FASB simplifies accounting for income taxes

At a glance
On December 18, the FASB issued guidance that simplifies the accounting for income taxes as part of the Board’s overall initiative to reduce complexity in accounting standards. Amendments include removal of certain exceptions to the general principles of ASC 740, Income taxes, and simplification in several other areas such as accounting for a franchise tax (or similar tax) that is partially based on income.

While not required to be adopted until 2021 for most calendar year public business entities (and 2022 for other entities), early adoption is permitted for any financial statements not yet issued to take advantage of the simplifications.

Key provisions of the FASB’s tax simplification

Removal of certain ASC 740 exceptions
The ASU removes certain exceptions to the general principles of ASC 740 in order to reduce the cost and complexity of its application.

Intraperiod tax allocation
Intraperiod tax allocation is the process of allocating total tax expense or benefit to components of the income statement (such as continuing operations and discontinued operations), shareholders’ equity, and other comprehensive income. Under the general principles of ASC 740, allocation of total tax expense or benefit follows a “with-and-without” approach. That is, companies first determine the amount of expense or benefit allocated to continuing operations and then proportionally allocate the remaining expense or benefit to other items. Prior to the ASU, there was an exception to the “with-and-without” approach when there was a loss from continuing operations.
and income or a gain from other items such as discontinued operations or other comprehensive income. The ASU removes that exception.

The ASU modifies the existing example in ASC 740-20 to reflect the updated guidance when the tax benefit from continuing operations is realizable. It also adds a new example that illustrates application of the guidance when the tax benefit from continuing operations is not realizable.

The ASU simplifies intraperiod allocation and mitigates the differences in interpretation and application that exist today about how to apply the exception. In addition, the amendment alleviates the counterintuitive outcomes that often resulted from application of the exception.

This amendment should be applied on a prospective basis.

Deferred tax liabilities related to outside basis differences

The ASU removes two exceptions to the general principles in ASC 740 with respect to accounting for outside basis differences of equity method investments and foreign subsidiaries. At a high level, prior to the ASU, deferred tax liabilities and/or outside basis differences were effectively “frozen” in the following scenarios as a result of the two exceptions:

- If a foreign subsidiary for which no deferred tax liability on unremitted earnings was recorded (because of the assertion that earnings were indefinitely reinvested or would be remitted in a tax-free manner) became an equity method investment, the parent would not recognize deferred taxes on the undistributed earnings that existed prior to the change in status until those earnings were remitted.

- If an equity method investment became a foreign subsidiary, the deferred tax liability for outside basis previously recognized could not be derecognized (even if the parent was otherwise able to assert that the earnings were indefinitely reinvested or would be remitted in a tax-free manner) until dividends received exceeded earnings from the foreign subsidiary after the date of transition.

Prior to the ASU, companies were required to track the “frozen” outside basis differences and any basis differences arising subsequent to the transition from foreign subsidiary to equity method investment (or vice-versa) separately. As a result of the ASU, companies will follow the general guidance in ASC 740 with respect to outside basis differences when an investment changes from a foreign subsidiary to an equity method investment or vice versa. As a result, the ASU will reduce complexity and provide increased comparability for similar investments.

This amendment should be applied on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption.
Year-to-date losses in interim periods

The interim-period income tax model in ASC 740-270 requires an entity to calculate an annual effective tax rate and apply that rate to year-to-date ordinary income (or loss) at the end of each quarter. Prior to the ASU, in cases when the year-to-date loss exceeded the anticipated loss for the year, an exception limited the income tax benefit recognized in the interim period. The ASU removes the exception so that companies will record the entire benefit calculated under the general ASC 740-270 model. It also modifies the related existing loss limitation example in order to illustrate the application of the revised approach.

The FASB noted that the amendment will reduce complexity in accounting for income taxes in interim periods and reduce costs for preparers. The FASB also noted that, historically, this exception has been subject to interpretation and proven difficult for preparers to apply. The ASU will improve consistency in the application of GAAP.

This amendment should be applied on a prospective basis.

Other areas of simplification

The ASU is intended to improve consistency and simplify GAAP in several other areas of ASC 740 by clarifying and amending existing guidance.

Franchise taxes and other taxes partially based on income

The ASU amends the scope of ASC 740 related to a franchise tax (or similar tax) that is partially based on income. The ASU requires an entity to recognize the amount of the tax based on income to be accounted for in accordance with ASC 740, with any incremental amount accounted for as a non-income-based tax (i.e., above the line) recognized entirely in the period incurred. This applies if, for example, a company is required to pay the greater of an income-based tax and a capital-based tax.

The amendment also specifies that deferred tax assets and liabilities should be measured using the applicable statutory income tax rate and that entities do not need to consider whether temporary differences will reverse in years when the tax is based on an amount other than income when assessing the need for a valuation allowance. For example, a deductible temporary difference may reduce an entity’s income tax liability, but because the entity remains subject to the non-income-based portion of the tax, the reversing deductible temporary difference may not actually result in less taxes paid during the period. In this circumstance, the assessment of realizability for any deductible temporary differences should disregard the fact that there may still be a non-income tax liability in a future period.

This amendment is based on stakeholder commentary that the existing guidance creates complexity in determining which tax rate is applicable to temporary differences. The FASB also noted that this amendment will bring the accounting for these types of taxes in line with other incremental taxes (e.g., the base erosion anti-abuse tax).
This amendment can be applied on either a retrospective basis for all periods presented or a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption.

**Step-up in tax basis goodwill**

In certain situations when an entity received a step-up in the tax basis of goodwill, it was prohibited from recognizing a deferred tax asset for the increase in the tax basis, except to the extent that the tax-deductible goodwill exceeded the remaining book balance of goodwill from a prior business combination. The ASU amends the guidance to clarify when a step-up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized and when it should be considered a separate transaction.

- In situations when the step-up in the tax basis of goodwill relates to the business combination, a deferred tax asset should be recorded only to the extent that the new tax basis exceeds the book basis in goodwill.
- If it is determined that the step-up in tax basis relates to a separate transaction, a deferred tax asset should be recorded since there is a tax basis with no corresponding book basis in the goodwill.

The FASB acknowledges that judgment is needed to make this determination. Pursuant to the ASU, indications that the step-up in tax basis relates to a separate transaction include, but are not limited to, the following:

- A significant lapse in time between the transactions has occurred
- The tax basis in the newly created goodwill is not the direct result of settlement of liabilities recorded in connection with the acquisition.
- 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.
- The transaction resulting in the step-up in tax basis requires more than a simple tax election.
- The entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step-up in tax basis.
- The transaction resulting in the step-up in tax basis was not contemplated at the time of the business combination.

The indicators above should be considered without regard to whether the measurement period for the business combination is still open. For example, it is possible for a company to conclude that a transaction taking place during the measurement period of a recent business combination is a separate transaction.

This amendment should be applied on a prospective basis.

**Separate entity financial statements**

When members of a consolidated tax filing group issue separate financial statements, ASC 740 requires allocation of the consolidated amount of current
and deferred tax expense within the separate financial statements. The ASU amends the guidance to specify that an entity is not required to allocate income tax expense to a legal entity that is both not subject to tax and disregarded by the taxing authority, but an entity may elect to do so. The FASB noted that a single-member limited liability company (LLC) that is disregarded from its owner is generally not severally liable for the taxes of its taxable owner. The FASB acknowledged, however, that some entities that are not subject to tax and are disregarded by the taxing authorities, such as certain rate-regulated entities, may want to include an allocation of the tax costs incurred by the consolidating parent entity. For this reason, the FASB has updated ASC 740 to give companies an accounting policy choice in this situation that can be applied on an entity-by-entity basis.

Many single-member LLCs currently provide deferred taxes in their standalone financial statements. This guidance makes it clear that such practice is no longer required. All companies that are impacted by this amendment should re-assess whether to allocate the consolidated income tax provision and record taxes in their separate financial statements. A subsequent change in the policy after adoption of the ASU would require an assessment that the alternative policy is preferable under ASC 250, Accounting Changes and Error Corrections.

The election to provide deferred taxes is not available for partnerships because they typically would not meet the requirement of being “disregarded” by the taxing authority.

This amendment should be applied on a retrospective basis for all periods presented.

**Interim recognition of enactment of tax laws or rate changes**

ASC 740 requires entities to recognize the income tax effects of an enacted change in tax law on deferred tax assets or liabilities on the date of enactment. However, prior to the ASU, there was diversity in that some believed the effect on taxes payable or refundable for the current year should also be accounted for in the period of enactment; others believed ASC 740 required that a company wait to account for these current effects until the period that included the effective date. For example, under the latter, if a law change that reduced the income tax rate was enacted on the first day of an entity’s fiscal year but was not effective until the entity’s second quarter, the estimated annual effective tax rate (AETR) for the first quarter would have reflected the higher income tax rate without consideration of the change in tax law. The reduced income tax rate would have been incorporated into the AETR in the second quarter, when the law became effective. The remeasurement of deferred tax assets and liabilities to the reduced rate would have been recorded in the first quarter. The ASU amends the interim guidance in ASC 740-270 to clarify that all tax effects, both deferred and current, should be accounted for in the interim period that includes the enactment date.

This amendment should be applied on a prospective basis.
Codification improvements

The ASU makes minor improvements to the Codification related to employee stock ownership plans (ASC 718-740, Compensation -- stock compensation) and investments in qualified affordable housing projects accounted for using the equity method (ASC 323-740, Investments -- equity method and joint ventures). These amendments should be applied on a prospective basis.

Effective dates for tax simplification and early adoption

ASU 2019-12 is effective for public business entities for annual reporting periods beginning after December 15, 2020, and interim periods within those reporting periods. For all other entities, it is effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022.

Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption (e.g., the quarterly data table in the annual report or comparative interim information in the following year’s Form 10-Qs may need to be revised to reflect adoption as of the beginning of the fiscal year). If an entity chooses to early adopt, it must adopt all changes as a result of the ASU (i.e., it cannot choose to early adopt the amendment related to intraperiod tax allocation while choosing not to early adopt the other amendments).

In the first fiscal year after the adoption date, and in the interim periods within the first fiscal year, entities should disclose the nature and reason for the change in accounting principle, the transition methods, and a qualitative description of the financial statement line items affected by the change.

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