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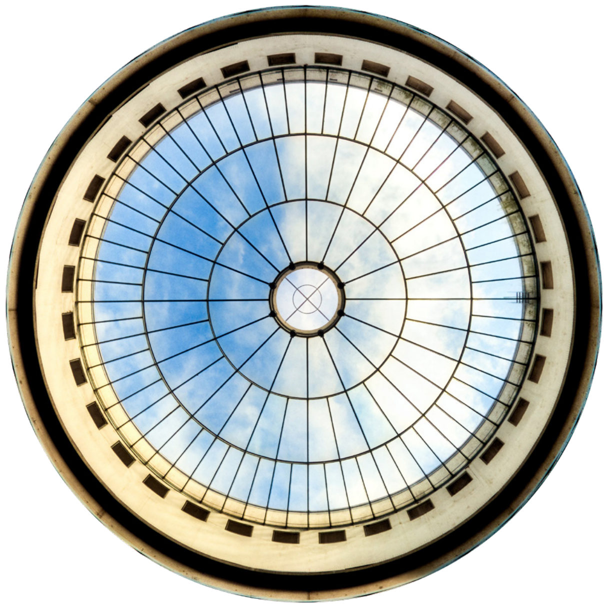

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FASB Proposes Simplifications to Accounting for Income Taxes

by Peggy Cullen and Chris Ahl, Deloitte & Touche LLP

Background

On May 14, 2019, the FASB issued a proposed ASU[1] that would modify ASC 740[2] to simplify the accounting for income taxes. The suggested 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 proposed 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."

Key Changes Made by the Proposed ASU

Hybrid Tax Regimes

The proposed ASU would amend 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 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, then only that excess is subject to the guidance in ASC 740. The FASB notes that stakeholders indicate that the current guidance on hybrid tax regimes increases the cost and complexity of applying ASC 740, particularly when

[1] FASB Proposed Accounting Standards Update (ASU), *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*.
[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

the tax amount deemed to be a non-income tax is insignificant. Further, the current guidance introduces complexity in the determination of the appropriate tax rate an entity should use when recording deferred taxes.

To reduce the cost and complexity of applying ASC 740, the FASB proposes to amend 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 would effectively reverse the order in which an entity determines the type of tax under current U.S. GAAP. In addition, the proposed 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 proposed amendments are consistent with the accounting for other incremental taxes, such as the base erosion anti-abuse tax.

The FASB proposes that these amendments would be applied retrospectively.

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 compared with the amounts used for financial reporting. Under current U.S. GAAP, a deferred tax asset (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 deferred tax liability (DTL).

After a business combination, certain transactions or events may increase the tax basis of the entity's assets, including goodwill. If a subsequent step-up in the tax basis of goodwill relates to the portion of goodwill from a prior business combination for which a DTL was not initially recognized, ASC 740-10-25-54 prohibits recognition of a DTA for the 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 current guidance in U.S. GAAP does not necessarily result in outcomes that are reflective of the economics of the underlying transactions. For example, an entity may sacrifice a net operating loss carryforward in exchange for tax basis in goodwill. In this case, economically, the entity has exchanged one asset for another and yet may be precluded from recognizing the asset received.

As a result of stakeholder feedback, the FASB proposes to remove 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." Instead, the FASB proposes a model that provides a list of factors to assist an entity in determining whether the step-up in tax basis relates 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 further notes in paragraph BC11 of the proposed ASU that entities will still need to apply judgment in this area, and the factors provided in the proposed ASU are intended to assist in this determination.

The FASB proposes that these amendments should be applied prospectively.

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." The guidance does not, however, further state which entities would be considered "members" of the group when an entity is determining 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 (SMLLC) 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 indicated that the current guidance is unclear, the FASB proposes to amend ASC 740-10-30-27 to clarify that legal entities that are not subject to tax (e.g., certain partnerships and disregarded SMLLCs) would not be required to allocate amounts of consolidated current and deferred taxes in their separate financial statements. An entity can, however, elect to allocate taxes to legal entities that are not subject to tax *and* disregarded by the taxing authority. In addition, the Board proposes to add to ASC 740-10-50-17A a requirement that an entity that is not subject to tax must affirmatively disclose that it has elected to allocate amounts of consolidated current and deferred taxes in its separate financial statements.

In paragraph BC12 of the proposed ASU, the FASB notes one reason to allow this policy election for entities not subject to tax and disregarded by the taxing authority is that for business reasons, some entities (e.g., certain rate-regulated entities or entities with cost-plus revenue arrangements) may want to include 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. However, the FASB notes that it would also be acceptable to exclude such tax allocations from an entity not subject to tax because (1) exclusion would appropriately reflect the economics of the entity (i.e., for tax purposes, the income is passed through to the owner of the entity, and the entity is not severally liable for the taxes of its owner) and (2) any tax liability recognized may not "meet the conceptual definition of a liability."

The FASB proposes that these amendments should be applied retrospectively.

Connecting the Dots

The proposed policy election to allocate taxes to legal entities that are not subject to tax *and* disregarded by the taxing authority would allow the inclusion of a tax provision in the separate financial statements of a SMLLC (a disregarded entity for tax) but not in the financial statements of a partnership (a regarded entity for tax).

Intraperiod Tax Allocation Exception to Incremental Approach

Under current 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 other comprehensive income. An exception to this approach is described in ASC 740-20-45-7, which requires that "all items . . . be considered in determining the amount of tax benefit that results from a loss from continuing operations." This exception applies only when there is 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) provides little perceived benefit to users of financial statements, and (3) is applied inconsistently in practice. On the basis of this feedback, the proposed ASU removes the exception in ASC 740-20-45-7. The FASB notes that removal of this exception "would reduce the cost of applying Topic 740, while not significantly altering the information provided to users of financial statements." In addition, the proposed 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 in ASC 740-20-45-7.

The FASB proposes that these amendments should be applied prospectively.

Ownership Changes in Investments — Changes From a Subsidiary to an Equity Method Investment

ASC 740-30-25-15 provides 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). 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 current 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) applies. This represents an exception to the general principle for accounting for outside basis differences of equity method investments.

The FASB notes that "this exception increases the cost and complexity of applying Topic 740" because it essentially requires 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 becomes an equity method investment is "frozen"; however, subsequent changes in the outside basis difference would be recognized separately. The FASB proposes to remove the exception in ASC 740-30-25-15 that restricts 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 would 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 would create consistency with current U.S. GAAP that disallows an equity method investor from asserting indefinite reinvestment of earnings to avoid recording deferred taxes on its outside basis differences.

The Board proposes that 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.

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. This guidance states that the DTL previously recognized for a foreign investment cannot be derecognized when the investment becomes a subsidiary unless dividends received from the subsidiary exceed earnings from the subsidiary after the date it became a subsidiary. This is this case regardless of whether an exception under ASC 740-30-25-18(a) applies.

In a manner similar to its observations related to ASC 740-30-25-15 above, the FASB notes that this requirement increases the cost and complexity of applying ASC 740 because it essentially requires an entity to bifurcate its outside basis difference in the subsidiary and account for the components separately. This complicates the accounting for investments and foreign subsidiaries and reduces comparability across entities (i.e., some of a reporting entity's subsidiaries may not be 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 proposes to remove 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 of the entity's subsidiaries for which indefinite reinvestment is asserted.

The Board proposes that 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.

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 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 proposes to amend ASC 740-270-25-5 to require that the effects of an enacted change in tax law be reflected in the computation of the annual effective tax rate (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.

The FASB proposes that these amendments should be applied prospectively.

Year-to-Date 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 year-to-date basis. ASC 740-270-30-28 provides additional guidance for situations in which an entity incurs a loss on a year-to-date 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 year-to-date loss. This represents an exception to the general guidance in ASC 740-270.

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 proposes to remove the exception in ASC 740-270-30-28 to reduce the cost and complexity of applying ASC 740. The FASB further notes that removal of the exception would not significantly affect the information provided to users of financial statements. In paragraph BC25 of the proposed 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 year-to-date 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.

The FASB proposes that these amendments should be applied prospectively.

Codification Improvements

The proposed ASU would make two minor improvements to the Codification topics discussed below.

Income Statement Presentation of Tax Benefits of Tax-Deductible Dividends

Once effective for a reporting entity, ASU 2016-09[3] 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). ASC 718-740-45-7, before the adoption of ASU 2016-09, states that the relevant tax benefit should be recognized *in income taxes allocated to continuing operations*. 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 proposes 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.

Impairment of Investment in Qualified Affordable Housing Projects Accounted for Under the Equity Method

ASC 323-740-55-8 includes an example of the accounting for an investment in a qualified affordable housing project under the equity method. The example indicates 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.[4] The FASB decided that the example in ASC 323-740-55-8 is not necessary because a more relevant and useful example already exists in the topic. Therefore, the FASB proposes to delete ASC 323-740-55-8.

Next Steps

After receiving feedback from the stakeholders, the FASB will determine the effective date of the proposed amendments and whether early adoption should be permitted. Comments on the proposed ASU are due by June 28, 2019.

[3] FASB Accounting Standards Update No. 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*.

[4] FASB Accounting Standards Update No. 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.

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