr>
<tr>
<td><em>Note:</em> The following definition is Pending Content; see Transition Guidance in 606-10-65-1.</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td><strong>Corporate Joint Venture</strong></td>
</tr>
<tr>
<td>A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.</td>
</tr>
<tr>
<td><strong>Current Tax Expense (or Benefit)</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Customer</strong></td>
</tr>
<tr>
<td>A user or reseller.</td>
</tr>
<tr>
<td><em>Note:</em> The following definition is Pending Content; see Transition Guidance in 606-10-65-1.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Deductible Temporary Difference</strong></td>
</tr>
<tr>
<td>Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference.</td>
</tr>
<tr>
<td><strong>Deferred Tax Asset</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Deferred Tax Consequences</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Deferred Tax Expense (or Benefit)</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Deferred Tax Liability</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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.

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.

Event

A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity.

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.

Fair Value

**Definition 1**

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.
Definition 2
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.

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.

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.

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.)

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.

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. 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.

Income Taxes
Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.

Income Taxes Currently Payable (Refundable)
See Current Tax Expense (or Benefit).

Income Tax Expense (or Benefit)
The sum of current tax expense (or benefit) and deferred tax expense (or benefit).

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).

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.)
<table>
<thead>
<tr>
<th><strong>ASC 740 Topics and Subtopics — Glossary (continued)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory</strong></td>
</tr>
<tr>
<td>The aggregate of those items of tangible personal property that have any of the following characteristics:</td>
</tr>
<tr>
<td>a. Held for sale in the ordinary course of business</td>
</tr>
<tr>
<td>b. In process of production for such sale</td>
</tr>
<tr>
<td>c. To be currently consumed in the production of goods or services to be available for sale.</td>
</tr>
<tr>
<td>The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.</td>
</tr>
</tbody>
</table>

| **Investor**                                         |
| A business entity that holds an investment in voting stock of another entity. |

| **Lease**                                            |
| An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. |

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

| **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. |

| **Lessee**                                           |
| An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration. |

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

| **Lessor**                                           |
| An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration. |

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

| **Leveraged Lease**                                  |
| From the perspective of a lessor, a lease that meets all of the conditions in paragraph 840-10-25-43(c). |

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date.

| **Local Currency**                                   |
| The currency of a particular country being referred to. |
Market Participants
Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
   a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
   b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
   c. They are able to enter into a transaction for the asset or liability
   d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

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.

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.

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.

Nonpublic Entity
An entity that does not meet any of the following criteria:
   a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).
   b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
   c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

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.

Operating Segment
A component of a public entity. See Section 280-10-50 for additional guidance on the definition of an operating segment.
### ASC 740 Topics and Subtopics — Glossary (continued)

#### 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).

#### 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. 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.)

#### Probable
The future event or events are likely to occur.

#### Public Business Entity
A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

#### 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.
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.

Reporting Currency
The currency in which a reporting entity prepares its financial statements.

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).

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.

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.

Security
A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.
ASC 740 Topics and Subtopics — Glossary (continued)

Share-Based Payment Arrangements
An arrangement under which either of the following conditions is met:

a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.

b. The entity incurs liabilities to suppliers that meet either of the following conditions:
   1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.)
   2. The awards require or may require settlement by issuance of the entity's shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity.

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. 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.

Note: The following definition is Pending Content; see Transition Guidance in 718-10-65-11.

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.

Significant Influence
Paragraphs 323-10-15-6 through 15-11 define significant influence.

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.)

Taxable Income
The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.

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.
**Tax Consequences**
The effects on income taxes — current or deferred — of an event.

**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.

**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.

**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 decision not to file a tax return
- An allocation or a shift of income between jurisdictions
- The characterization of income or a decision to exclude reporting taxable income in a tax return
- A decision to classify a transaction, entity, or other position in a tax return as tax exempt
- An entity’s status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.

**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:

- Result from events that have been recognized in the financial statements
- 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.

**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:

- Result from events that have been recognized in the financial statements
- 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.
### 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).

### 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:
- The actual functional currency cash flows realized upon settlement of foreign currency transactions
- The expected functional currency cash flows on unsettled foreign currency transactions.

### Translation Adjustments
Translation adjustments result from the process of translating financial statements from the entity's functional currency into the reporting currency.

### Underlying Asset
**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.
An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset.

### 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.

### 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).

### 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.

### Variable Interest Entity
A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.
Appendix E — Sample Disclosures of Income Taxes

E.1 Background
This appendix is adapted and updated from Deloitte's February 2015 Sample Disclosures: Accounting for Income Taxes.

The sample disclosures in this document reflect accounting and disclosure requirements outlined in SEC Regulation S-K, SEC Regulation S-X, and ASC 740 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.

In March 2019, the FASB issued a proposed ASU that would modify or eliminate certain requirements related to income tax disclosures as well as establish new disclosure requirements. Comments on the proposed ASU were due by May 31, 2019. The FASB is reviewing the comments and is redeliberating. Because this ASU has not been finalized, we have included details related to the changes it will mandate in Chapter 14 and Appendix C but have not updated the disclosure samples below.

E.2 Use of These Sample Disclosures
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.

E.3 Recent ASUs Not Reflected in This Guidance
In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes. No new income tax disclosure requirements were added by ASU 2016-09. However, existing disclosures, such as those recommended in Section E.9.4.8, may be affected by the amendments made by ASU 2016-09.

In October 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 ETR 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.

E.4  MD&A — General

Before the enactment of tax law proposals or changes to existing tax rules, SEC registrants should consider whether the potential changes represent an uncertainty that management reasonably expects could have a material effect on the results of operations, financial position, liquidity, or capital resources. If so, registrants should consider disclosing information about the scope and nature of any potential material effects of the changes.

After the enactment of a new tax law, registrants should consider disclosing, when material, the anticipated current and future impact of the law on their results of operations, financial position, liquidity, and capital resources. In addition, registrants should consider disclosures in the critical accounting estimates section of 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 ETR is not sustainable and may change materially; (3) the valuation allowance on net DTAs 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.

E.5  MD&A — Results of Operations

Sample Disclosure

Results of Operations

Our ETR 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 ETR:

20X3

1. A $XXX (XX percent) reduction resulting from changes in UTBs for tax positions taken in prior periods, related primarily to favorable developments in an IRS position. Note that a detailed explanation of the change and the amount previously recorded as a UTB would be expected.

2. A $XXX (XX percent) increase resulting from multiple unfavorable foreign audit assessments. Note that a detailed explanation of the change and the amount previously recorded as a UTB 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 that 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.
Sample Disclosure (continued)

**20X2**
The notes accompanying the 20X3 items above also apply to the 20X2 items listed below.
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.

**20X1**
The notes accompanying the 20X3 items above also apply to the 20X1 items listed below.
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.

For more information, see SEC Regulation S-K, Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

SEC 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 2016-16**

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.

**Connecting the Dots**

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 consider 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 DTAs. These DTAs include approximately $XX million related to NOL 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 DTAs as of both December 31, 20X2, and December 31, 20X1. We intend to continue maintaining a full valuation allowance on our DTAs 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 DTAs 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.

Connecting the Dots

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 DTAs and DTLs and our ETR 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 AETR for 20X4 by approximately X percentage points as compared to 20X3.
E.6 MD&A — Critical Accounting Estimates

Sample Disclosure

Our income tax expense, DTAs and DTLs, and liabilities for UTBs 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 DTAs in the jurisdiction from which they arise, we consider all available positive and negative evidence, including scheduled reversals of DTLs, 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 NOL carryforwards of $XXX and $XXX, which will expire on various dates from 20X4 through 20Y8 as follows:

<table>
<thead>
<tr>
<th>Year Range</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X4–20X8</td>
<td>$ XXX</td>
</tr>
<tr>
<td>20X9–20Y3</td>
<td>XXX</td>
</tr>
<tr>
<td>20Y4–20Y8</td>
<td>XXX</td>
</tr>
<tr>
<td></td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

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 DTAs 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 DTAs 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 UTBs as liabilities in accordance with ASC 740 and (2) adjust these liabilities when our judgment changes as a result of the evaluation of new information not previously available. Because of the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the UTB 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 UTBs 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 UTBs, each of which is individually insignificant, may be recognized by the end of 20X4 as a result of a lapse of the statute of limitations.

1 At the 2013 AICPA Conference on Current SEC and PCAOB Developments (the “AICPA Conference”), in remarks related to disclosures about valuation allowances on DTAs, 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 NOLs and FTCs). 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 DTA, 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 DTA. For additional information, see Deloitte’s December 16, 2013, Heads Up on the AICPA Conference.
Sample Disclosure (continued)

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 DTL 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.

For more information, see 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.

E.7 MD&A — Liquidity and Capital Resources

Sample Disclosure

As of December 31, 2018, the company has accumulated undistributed earnings of approximately $XXX million generated by foreign subsidiaries. Because $XXX million of such earnings have previously been subject to the one-time transition tax on foreign earnings required by the Tax Cuts and Jobs Act (the “Act”), any additional taxes due with respect to such earnings or the excess of the amount for financial reporting over the tax basis of our foreign investments would generally be limited to foreign and state taxes. We intend, however, to indefinitely reinvest these earnings and expect future U.S. cash generation to be sufficient to meet future U.S. cash needs.

For more information, see SEC Regulation S-K, Item 303, “Management’s Discussion and Analysis of Financial Conditions and Results of Operations.”

Connecting the Dots

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. A registrant may disclose this information in the Cash and Investments section of its MD&A.

---

2 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 DTL 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.
E.8 MD&A — Contractual Obligations

Sample Disclosure

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.

<table>
<thead>
<tr>
<th>Contractual Obligations (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Long-term debt obligations</td>
</tr>
<tr>
<td>Interest payments on long-term debt</td>
</tr>
<tr>
<td>Operating lease obligations</td>
</tr>
<tr>
<td>Capital lease obligations</td>
</tr>
<tr>
<td>UTBs, including interest and penalties</td>
</tr>
<tr>
<td>Other liabilities reflected on consolidated balance sheet</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

In the table above, the UTBs, including interest and penalties, are related to temporary differences. The years for which the temporary differences related to the UTBs will reverse have been estimated in the schedule of obligations above. In addition, approximately $XX of UTBs 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 UTBs not included in the table above.

Sample Disclosure

The following table presents certain payments due under contractual obligations with minimum firm commitments as of December 31, 20X3:

<table>
<thead>
<tr>
<th>Payments Due In (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Operating lease obligations</td>
</tr>
<tr>
<td>Purchase obligations</td>
</tr>
<tr>
<td>Other obligations</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>
Sample Disclosure (continued)

Our other noncurrent liabilities in the consolidated balance sheet include UTBs and related interest and penalties. As of December 31, 20X3, we had gross UTBs 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.

For more information, see SEC Regulation S-K, Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Connecting the Dots
Entities may disclose in either a footnote to the table or an “other” column added to the table a liability for UTBs for which reasonable estimates about the timing of payment cannot be made.

E.9 Notes to Consolidated Financial Statements

E.9.1 Note A — Summary of Significant Accounting Policies

E.9.1.1 Income Taxes

Sample Disclosure

We account for income taxes under the asset and liability method, which requires the recognition of DTAs and DTLs for the expected future tax consequences of events that have been included in the financial statements. Under this method, we determine DTAs and DTLs 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 DTAs and DTLs is recognized in income in the period that includes the enactment date.

We recognize DTAs 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 DTAs in the future in excess of their net recorded amount, we would make an adjustment to the DTA 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.

E.9.1.2 Classification of Interest and Penalties

Sample Disclosure

We recognize interest and penalties related to UTBs 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

We recognize interest and penalties related to UTBs 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.

For more information, see ASC 740-10-50-19.

### E.9.1.3 ITC Recognition Policy

Sample Disclosure

We earn ITCs from the state of X's economic development program. We use the deferral method of accounting for ITCs.

Sample Disclosure

We use the flow-through method to account for ITCs earned on eligible scientific R&D expenditures. Under this method, the ITCs are recognized as a reduction to income tax expense in the year they are earned.

For more information, see ASC 740-10-50-20.

### E.9.2 Note B — Statement of Cash Flows

Sample Disclosure

Supplemental cash flows and noncash investing and financing activities are as follows:

<table>
<thead>
<tr>
<th>Noncash Investing and Financing Activities</th>
<th>Years Ended December 31 (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition of property and equipment on account</td>
<td>20X3: $ XXX, 20X2: $ XXX, 20X1: $ XXX</td>
</tr>
<tr>
<td>Acquisition of property and equipment through long-term financing</td>
<td>20X3: XXX, 20X2: XXX, 20X1: XXX</td>
</tr>
</tbody>
</table>

**Supplemental Cash Flow Information**

- Income taxes paid, net of refunds: 20X3: XXX, 20X2: XXX, 20X1: XXX
- Interest paid: 20X3: XXX, 20X2: XXX, 20X1: XXX

**Connecting the Dots**

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.
E.9.3 Note C — Acquisitions

Sample Disclosure

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 DTA 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 DTA 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

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.

See ASC 805-10-50-5 for more information on financial effects of adjustments related to business combinations that occurred in the current or previous reporting periods, and see ASC 805-30-50-1(d) for total amount of goodwill that is expected to be deductible for tax purposes.
### Appendix E — Sample Disclosures of Income Taxes

#### E.9.4 Note D — Income Taxes

**Sample Disclosure**

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

<table>
<thead>
<tr>
<th></th>
<th>Years Ended December 31 (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20X3</td>
</tr>
<tr>
<td>United States</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Foreign</td>
<td>$ XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$XXX</td>
</tr>
</tbody>
</table>

The expense (benefit) for income taxes consists of:

<table>
<thead>
<tr>
<th></th>
<th>Years Ended December 31 (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20X3</td>
</tr>
<tr>
<td>Current:</td>
<td></td>
</tr>
<tr>
<td>Federal</td>
<td>$ XXX</td>
</tr>
<tr>
<td>State</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Foreign</td>
<td>$ XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ XXX</td>
</tr>
<tr>
<td>Deferred and other:</td>
<td></td>
</tr>
<tr>
<td>Federal</td>
<td>$ XXX</td>
</tr>
<tr>
<td>State</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Foreign</td>
<td>$ XXX</td>
</tr>
<tr>
<td><strong>Total tax expense</strong></td>
<td>$XXX</td>
</tr>
</tbody>
</table>

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 ETR for net income attributable to domestic operations and foreign operations and stated that the lack of such disclosure may result in SEC staff comments. For additional information, see SEC Regulation S-X, Rule 4-08(h), “General Notes to Financial Statements: Income Tax Expense.”
## Sample Disclosure

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

<table>
<thead>
<tr>
<th>Years Ended December 31 (in millions)</th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Foreign</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$XXX</strong></td>
<td><strong>$XXX</strong></td>
<td><strong>$XXX</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Years Ended December 31 (in millions)</th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Federal:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Deferred</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>U.S. State:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Deferred</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Foreign:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Deferred</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

**Provision for income taxes**

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Provision for income taxes</strong></td>
<td><strong>$XXX</strong></td>
<td><strong>$XXX</strong></td>
<td><strong>$XXX</strong></td>
</tr>
</tbody>
</table>
### E.9.4.1 Components of Income Tax Expense or Benefit

#### Sample Disclosure

<table>
<thead>
<tr>
<th>Years Ended December 31 (in millions)</th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense (benefit)</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Tax expense (benefit) related to an increase (decrease) in UTBs</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Interest expense — gross of related tax effects</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Penalties — gross of related tax effects</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Tax expense recorded as an increase of paid-in capital</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total tax expense</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
</tbody>
</table>

For more information, see ASC 740-10-50-9, which 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 ETR).

#### Sample Disclosure

<table>
<thead>
<tr>
<th>Years Ended December 31 (in millions)</th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense (benefit)</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Other tax expense (benefit)</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total tax expense</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
</tbody>
</table>

If presented, the other tax expense (benefit) line above would include items affecting the expense that neither meet the definition of a deferred tax item (see ASC 740-10-30-4) nor the definition of a current tax item (see ASC 740-10-20). If material, the components of the other tax expense (benefit) should be separately described below the table. For additional information, see ASC 740-10-50-9.
## E.9.4.2 Rate Reconciliation

**Sample Disclosure**

Reconciliation between the ETR on income from continuing operations and the statutory tax rate is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Years Ended December 31 (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20X3</td>
</tr>
<tr>
<td>Income tax expense (benefit) at federal statutory rate</td>
<td>$ XXX</td>
</tr>
<tr>
<td>State and local income taxes net of federal tax benefit</td>
<td>XXX</td>
</tr>
<tr>
<td>Foreign tax rate differential*</td>
<td>XXX</td>
</tr>
<tr>
<td>Change in valuation allowance</td>
<td>XXX</td>
</tr>
<tr>
<td>Effect of flow-through entity</td>
<td>XXX</td>
</tr>
<tr>
<td>Effect of double taxation net of dividends received deduction</td>
<td>XXX</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>XXX</td>
</tr>
<tr>
<td>Nondeductible/nontaxable items</td>
<td>XXX</td>
</tr>
<tr>
<td>Share-based compensation</td>
<td>XXX</td>
</tr>
<tr>
<td>Tax audit settlements</td>
<td>XXX</td>
</tr>
<tr>
<td>Other — net</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Income tax expense (benefit)</strong></td>
<td><strong>$XXX</strong></td>
</tr>
</tbody>
</table>

* 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.

For more information, see ASC 740-10-50-12 through 50-14.

### Connecting the Dots

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 constitute 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.
### Sample Disclosure

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:

<table>
<thead>
<tr>
<th>Years Ended December 31 (in millions)</th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected income tax (benefit) expense at federal statutory rate</td>
<td>$ XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Valuation allowance for DTAs</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Fair value of preferred stock equity conversion feature</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Residual tax on foreign earnings</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Foreign rate differential*</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Bargain purchase gain</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Gain on contingent purchase price reduction</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Meals and entertainment</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Exempt foreign income</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>UTBs</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>State and local income taxes</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Dividends received deduction</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Capitalized transaction costs</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Other</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Reported income tax (benefit) expense</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
<tr>
<td><strong>ETR</strong></td>
<td>XX%</td>
<td>XX%</td>
<td>XX%</td>
</tr>
</tbody>
</table>

* See footnote 3.

---

### E.9.4.3 Unrecognized DTL Related to Investments in Foreign Subsidiaries

#### Sample Disclosure

As of December 31, 2018, the company has accumulated undistributed earnings generated by foreign subsidiaries of approximately $XXX million. Because $XXX million of such earnings have previously been subject to the one-time transition tax on foreign earnings required by the Act, any additional taxes due with respect to such earnings or the excess of the amount for financial reporting over the tax basis of our foreign investments would generally be limited to foreign and state taxes. We intend, however, to indefinitely reinvest these earnings and expect future U.S. cash generation to be sufficient to meet future U.S. cash needs.

---

4 See footnote 1.
### E.9.4.4 Components of the Net DTA or DTL

#### Sample Disclosure

<table>
<thead>
<tr>
<th>Components</th>
<th>20X3</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable allowances</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Reserves and accruals not currently deductible for tax purposes</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Share-based compensation</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>R&amp;D costs</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>NOL and tax credit carryforwards</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Restructuring and settlement reserves</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Other</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Less: valuation allowance</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Total net DTAs</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Inventory valuation and other assets</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Other</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Total DTLs</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Net DTL</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

For more information, see ASC 740-10-50-2, ASC 740-10-50-6, ASC 740-10-50-8, and ASC 740-10-50-16.

### E.9.4.5 Operating Loss and Tax Credit Carryforwards

#### Sample Disclosure

We have income tax NOL carryforwards related to our international operations of approximately $XXX. We have recorded a DTA of $XXX reflecting the benefit of $XXX in loss carryforwards. Such DTAs expire as follows:

<table>
<thead>
<tr>
<th>Year Range</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X4–20X8</td>
<td>$ XXX</td>
</tr>
<tr>
<td>20X9–20Y3</td>
<td>XXX</td>
</tr>
<tr>
<td>20Y4–20Y8</td>
<td>XXX</td>
</tr>
<tr>
<td></td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

For more information, see ASC 740-10-50-3.
E.9.4.6 Valuation Allowance\(^5\) and Risks and Uncertainties

**Sample Disclosure**

Management assesses the available positive and negative evidence to estimate whether sufficient future taxable income will be generated to permit use of the existing DTAs. 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 DTA that is more likely than not to be realized. The amount of the DTA considered realizable, however, could be adjusted if estimates of future taxable income during the carryforward period are reduced or increased or if objective negative evidence in the form of cumulative losses is no longer present and additional weight is given to subjective evidence such as our projections for growth.

For more information, see ASC 275-10-50-8.

**Sample Disclosure**

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:

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X4–20X8</td>
<td>$ XXX</td>
</tr>
<tr>
<td>20X9–20Y3</td>
<td>XXX</td>
</tr>
<tr>
<td>20Y4–20Y8</td>
<td>XXX</td>
</tr>
<tr>
<td></td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

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 DTAs related to these state NOL carryforwards. If or when recognized, the tax benefits related to any reversal of the valuation allowance on DTAs 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 UTBs. The DTAs recognized for those NOLs are presented net of these UTBs.

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.

\(^5\) 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 DTA 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.
E.9.4.7 Valuation Allowance Reversal

**Sample Disclosure**

As of December 31, 20X3, our DTAs 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 DTA 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 DTAs 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 DTAs. 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 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.

E.9.4.8 DTA Attributable to Excess Stock Option Deductions — Before the Adoption of ASU 2016-09

**Sample Disclosure**

As a result of certain realization requirements of ASC 718, the table of DTAs and DTLs does not include certain DTAs 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 DTAs are ultimately realized. We use ASC 740 ordering when determining when excess tax benefits have been realized.

---

6 At the 2012 AICPA Conference, Mark Shannon noted that registrants who have returned to profitability may be considering whether they should reverse a previously recognized valuation allowance. He indicated that factors to consider in making this determination include (1) the magnitude and duration of past losses and (2) the magnitude and duration of current profitability as well as changes in the factors that drove losses in the past and those currently driving profitability. Nili Shah further noted that registrants should assess the sustainability of current profits as well as their track record of accurately forecasting future financial results. She pointed out that registrants’ disclosures should include a discussion of the factors or reasons that led to a reversal of a valuation allowance that effectively answers the question “why now.” Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the entity weighed each piece of evidence in its assessment. She also reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.
**Sample Disclosure**

As a result of certain realization requirements of ASC 718, the table of DTAs and DTLs does not include certain DTAs 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 DTAs are ultimately realized. We use tax law ordering when determining when excess tax benefits have been realized.

**Connecting the Dots**

As of the date of adoption of FASB Statement 123(R) (codified in ASC 718), an entity that previously recognized a DTA for excess tax benefits before its realization was required to discontinue that practice prospectively. As a result, some entities may continue to have DTAs 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 DTA was first recorded, even if the facts and circumstances indicate that it is more likely than not that the DTA 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 the inclusion in operating cash flows of the income taxes that the entity would have paid had it not been for the excess tax benefit.

**E.9.4.9 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.

For more information, see SAB Topic 11.C.
E.9.4.10  UTBs

E.9.4.10.1  Tabular Reconciliation of UTBs

**Sample Disclosure**

Below is a tabular reconciliation of the total amounts of UTBs; this tabular reconciliation disclosure is not required for nonpublic entities.

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2 (in millions)</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UTBs — January 1</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
<tr>
<td>Gross increases — tax positions in prior period</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Gross decreases — tax positions in prior period</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Gross increases — tax positions in current period</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Settlement</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Lapse of statute of limitations</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>UTBs — December 31</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
</tbody>
</table>

**Sample Disclosure**

The table below 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.

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2 (in millions)</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UTBs — January 1</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
<tr>
<td>Current year — increase</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Prior year — increase</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Claims</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Prior year — decrease</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Accrual to return changes</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Settlements</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Statute expiration</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Current year acquisitions</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Divestitures</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Currency</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>UTBs — December 31</strong></td>
<td>$XXX</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
</tbody>
</table>
E.9.4.10.2  UTBs That, if Recognized, Would Affect the ETR

**Sample Disclosure**

Included in the balance of UTBs 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 ETR. Also included in the balance of UTBs 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.

For more information, see ASC 740-10-50-15A(b).

E.9.4.10.3  Total Amounts of Interest and Penalties Recognized in the Statement of Operations and Total Amounts of Interest and Penalties Recognized in the Statements of Financial Position

**Sample Disclosure**

We recognize interest accrued related to UTBs and penalties as income tax expense. We accrued penalties of $XX and interest of $XX during 20X3 and in total, as of December 31, 20X3, recognized a liability related to the UTBs noted above 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, recognized a liability for penalties of $XX and interest of $XX. During 20X1, we accrued penalties of $XX and interest of $XX.

For more information, see ASC 740-10-50-15(c).

E.9.4.10.4  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

**Sample Disclosure**

We believe that it is reasonably possible that a decrease of up to $XX in UTBs 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 UTBs, each of which is 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 UTBs related to state tax exposures would have occurred during the year ended December 31, 20X3. During the year ended December 31, 20X3, UTBs related to those state exposures actually decreased by $XX as illustrated in the table above.

For more information, see ASC 740-10-50-15(d).

E.9.4.10.5  Description of Tax Years That Remain Subject to Examination by Major Tax Jurisdictions

**Sample Disclosure**

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.

For more information, see ASC 740-10-50-15(e).
**E.9.4.11 Subsequent-Events Disclosure**

<table>
<thead>
<tr>
<th>Sample Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>In January 20X4, we received notice of a tax incentive award of $XX that will allow us to monetize approximately $XX of state R&amp;D tax credits. In exchange for this award, we pledged to hire more employees and maintain the additional head count through at least December 31, 20X8. Failure to do so could result in our being required to repay some or all of these incentives.</td>
</tr>
</tbody>
</table>

For more information, see ASC 855-10-50-2.

**Connecting the Dots**

Disclosure of a nonrecognized subsequent event is required only when the financial statements would be considered misleading without such disclosure.

**E.10 Schedule II — Valuation and Qualifying Accounts**

The schedule and accompanying footnote below are reproduced from SEC Regulation S-X, Rule 12-09.

<table>
<thead>
<tr>
<th>SEC Regulation S-X, Rule 12-09, “Valuation and Qualifying Accounts”</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Column A — Description</strong> 1</td>
</tr>
<tr>
<td><strong>Column B — Balance at Beginning of Period</strong></td>
</tr>
<tr>
<td><strong>Column C — Additions</strong></td>
</tr>
<tr>
<td><strong>Column D — Deductions — Describe</strong></td>
</tr>
<tr>
<td><strong>Column E — Balance at End of Period</strong></td>
</tr>
<tr>
<td>Column A — Description 1</td>
</tr>
<tr>
<td>Column B — Balance at Beginning of Period</td>
</tr>
<tr>
<td>(1) — Charged to Costs and Expenses</td>
</tr>
</tbody>
</table>

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 [that] support the balance sheet caption, Reserves. Valuation and qualifying accounts and reserves as to which [of] 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.

**Connecting the Dots**

A liability for UTBs is not a valuation or qualifying account, whereas a valuation allowance on a DTA is a valuation account.
E.11 Interim Disclosures

Sample Disclosure

Our 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 YTD 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

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 YTD ordinary loss exceeded the full-year expected ordinary loss. The tax benefit for that YTD ordinary loss was limited to the amount that would be recognized if the YTD ordinary loss were the anticipated ordinary loss for the full year.

Sample Disclosure

We have historically calculated the provision for income taxes during interim reporting periods by applying an estimate of the AETR 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 ETR 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 AETR, the historical method would not provide a reliable estimate for the fiscal three- and six-month periods ended June 30, 20X2.

For more information on variations in customary income tax expense relationships, see ASC 740-270-50-1.

E.12 Separate Company Financial Statements

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 is 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.

For more information on entities with separately issued financial statements that are members of a consolidated tax return, see ASC 740-10-50-17(b).
Appendix F — Differences Between U.S. GAAP and IFRS Standards

F.1 Background

Under U.S. GAAP, ASC 740 is the primary source of guidance on accounting for income taxes.

Under IFRS Standards,¹ IAS 12 is the primary source of guidance on accounting for income taxes.

In general, the income tax accounting frameworks under both U.S. GAAP and IFRS Standards contain the same basic principle concerning the basis of DTAs and DTLs: the recognition of temporary differences between the carrying amount of assets and liabilities in the financial statements and their basis for income tax reporting purposes.

The table below summarizes the key differences between U.S. GAAP and IFRS Standards in the accounting for income taxes and is followed by a detailed explanation of each difference.²

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognition of DTAs</td>
<td>DTAs are recognized in full and then reduced by a valuation allowance if it is more likely than not that some or all of the DTAs will not be recognized.</td>
<td>There is no valuation allowance for DTAs, which are recognized only if it is probable (more likely than not) that they will be used.</td>
</tr>
<tr>
<td>Tax rate for measuring DTAs and DTLs</td>
<td>Enacted tax rates are used.</td>
<td>Enacted or “substantively” enacted tax rates are used.</td>
</tr>
</tbody>
</table>

¹ The IASB issued the IFRS for SMEs® Standard (the “SMEs Standard”) in July 2009. The SMEs Standard is a stand-alone standard and does not require preparers of private entity financial statements to cross-refer to full IFRS Standards. Section 29 of the SMEs Standard is the primary source of guidance on accounting for income taxes for entities applying the SMEs Standard. This appendix does not address the differences between Section 29 and IAS 12 and, therefore, the differences in the accounting for income taxes that might exist between U.S. GAAP and the SMEs Standard.

² Differences are based on comparison of authoritative literature under U.S. GAAP and IFRS Standards and do not necessarily include interpretations of such literature.
### Uncertain tax positions

ASC 740 prescribes a two-step recognition and measurement approach to determining the amount of tax benefit to recognize in the financial statements. The first step is recognition: The entity determines whether it is more likely than not that a tax position will be sustained upon examination. The second step is measurement: The entity measures a tax position that reaches the more-likely-than-not recognition threshold to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely to be realized upon settlement.

IFRIC Interpretation 23 was issued by the International Accounting Standards Board (IASB®) in June 2017 and is effective for annual periods beginning on or after January 1, 2019, with earlier application permitted. The standard clarified how uncertainty over income tax treatment should be recognized and measured under IAS 12.

**Before the adoption of IFRIC Interpretation 23:**
IAS 12 does not specifically address the accounting for tax uncertainties. The recognition and measurement provisions of IAS 37 are relevant because an uncertain tax position may give rise to a liability of uncertain timing and amount. Recognition is based on whether it is probable that an outflow of economic resources will occur. “Probable” is defined as “more likely than not.” Measurement is based on the entity's best estimate of the amount of the tax benefit.

**After the adoption of IFRIC Interpretation 23:**
If an entity concludes that it is probable that the taxing authority will accept an uncertain tax treatment, recognition and measurement are consistent with the positions as taken in the tax filings. If the entity concludes that it is not probable that the taxing authority will accept the tax treatment as filed, the entity is required to reflect the uncertainty by using (1) the most likely amount or (2) the expected value. “Probable” is defined as “more likely than not.”

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncertain tax positions</td>
<td>ASC 740 prescribes a two-step recognition and measurement approach to</td>
<td>IFRIC Interpretation 23 was issued by the International Accounting Standards</td>
</tr>
<tr>
<td></td>
<td>determining the amount of tax benefit to recognize in the financial</td>
<td>Standards Board (IASB®) in June 2017 and is effective for annual periods</td>
</tr>
<tr>
<td></td>
<td>statements. The first step is recognition: The entity determines whether</td>
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<td>recognized and measured under IAS 12.</td>
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<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
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</thead>
<tbody>
<tr>
<td>Uncertain tax positions</td>
<td>ASC 740 prescribes a two-step recognition and measurement approach to</td>
<td>IFRIC Interpretation 23 was issued by the International Accounting Standards</td>
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<td>determining the amount of tax benefit to recognize in the financial</td>
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</tr>
<tr>
<td>Tax consequences of intra-entity sales</td>
<td>Tax effects of intra-entity transfers of inventory are deferred until the related inventory is sold or disposed of, and no deferred taxes are recognized for the purchaser's change in tax basis.</td>
<td>No such exception for intra-entity transfers of inventory exists. Tax expense from intra-entity transfers is recognized in the seller's jurisdiction, and deferred taxes are recognized in the buyer's jurisdiction for the difference between the basis of the transferred asset for financial reporting purposes and that for income tax reporting purposes at the buyer's tax rate.</td>
</tr>
<tr>
<td>Deferred taxes on foreign nonmonetary assets/liabilities when the functional currency is not the local currency and the remeasurement is based on historical exchange rates</td>
<td>No deferred tax is recognized on basis differences resulting from changes in exchange rates and the indexing of basis for income tax reporting purposes.</td>
<td>Deferred tax is recognized on the basis differences resulting from changes in exchange rates and the indexing of basis for income tax reporting purposes.</td>
</tr>
<tr>
<td>Other exceptions to the basic principle that deferred tax is recognized for all temporary differences</td>
<td>(1) Leveraged lease (commencing before the adoption of ASU 2016-02) exemption — no deferred tax is recognized under ASC 740. See ASC 840-30 for information about the tax consequences of leveraged leases. ASC 842 does not include guidance on leveraged leases. Entities are not permitted to account for any new or subsequently amended lease arrangements as leveraged leases after the effective date of ASC 842. (2) No “initial recognition” exception under U.S. GAAP.</td>
<td>(1) No similar exception under IFRS Standards because they do not address leveraged leases. (2) &quot;Initial recognition&quot; exemption — deferred tax is not recognized for taxable or deductible temporary differences that arise from the initial recognition of an asset or liability in a transaction that (a) is not a business combination and (b) at the time of the transaction does not affect accounting profit or taxable profit. Changes in this unrecognized DTA or DTL are not subsequently recognized.</td>
</tr>
<tr>
<td>Special deductions (special deductions provide tax benefits under specific tax jurisdictions for unique industries or governmental purposes)</td>
<td>An entity should not anticipate special-deduction tax benefits by offsetting a DTL. Instead, the entity should recognize such tax benefits for financial reporting purposes no earlier than the year in which they are available to reduce taxable income on the entity's tax returns. In addition, the future tax effects of special deductions may nevertheless affect (1) the average graduated tax rate to be used in measuring DTAs and DTLs when graduated tax rates are a significant factor and (2) the need for a valuation allowance for DTAs.</td>
<td>No similar guidance in IAS 12.</td>
</tr>
<tr>
<td>Subject</td>
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<tr>
<td>Share-based compensation</td>
<td>For awards that ordinarily give rise to a tax deduction, deferred taxes are computed on the basis of compensation expense recognized for financial reporting purposes. Tax benefits in excess of or less than the related DTA are recognized in the income statement when realized for income tax reporting purposes.</td>
<td>For awards that will give rise to a tax deduction in a later accounting period, deferred taxes are computed on the basis of the hypothetical tax deduction for the share-based payment in every period under the applicable tax law (i.e., intrinsic value). Recognition of deferred taxes could be through either profit or loss or equity.</td>
</tr>
<tr>
<td>Subsequent changes in deferred taxes that were originally charged or credited to equity (backward tracing)</td>
<td>Backward tracing is generally prohibited. Subsequent changes to deferred taxes originally charged or credited to equity (e.g., because of a change in tax rate) are generally allocated to continuing operations, not to equity.</td>
<td>As with the initial treatment, IAS 12 requires that the resulting change in deferred taxes also be charged or credited back directly to equity.</td>
</tr>
<tr>
<td>Reconciliation of actual and expected tax rate</td>
<td>Required for public companies only; expected tax expense is computed by applying the domestic federal statutory rates to pretax income from continuing operations. Nonpublic companies must disclose the reconciling nature of the reconciling items but are not required to provide the amounts.</td>
<td>Required for all entities applying IFRS Standards; expected tax expense is computed by applying the applicable tax rate(s) to accounting profit, disclosing also the basis on which any applicable tax rate is computed.</td>
</tr>
<tr>
<td>Undistributed earnings on foreign subsidiaries</td>
<td>No deferred tax is recognized on undistributed earnings of foreign subsidiaries and corporate joint ventures (that are essentially permanent in duration) if such earnings can be demonstrated to be indefinitely reinvested. Note that according to paragraph 64 of ASU 2015-10, “[t]his exception to recognizing deferred taxes is not applicable for partnerships (or other pass-through entities).”</td>
<td>Deferred tax is recognized on the undistributed earnings of any form of investee (foreign or domestic, subsidiaries, branches, associates, and interests in joint arrangements) unless (1) the parent is able to control the timing of the temporary difference’s reversal and (2) it is probable that the temporary difference will not reverse in the foreseeable future. Note that there is no similar prohibition on applying the exception to partnerships.</td>
</tr>
<tr>
<td>Interim reporting and tax rate</td>
<td>The forecasted tax rate is generally computed at an entity level on the basis of the forecasted ordinary income/(loss) and associated tax expense for the entire reporting group and combined into one overall forecasted AETR. YTD tax expense is typically calculated by multiplying the group’s YTD pretax income by the group’s forecasted AETR.</td>
<td>Each jurisdiction computes its projected rate, and that rate must be applied in each jurisdiction to the actual YTD income. The interim-period tax charge is the sum of each entity’s interim tax charge. If the determination of such a sum is not practicable, a weighted average of all group rates may be used if it is a reasonable approximation of the effect of using more specific rates.</td>
</tr>
</tbody>
</table>
F.2 Recognition of DTAs
Under U.S. GAAP, ASC 740-10-30-5(e) states that DTAs are recognized in full and then reduced “by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.” The valuation allowance will “reduce the deferred tax asset to the [net] amount that is more likely than not to be realized.”

Under IFRS Standards, DTAs are recognized only to the extent that realizing them is probable (akin to the more-likely-than-not threshold under U.S. GAAP). Therefore, there is no need for a DTA valuation allowance.

F.3 Tax Rate for Measuring DTAs and DTLs
Under U.S. GAAP, DTLs (assets) are measured at the enacted tax rates only. ASC 740-10-10-3 states that “the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.”

Under IFRS Standards, DTLs (assets) should be measured at the tax rates that are expected to apply when the liability is settled or the asset is realized, on the basis of tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Paragraph 48 of IAS 12 states, in part:

Current and deferred tax assets and liabilities are usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

F.4 Uncertain Tax Positions
Under U.S. GAAP, an entity cannot recognize a tax benefit in its financial statements unless it concludes that it is “more likely than not” that the benefit will be sustained on audit by the taxing authority solely on the basis of the technical merits of the associated tax position. In making this determination, an entity must assume that the position will be (1) examined by a taxing authority that has full knowledge of all relevant information and (2) resolved in the court of last resort. If the recognition threshold is not reached, no benefit can be recognized, even when the entity believes that some amount of benefit will ultimately be realized.

If the recognition threshold is reached, the tax benefit recognized is measured at the largest amount of the tax benefit that, in the entity's judgment, is more than 50 percent likely to be realized. The analysis should be based on the amount the taxpayer would ultimately accept in a negotiated settlement with the taxing authority. To compute the amount that is more than 50 percent likely to be realized, an entity must perform a cumulative-probability assessment of the possible outcome(s). Assigning probabilities in measuring a recognized tax position requires a high degree of judgment and should be based on all relevant facts, circumstances, and information.

F.4.1 Before the Adoption of IFRIC Interpretation 23
No formal guidance existed concerning uncertain tax positions. Since IAS 12 did not specifically address accounting uncertainties, the recognition and measurement criteria of IAS 37 were considered relevant because an uncertain tax position may give rise to a liability of uncertain timing and amount. Under IAS 37, recognition is based on whether it is probable that an outflow of economic resources will occur. “Probable” is defined as “more likely than not.” Measurement is based on the entity’s best estimate of the amount of the tax benefit.
F.4.2 After the Adoption of IFRIC Interpretation 23

Entities should no longer analogize to IAS 37. Paragraphs 9 and 10 of IFRIC Interpretation 23 state:

An entity shall consider whether it is probable that a taxation authority will accept an uncertain tax treatment. If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.

The entity assesses whether it is probable that a taxing authority will accept an uncertain tax treatment. The assessment is based on the tax position as filed on the tax return and therefore must include consideration of both the technical merits of the position and the amount included on the return. While IFRIC Interpretation 23 is silent on the definition of “probable,” the word is defined in IAS 37 as “more likely than not.”

Paragraph 11 of IFRIC Interpretation 23 states:

If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty:

a. the most likely amount — the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.

b. the expected value — the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

The determination of whether to use the most likely amount method or the expected value method is not an accounting policy decision but is based on facts and circumstances.

In general, although the principles of IFRIC Interpretation 23 are similar to those in ASC 740 and IAS 37, the methods introduced by IFRIC Interpretation 23 to reflect uncertainty may create measurement differences in comparison with the cumulative probability assessment requirement under U.S. GAAP. Other differences between IFRIC Interpretation 23 and ASC 740 may include recognition of interest and penalties, classification, presentation, and disclosure related to uncertainty in income taxes.

Example F-1

Assume that an entity takes a deduction of $1,000 that is not a timing item (resulting in a $250 reduction in the income tax payable on the basis of a tax rate of 25 percent) on its tax return.

Under ASC 740, the entity concludes solely on the basis of the technical merits of the tax position that it is more likely than not that the position will be sustained if the taxpayer takes the dispute to the court of last resort. Under IAS 37, the entity concludes that loss is probable upon examination by and settlement with the taxing authority. Under IFRIC Interpretation 23, the entity concludes that it is not probable that the taxing authority will accept the tax treatment used in the tax return. This conclusion includes consideration of how the taxing authority will evaluate both the technical merits of the position and the amount shown on the return.
Example F-1 (continued)

The entity estimates the probabilities of the possible tax benefit amounts that may be sustained upon examination by the taxing authority as indicated in the table below.

<table>
<thead>
<tr>
<th>Possible Estimated Outcome (A)</th>
<th>Individual Probability of Occurring (B)</th>
<th>Cumulative Probability of Occurring (C)</th>
<th>Estimate of Expected Value (D) = (A) × (B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250</td>
<td>22%</td>
<td>22%</td>
<td>$55</td>
</tr>
<tr>
<td>200</td>
<td>30%</td>
<td>52%</td>
<td>60</td>
</tr>
<tr>
<td>150</td>
<td>20%</td>
<td>72%</td>
<td>30</td>
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<tr>
<td>100</td>
<td>20%</td>
<td>92%</td>
<td>20</td>
</tr>
<tr>
<td>0</td>
<td>8%</td>
<td>100%</td>
<td>0</td>
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</tbody>
</table>

Under ASC 740, the entity would measure the associated tax benefit at the largest amount of benefit that is more than 50 percent likely to be realized upon settlement. Therefore, the entity should recognize a tax benefit of $200 because this represents the largest benefit with a cumulative probability of more than 50 percent. Accordingly, the entity should record a $50 income tax liability.

Under IAS 37, an income tax liability is required because the entity has determined that loss is probable upon examination by and settlement with the taxing authority. IAS 37 does not provide explicit guidance on which of the many acceptable methods the entity should use in determining the best estimate of the liability to recognize. One such method is a weighted-average method (i.e., the expected value method), which would result in an income tax liability of $85 in accordance with the example above since the weighted average of all possible outcomes is a benefit of $165.

Under IFRIC Interpretation 23, the entity must recognize the effect of uncertainty because it is not probable that the full deduction taken on its tax return will be accepted by the taxing authority. To measure the required liability, the entity should select the measurement method that best predicts the resolution of uncertainty. By applying the most likely amount method, the entity would initially calculate a $50 income tax liability on the basis of a $200 benefit with a 30 percent likelihood. However, the entity would observe that there was a range of possible outcomes that were neither binary nor concentrated on one value. Consequently, the entity would conclude that the expected value method, which results in recognition of an $85 income tax liability on the basis of a $165 sustained benefit, would best predict the resolution of uncertainty in view of the facts and circumstances surrounding this tax position.

F.5 Tax Consequences of Intra-Entity Sales

Under U.S. GAAP, when accounting for the tax consequences of intra-entity sales of inventory between different tax jurisdictions, an entity should eliminate intra-entity profit on the internal transaction. The FASB has concluded that an entity's income statement should not reflect a tax consequence for intra-entity sales of inventory that are eliminated in consolidation. The current tax paid or payable from the sale of inventory is deferred upon consolidation (as a prepaid income tax) and is not recorded until the inventory is sold to an unrelated party. In addition, under U.S. GAAP, the buyer is prohibited from recognizing a temporary difference between the book carrying amount and the inventory's tax base. There is no difference between U.S. GAAP and IFRS Standards on the tax treatment of intra-entity sales of assets other than inventory.

Under IFRS Standards, there is no exception related to intra-entity transfers of inventory.
Appendix F — Differences Between U.S. GAAP and IFRS Standards

F.6 Deferred Taxes on Foreign Nonmonetary Assets/Liabilities When the Functional Currency Is Not the Local Currency and the Remeasurement Is Based on Historical Exchange Rates

Under U.S. GAAP, ASC 740 prohibits recognition of deferred tax consequences for differences that arise from changes in exchange rates or indexing for tax purposes for those foreign subsidiaries that are required to use historical rates to remeasure nonmonetary assets and liabilities from the local currency into the functional currency. Although this basis difference technically meets the definition of a temporary difference under ASC 740, the FASB has concluded that to account for it as a temporary difference is to effectively recognize deferred taxes on exchange gains and losses that are not recognized in the income statement under ASC 830.

Under IFRS Standards, deferred taxes are recognized. Paragraph 41 of IAS 12 states:

The non-monetary assets and liabilities of an entity are measured in its functional currency (see IAS 21 The Effects of Changes in Foreign Exchange Rates). If the entity’s taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognized deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58).

F.7 Other Exceptions to the Basic Principle That Deferred Tax Is Recognized for All Temporary Differences

F.7.1 Leveraged Leases — Commencing Before the Adoption of ASU 2016-02

Under U.S. GAAP, an exemption is made to the basic principles of ASC 740 when applied to leveraged leases. Under ASC 840-30, the tax consequences of leveraged leases are incorporated directly into the lease accounting measurements; therefore, no temporary differences are recognized.

ASC 842 does not include guidance on leveraged leases. Entities are not permitted to account for any new lease arrangements as leveraged leases after the effective date of ASC 842, which eliminates the difference between U.S. GAAP and IFRS Standards on leveraged leases.

IFRS Standards do not include a concept of leveraged leases.

F.7.2 Initial Recognition

Under IFRS Standards, deferred tax is not provided on temporary differences that arise from the initial recognition of an asset or liability in a transaction that (1) is not a business combination and (2) does not affect accounting profit or taxable profit. In addition, changes in this unrecognized DTA or DTL are not subsequently recognized. For example, in some tax jurisdictions, certain assets may not be deductible for tax purposes. That is, an asset’s book basis is greater than its tax basis of zero. In this situation, even though the difference between the asset’s book basis and tax basis represents an initial temporary difference, IFRS Standards do not permit the recognition of the deferred taxes on the basis of the “initial recognition” exemption. IFRS Standards state that the recognition of deferred tax in this case would simply gross up the balance sheet and make the financial statements less “transparent.”

Unlike IFRS Standards, U.S. GAAP do not contain an “initial recognition” exemption.
F.8 Special Deductions
Under U.S. GAAP, tax benefits of special deductions for financial reporting purposes are recognized no earlier than the year in which they are available to reduce taxable income on the tax return. Although anticipation of future special deductions in the measurement of deferred liabilities is not permitted, the future tax effects of special deductions may nevertheless affect (1) the average graduated tax rate used for measuring DTAs and DTLs when graduated tax rates are a significant factor and (2) the need for a valuation allowance for DTAs. In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income, and future taxable income is used to determine the average graduated tax rate and may affect the need for a valuation allowance.

There is no guidance on special deductions under IFRS Standards.

F.9 Share-Based Compensation
Under U.S. GAAP, the deferred tax recorded on share-based compensation is computed on the basis of the expense recognized in the financial statements for awards that ordinarily give rise to a tax deduction. Therefore, changes in an entity’s share price do not affect the DTA recorded on the entity’s financial statements.

All excess tax benefits (e.g., tax deduction on the award is in excess of cumulative compensation for financial reporting) and tax deficiencies (e.g., tax deduction on the award is less than cumulative compensation for financial reporting) are recognized as income tax expense or benefit in the income statement.

Under IFRS Standards, the deferred tax is computed on the basis of the expected tax deduction for the share-based payments in every period under the applicable tax law (i.e., intrinsic value). Therefore, changes in share price do affect the DTA at period-end and result in adjustments to the DTA. If the amount of the estimated future tax deduction for awards exceeds the amount of the tax effect of the related cumulative compensation expense for financial reporting purposes, a portion of the tax deduction is deemed to be related to an equity item. The excess of the associated deferred tax is therefore recognized directly in equity. If the tax deduction received is less than the compensation expense or if no tax deduction is anticipated (e.g., because the share price has declined), the DTA is reversed to profit or loss or equity, or both, as appropriate, depending on how the deferred tax benefit was originally recorded.

F.10 Subsequent Changes in Deferred Taxes That Were Originally Charged or Credited to Equity (Backward Tracing)
Under U.S. GAAP, subsequent-period changes in deferred tax items that were originally charged or credited to shareholders’ equity or comprehensive income are allocated to the income tax provision related to continuing operations and not directly charged or credited to shareholders’ equity or to OCI. For example, the effect of a change in the subsequent tax rate on recorded deferred tax would be charged or credited to the current income tax provision of continuing operations even if such a tax effect was originally recorded in shareholders’ equity. (Note that there are limited exceptions to the above in ASC 740-10-45-20 and ASC 740-20-45-11(c)–(f).)

Under IFRS Standards, however, subsequent-period changes in deferred taxes that were originally charged or credited to shareholders’ equity are also allocated to shareholders’ equity. Paragraph 61A of IAS 12 states, “Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss.” For example, a deferred tax item originally recognized by a charge or credit to shareholders’ equity may change
either because of changes in assessments of recovery of DTAs or changes in tax rates, laws, or other measurement attributes. In a manner consistent with the original treatment, IFRS Standards require that the resulting subsequent change in deferred taxes be charged or credited directly to equity as well.

**F.11 Reconciliation of Actual and Expected Tax Rate**

Under U.S. GAAP, all public entities must disclose a reconciliation by using percentages or dollars between (1) the reported amount of income tax expense attributable to continuing operations and (2) the amount of income tax expense that would have resulted from applying domestic federal statutory rates to pretax income from continuing operations. The amount and nature of each significant reconciling item should be disclosed as well. For nonpublic entities, a numerical reconciliation is not required; however, the nature of all significant reconciling items between (1) and (2) above should be disclosed.

Under IFRS Standards, paragraph 81(c) of IAS 12 states that all entities must disclose a numerical reconciliation in either or both of the following forms:

1. The reported “tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which [any] applicable tax [rate is] computed.”
2. The “average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.”

**F.12 Undistributed Earnings on Foreign Subsidiaries**

Under U.S. GAAP, a deferred tax is generally required on undistributed earnings arising after 1992 that are related to a domestic subsidiary or a domestic joint venture. However, no deferred tax is recognized on the undistributed profits of an investment in a foreign subsidiary or foreign corporate joint venture (that is permanent in duration) if such earnings can be demonstrated to be indefinitely reinvested. In accordance with paragraph 64 of ASU 2015-10, “[t]his exception to recognizing deferred taxes is not applicable for partnerships (or other pass-through entities).”

IFRS Standards require recognition of a deferred tax for all undistributed earnings associated with any form of investee except to the extent that (1) the parent is able to control the timing of the reversal of the temporary difference and (2) it is probable that the temporary difference will not reverse in the foreseeable future. Under IFRS Standards, however, there is no distinction between domestic and foreign investments.

**F.13 Interim Reporting and Tax Rate**

Under U.S. GAAP, an entity must estimate its ordinary income and the related tax expense or benefit for the full fiscal year (total of expected current and deferred provisions) to calculate its estimated annualized ETR. Ordinary income or loss is income from continuing operations less significant unusual or infrequently occurring items. Certain other exceptions may apply that remove ordinary income/(loss) from the computation. Amounts and related tax effects, if any, excluded from the overall forecasted ETR are generally accounted for either discretely or through a separate forecasted tax rate.

Under IFRS Standards, a separate estimated average annual effective income tax rate is determined for each taxing jurisdiction and applied individually to the interim-period pretax income of each jurisdiction. The interim-period tax charge is the sum of each entity’s interim tax charge. IAS 12 does not address interim tax reporting. Paragraphs B12 through B22 of IAS 34 provide examples of the application of the recognition and measurement principles of IAS 34 to interim income tax expense.
Appendix G — Titles of Standards and Other Literature

**AICPA Literature**

**Audit Section**

AU-C Section 570, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*

**Statements on Standards for Attestation Engagement**

AT Section 301, *Financial Forecasts and Projections*

**FASB Literature**

**ASC Topics**

ASC 105, *Generally Accepted Accounting Principles*

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Comprehensive Income*

ASC 225, *Income Statement*

ASC 230, *Statement of Cash Flows*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 320, *Investments — Debt and Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 325, *Investments — Other*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 420, *Exit or Disposal Cost Obligations*
Appendix G — Titles of Standards and Other Literature

ASC 450, Contingencies
ASC 460, Guarantees
ASC 470, Debt
ASC 505, Equity
ASC 606, Revenue From Contracts With Customers
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 835, Interest
ASC 840, Leases
ASC 842, Leases
ASC 852, Reorganizations
ASC 855, Subsequent Events
ASC 942, Financial Services — Depository and Lending
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies
ASC 958, Not-for-Profit Entities
ASC 960, Plan Accounting — Defined Benefit Pension Plans
ASC 962, Plan Accounting — Defined Contribution Pension Plans
ASC 965, Plan Accounting — Health and Welfare Benefit Plans
ASC 970, Real Estate — General
ASC 980, Regulated Operations
ASC 995, U.S. Steamship Entities
ASUs

ASU 2010-08, Technical Corrections to Various Topics
ASU 2014-01, Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects — a consensus of the FASB Emerging Issues Task Force
ASU 2014-17, Business Combinations (Topic 805): Pushdown Accounting — a consensus of the FASB Emerging Issues Task Force
ASU 2015-10, Technical Corrections and Improvements
ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments
ASU 2016-02, Leases (Topic 842)
ASU 2016-09, Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting
ASU 2016-13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments
ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory
ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business
ASU 2017-04, Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment
ASU 2017-15, Codification Improvements to Topic 995, U.S. Steamship Entities: Elimination of Topic 995
ASU 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes

Proposed ASUs

2019-700, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes

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Topic 740, No. 3, “Whether to Discount Alternative Minimum Tax Credits That Become Refundable”
Topic 740, No. 4, “Accounting for the Base Erosion Anti-Abuse Tax”
Topic 740, No. 5, “Accounting for Global Intangible Low-Taxed Income”
Federal Regulations

CFR
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  • Section § 1.901-1, “Allowance of Credit for Taxes”
  • Section § 301.6511(d)-3, “Special Rules Applicable to Credit Against Income Tax for Foreign Taxes”

IRC (U.S. Code)
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Section 171, “Amortizable Bond Premium”
Section 199, “Income Attributable to Domestic Production Activities”
Section 245A, “Deduction for Foreign Source-Portion of Dividends Received by Domestic Corporations From Specified 10-Percent Owned Foreign Corporations”
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Section 612, “Basis for Cost Depletion”
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**IRC Treas. Reg.**
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IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*
IAS 21, *The Effects of Changes in Foreign Exchange Rates*
IAS 34, *Interim Financial Reporting*
IAS 35, *Discontinuing Operations* (superseded by IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*)
IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*
IFRIC Interpretation 23, *Uncertainty Over Income Tax Treatments*

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**SEC Literature**

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Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”

**Regulation S-X**
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Rule 5-02, “Balance Sheets”
Rule 5-03, “Statements of Comprehensive Income”
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No. 1.B.1, “Costs Reflected in Historical Financial Statements”

No. 1.M, “Materiality” (SAB 99)

No. 1.N, “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements” (SAB 108)


No. 11.C, “Tax Holidays”

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**Accounting Principles Board (APB) Opinions**

Opinion No. 2, *Accounting for the “Investment Credit”*

Opinion No. 4, *Accounting for the “Investment Credit”*

Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

**EITF Issues**

86-43, “Effect of a Change in Tax Law or Rates on Leveraged Leases”

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No. 18, *Accounting for Income Taxes in Interim Periods* — an interpretation of APB Opinion No. 28

No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109

**FASB Statements**

No. 52, *Financial Reporting by Cable Television Companies*

No. 109, *Accounting for Income Taxes*

No. 123(R), *Share-Based Payment*

No. 141, *Business Combinations*

No. 141(R), *Business Combinations*
# Appendix H — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>AC</td>
<td>acquiring company</td>
</tr>
<tr>
<td>AETR</td>
<td>annual effective tax rate</td>
</tr>
<tr>
<td>AFS</td>
<td>available for sale</td>
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<tr>
<td>AGUB</td>
<td>adjusted grossed-up basis</td>
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<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AMT</td>
<td>alternative minimum tax</td>
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<tr>
<td>AOCI</td>
<td>accumulated other comprehensive income</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
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<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>BEAT</td>
<td>base erosion anti-abuse tax</td>
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<tr>
<td>BEMTA</td>
<td>base erosion minimum tax amount</td>
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<tr>
<td>CAD</td>
<td>Canadian dollar</td>
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<tr>
<td>CFC</td>
<td>controlled foreign corporation</td>
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<tr>
<td>CFR</td>
<td>Code of Federal Regulations</td>
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<tr>
<td>CNIT</td>
<td>corporate net income tax</td>
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<tr>
<td>CPP</td>
<td>cash purchase price</td>
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<tr>
<td>CTA</td>
<td>cumulative translation adjustment</td>
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<tr>
<td>DTA</td>
<td>deferred tax asset</td>
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<tr>
<td>DTL</td>
<td>deferred tax liability</td>
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<tr>
<td>E&amp;P</td>
<td>earnings and profits</td>
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<tr>
<td>ED</td>
<td>exposure draft</td>
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<tr>
<td>EITF</td>
<td>FASB’s Emerging Issues Task Force</td>
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<tr>
<td>EPS</td>
<td>earnings per share</td>
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<tr>
<td>ESOP</td>
<td>employee stock ownership plan</td>
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<tr>
<td>ESPP</td>
<td>employee stock purchase plan</td>
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<tr>
<th>Abbreviation</th>
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<td>ETR</td>
<td>effective tax rate</td>
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<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<td>FBB</td>
<td>final book basis</td>
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<td>FCC</td>
<td>Federal Communications Commission</td>
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<td>FDII</td>
<td>foreign-derived intangible income</td>
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<td>FRM</td>
<td>SEC Division of Corporation Finance’s Financial Reporting Manual</td>
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<td>FTC</td>
<td>foreign tax credit</td>
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<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<td>GILT</td>
<td>global intangible low-taxed income</td>
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<td>HTM</td>
<td>held to maturity</td>
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<td>IAS</td>
<td>International Accounting Standard</td>
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<td>IASB</td>
<td>International Accounting Standards Board</td>
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<td>IFRIC</td>
<td>IFRS Interpretations Committee</td>
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<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IPO</td>
<td>initial public offering</td>
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<td>IRC</td>
<td>Internal Revenue Code</td>
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<td>IRS</td>
<td>Internal Revenue Service</td>
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<td>ISO</td>
<td>incentive stock option</td>
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<td>ITC</td>
<td>investment tax credit</td>
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<td>LC</td>
<td>local currency</td>
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<td>LICITI</td>
<td>life insurance company taxable income</td>
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<tr>
<td>LIFO</td>
<td>last in, first out</td>
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<td>Abbreviation</td>
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<tr>
<td>LLC</td>
<td>limited liability company</td>
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<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
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<td>NFP</td>
<td>not-for-profit entity</td>
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<tr>
<td>NOL</td>
<td>net operating loss</td>
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<td>NQSO</td>
<td>nonqualified option</td>
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<tr>
<td>OCI</td>
<td>other comprehensive income</td>
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<tr>
<td>OTTI</td>
<td>other-than-temporary impairment</td>
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<tr>
<td>PBE</td>
<td>public business entity</td>
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<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<tr>
<td>PP&amp;E</td>
<td>property, plant, and equipment</td>
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<tr>
<td>PTI</td>
<td>percentage of taxable income</td>
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<tr>
<td>QAHP</td>
<td>qualified affordable housing project</td>
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<tr>
<td>Q&amp;A</td>
<td>question and answer</td>
</tr>
<tr>
<td>QBAI</td>
<td>qualified business asset investment</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<tr>
<td>REIT</td>
<td>real estate investment trust</td>
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<tr>
<td>RIC</td>
<td>regulated investment company</td>
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<tr>
<td>ROU</td>
<td>right of use</td>
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<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
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<tr>
<td>SAR</td>
<td>share appreciation right</td>
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<tr>
<td>SEC</td>
<td>U.S. Securities and Exchange Commission</td>
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<td>SFAS</td>
<td>Statement of Financial Accounting Standards</td>
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<tr>
<td>SFC</td>
<td>specified foreign corporation</td>
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<tr>
<td>TC</td>
<td>target company</td>
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<tr>
<td>TTB</td>
<td>total tax benefit</td>
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<td>USD</td>
<td>U.S. dollar</td>
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<tr>
<td>UTB</td>
<td>unrecognized tax benefit</td>
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<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
<tr>
<td>YTD</td>
<td>year to date</td>
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