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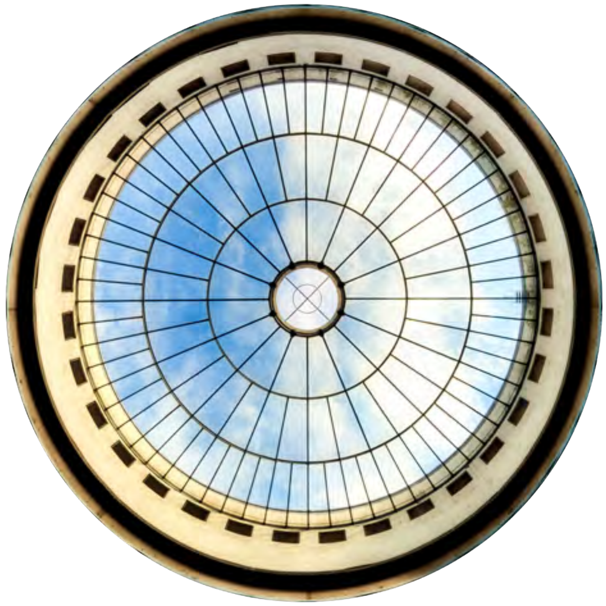

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Keep It Simple: FASB Issues ASU on Income Taxes

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Background

On December 18, 2019, the FASB issued ASU 2019-12,[1] which modifies ASC 740[2] to simplify the accounting for income taxes. The ASU's amendments are based on changes that were suggested by stakeholders as part of the FASB's simplification initiative (i.e., the Board's effort to reduce the complexity of accounting standards while maintaining or enhancing the helpfulness of information provided to financial statement users).

Key Changes Made by the ASU

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 nonincome tax was insignificant. Further, such guidance made it more difficult for entities to determine the appropriate tax rate to use when recording deferred taxes.

[1] FASB Accounting Standards Update (ASU) No. 2019-12, *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*."

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 base erosion anti-abuse tax. 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.

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 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. 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 the previous guidance in U.S. GAAP did not necessarily result in outcomes that reflected the economics of the underlying transactions. For example, an entity may sacrifice a net operating loss carryforward in exchange for tax basis in goodwill. From an economic perspective, such an entity has exchanged one asset for another and yet may be 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 the ASU, the Board acknowledged that entities will still need to apply judgment in making this determination.

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, this paragraph 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 (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 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 SMLLCs) 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 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 the ASU 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, an SMLLC (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.

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 other comprehensive income. 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.

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 accounting for outside basis differences of equity method investments.

In paragraph BC31 of the ASU, the FASB decided 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 this exception in ASC 740-30-25-15, which previously 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.

Ownership Changes in Investments — Changes From an Equity Method 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.

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 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 was also amended to reflect the change. This amendment superseded the example in ASC 740-270-55-50 and 55-51.

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 on 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, 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 year-to-date 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 the ASU, 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 year-to-date 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.

Codification Improvements

The ASU makes 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). 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

[3] FASB Accounting Standards Update No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*.

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.

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

ASC 323-740-55-8 includes an example illustrating the accounting for an investment in a qualified affordable housing project 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.[4] 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.

Transition and Effective Date

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 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.

[4] FASB Accounting Standards Update No. 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects* — a consensus of the FASB Emerging Issues Task Force.

Effective Date

The amendments in ASU 2019-12 are effective for public business entities 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).

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