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This publication has been updated to reflect new and updated authoritative and interpretive guidance since the 2012 edition. See Appendix A for a Summary of Noteworthy Revisions.

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Dear Clients and Friends:

The overall accounting model for income taxes has been in place for many years, yet the accounting for income taxes continues to pose many challenges for preparers, users, and auditors. Among those challenges are the tax accounting rules for valuation allowance, intraperiod allocation, business combinations, and foreign operations.

PwC is pleased to offer this comprehensive guide on the accounting for income taxes. It is intended to assist you in interpreting the existing literature in this complex area of accounting by bringing together all of the key guidance into one publication. It provides several comprehensive examples to help navigate the guidance, and offers our perspective throughout, based on both analysis of the guidance and our experience in applying it.

This guide is intended to clarify the fundamental requirements involved in the accounting for income taxes and to highlight key points that should be considered before and after transactions are undertaken. We hope you will find in these pages the information and insights needed to work with greater confidence and certainty when applying the accounting model for income taxes.

PricewaterhouseCoopers LLP
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Executive Summary
Executive Summary

Change: The one constant

Benjamin Franklin once said that nothing in this world is certain but death and taxes. Had he been able to anticipate this century’s standard-setting activity, he might have phrased things somewhat differently. Nowadays, the only certainty about taxes is that things will change.

Complexity

Already complex, accounting for income taxes will become even more so as a result of new and forthcoming guidance here in the United States. The accounting model for income taxes has been around for some time—a fact that suggests companies have had sufficient time to fully acclimate themselves to the standard’s provisions. In the intervening years, however, the overall business environment has grown decidedly more complex. So too has accounting under U.S. generally accepted accounting principles (GAAP). The way that governments (local, federal and foreign) levy taxes is also more complex now. These factors have made the interpretation of the accounting model for income taxes particularly challenging.

Complications

Where there is complexity, there is the greater likelihood of complications. In recent years, controls around the accounting for income taxes have been a critical source of material weakness in companies’ internal controls over financial reporting. Accounting for income taxes has also been a primary reason for restating financial statements.

Further complications may arise as U.S. GAAP begins to converge with International Financial Reporting Standards (IFRS). While the Securities and Exchange Commission (SEC) ponders whether it will allow U.S. companies to file financial statements prepared under IFRS, many practitioners will want to become familiar with the similarities and differences between the two frameworks.

How this guide helps

We have kept these factors very much in mind while writing this guide. Intended as a practice aid for PwC engagement teams and other parties, this guide serves as a central location for the following information:

• A comprehensive summary of ASC 740
• PwC’s interpretation of that literature
• PwC’s insights on accounting matters related to income taxes

In reading this guide, it is important to remember that under ASC 740, as under any principles-based standard, facts and circumstances particular to a given situation must be considered in reaching an accounting conclusion (or might lead to more than one supportable conclusion). We hope it is with this understanding that our readers will use this guide.
How this guide is organized

The beginning chapters address the following matters:

- The basic model of ASC 740 (e.g., the scope, objectives, and basic principles)
- Identification of temporary differences
- Recognition and measurement of deferred tax assets and liabilities

The guide then moves on to some of the more complex areas of tax accounting:

- Establishment of a valuation allowance
- Accounting for changes in tax laws and tax status
- Business combinations
- Temporary differences on outside basis
- Intraperiod allocation

The final chapters of the guide deal with the following issues:

- Disclosure
- Separate financial statements of a subsidiary
- Interim reporting
- Tax accounting for stock-based compensation
- Accounting for uncertainty in income taxes
- Summary of differences in accounting for income taxes between U.S. GAAP and IFRS

As noted, this guide includes chapters on business combinations and stock-based compensation. The income tax aspects of those topics are included in our guide because they apply to most companies. Please also refer to PwC’s A Global Guide to Accounting for Business Combinations and Noncontrolling Interests and PwC’s Guide to Stock-based Compensation for broader information on those topics.

The income tax aspects for regulated entities and bankruptcies are simply cross-referenced to PwC’s Guide to Accounting by Utilities and Power Companies and PwC’s Guide to Accounting for Bankruptcies and Liquidations, as those topics are applicable to a much more limited group of companies.

As the environment continues to change, so will the content in this guide. This guide considers existing guidance as of May 31, 2013. Future editions will be released to keep pace with significant developments. Subsequent editions will also provide practitioners with guidance on navigating the many complexities of accounting for income taxes, which we believe (with the same conviction that Franklin had about death and taxes) will only keep proliferating.
Chapter 1:
Scope of ASC 740
Chapter Summary

Accounting Standards Codification (ASC) 740, *Income Taxes* addresses how companies should account for and report the effects of taxes based on income. While the scope of ASC 740 appears to be self-explanatory (i.e., ASC 740 applies to all income based tax structures), the unique characteristics of tax structures across the United States and the world can make it quite difficult to determine whether a particular tax structure is a tax based on income. Matters are further complicated when the determination involves the U.S. tax treatment of a structure such as a single-member limited liability company or entails applying the “check the box” rules for entity classification. This chapter looks at what would constitute a tax based on income and discusses the applicability of ASC 740 to various types of entities.
Excerpts from ASC 740

ASC 740-10-15-2:
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.

ASC 740-10-15-3:
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.

ASC 740-10-15-4:
The guidance in this Topic does not apply to the following transactions and activities:

a. A franchise tax to the extent it is based on capital and there is no additional tax based on income. If there is an additional tax based on income, that excess is considered an income tax and is subject to the guidance in this Topic. See Example 17 (paragraph 740-10-55-139) for an example of the determination of whether a franchise tax is an income tax.

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.
1.1 **Scope of ASC 740**

1.1.1 **In General (ASC 740-10-15-3)**

ASC 740’s principles and requirements apply to domestic and foreign entities in preparing financial statements in accordance with U.S. GAAP, including not-for-profit entities (NFP) with activities that are subject to income taxes, including the following:

- 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
- An entity’s domestic and foreign operations that are consolidated, combined, or accounted for by the equity method

In short, any income-based tax that an entity must pay to a governmental authority is subject to the provisions of ASC 740.

It is also important to note that ASC 740 applies to all entities that are part of a reporting entity. It will be necessary, therefore, to consider the tax impact of other entities that interact with the companies that make up the financial reporting entity (e.g., equity-method investees and entities that are combined due to common control, or variable interest entities (VIEs) required to be consolidated under ASC 810 Consolidation)—not just the tax impact of consolidated subsidiaries.

1.1.2 **Scope Exceptions (ASC 740-10-15-4)**

ASC 740 explicitly states that it does not address:

- A franchise tax to the extent it is based on capital and there is no additional tax based on income (Section TX 1.2.2.1)
- A withholding tax for the benefit of the recipients of a dividend (Section TX 1.2.1.1)

1.2 **Defining a “Tax Based on Income”**

1.2.1 **In General**

As discussed above in Section TX 1.1.1, the principles of ASC 740 are applicable to “taxes based on income.” However, authoritative literature under U.S. GAAP does not clearly define the term “tax based on income” or specify characteristics that differentiate taxes based on income from taxes that are not. The legal definition of the tax structure (as an income tax or otherwise) is not determinative in an evaluation of whether a tax structure should be accounted for as a tax based on income.

We believe that a tax based on income is predicated on a concept of income less allowable expenses incurred to generate and earn that income. That being said, the tax structure does not need to include all income statement accounts in order to be an income tax. A tax on a subset of the income statement, such as a tax on net investment income (which taxes investment income less investment-related expenses), would also appear to be a tax on income, since it would employ the net income concept. In general, practice has been that a “tax based on income” would even apply to tax regimes in which revenues or receipts are reduced by only one category of expense.

To define income taxes, we look to the ASC Master Glossary, which defines income taxes as “domestic and foreign federal (national), state, and local (including franchise)
1.2.1.1 Withholding Taxes—Entities That Withhold Taxes for the Benefit of Others

ASC 740-10-15-4 indicates that a withholding tax for the benefit of the recipients of a dividend is not an income tax of the entity that pays the dividend if both of the following conditions are met:

- 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.
- Shareholders receiving the dividend are entitled to claim the withholding as tax paid by the entity, on their behalf, either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

This guidance indicates that if both of the above conditions are met, the withholding tax would not be considered an income tax of the entity that pays the dividend. We believe that this guidance would also apply to withholding taxes for the benefit of the recipients of interest, royalty or other payments if the above conditions are satisfied.

1.2.1.2 Withholding Taxes—Entities That Receive Dividends, Interest, Royalties or Other Income

The ASC 740-10-15-4 exception does not apply to entities that have taxes withheld from dividends, interest, royalties or other income on their behalf. Accordingly, these entities must determine whether such withholding taxes are income taxes which must be accounted for in accordance with ASC 740.

In many cases, withholding taxes will be deemed to be income taxes of the entity that receives the dividends, interest, royalties or other income. Withholding taxes are typically considered under local country laws, together with respective tax treaties, to be prepayments of (or in lieu of) local income taxes. In other words, the withholding taxes are essentially a substitute for a complete income tax calculation because the recipient of the payment (against which the tax is withheld) is outside the country and may not otherwise be required to file a local income tax return. If the company that received the dividends, interest, royalties or other income were to file an income tax return in the local jurisdiction, it would be able to claim the withholdings as a prepayment of the income taxes. In the U.S., such withholding taxes would typically be expected to generate foreign tax credits, and thus directly interact with the recipient entity’s U.S. income tax computation. If withholding taxes are determined to be income taxes, they would be subject to the accounting requirements of ASC 740. In situations in which taxes have not been withheld and the withholding would have qualified as an income tax, companies should be mindful of ASC 740’s requirements for the accounting for uncertain tax positions.
1.2.2 Application of Guidance to Specific Tax Jurisdictions and Tax Structures

As noted above, we historically have seen tax laws enacted in a number of jurisdictions where, based on the manner in which the tax is computed, it is not always clear whether the tax meets the definition of a “tax based on income.” In some cases, the tax might be just partially based on income (e.g., the taxpayer pays the higher of an income tax or equity-based tax in any given year). In other cases, the multiple characteristics of the enacted tax law and the law’s overall complexity may make it difficult to determine whether the tax is based (either wholly or partially) on income. Below are our views on certain tax regimes that have been enacted in various taxing jurisdictions.

1.2.2.1 Higher of an Income-Based or Capital-Based Computation

As noted in Section TX 1.1.2, franchise taxes based on capital are explicitly scoped out of ASC 740. However, certain states impose on corporations a franchise tax that is computed as the higher of a tax based on income or a tax based on capital. As discussed in ASC 740-10-15-4, any taxes based on income in excess of the franchise tax based on capital are subject to ASC 740. The Financial Accounting Standards Board (FASB) provided an example of one such tax in ASC 740-10-55-139 through 55-144. The example indicates that the franchise tax was an income tax only to the extent that it exceeded the capital-based tax in a given year. The same approach would be appropriate for any state tax that is similarly determined (i.e., is the higher of a capital-based computation or an income-based computation).

In such states, there is the question of how ASC 740 should be applied in determining the applicable tax rate that is used to compute deferred tax assets and deferred tax liabilities for temporary differences and carryforwards. We infer from ASC 740-10-55-144 that the tax operates as a graduated tax. Assuming that the statute prescribes a single tax rate for the income-based calculation, the tax rate is zero on the amount of taxable income for which the income-based tax calculation would equal the capital-based computation, and any additional taxable income is taxed at the tax rate prescribed in the statute. When graduated rates are a significant factor, the applicable rate is the average rate that is expected to be applicable to the amount of estimated taxable income in the reversal year(s).

Example 1-1: Higher of an Income-Based or a Capital-Based Computation

Background/Facts:
A state tax is the greater of (1) a tax based on income (e.g., 4.5 percent of taxable income) or (2) a tax based on equity (e.g., .25 percent of equity). In this example, the company’s equity is $200,000 each year. In year 1, book income is $13,000 and taxable income is $16,000 due to an originating deductible temporary difference of $3,000.

Question:
How should the tax based on income be reported?

(continued)
**Analysis/Conclusion:**
Based on the facts above, the current tax provision would be calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$16,000</td>
</tr>
<tr>
<td>Income tax rate</td>
<td>4.5%</td>
</tr>
<tr>
<td>Current tax computed based on income-based tax</td>
<td>$720</td>
</tr>
<tr>
<td>Less: Current tax computed based on equity-based tax</td>
<td>(500)</td>
</tr>
<tr>
<td>[200,000 equity x .0025%]</td>
<td></td>
</tr>
<tr>
<td>Current tax attributed to the income-based tax</td>
<td>$220</td>
</tr>
</tbody>
</table>

In measuring the deferred tax asset and computing the deferred tax provision, an entity should base the applicable rate on the incremental expected tax rate for the year that the deductible temporary difference is anticipated to reverse. If the $3,000 temporary difference was expected to reverse in year 2 (at which point, it is estimated, the taxable income will be $15,000), the applicable state tax rate at which the year 1 deferred tax asset would be calculated would be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$15,000</td>
</tr>
<tr>
<td>Income tax rate</td>
<td>4.5%</td>
</tr>
<tr>
<td>Less: Equity-basis tax</td>
<td>(500)</td>
</tr>
<tr>
<td>Incremental income taxes</td>
<td>$175</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$15,000</td>
</tr>
<tr>
<td>Rate to be applied to deductible temporary difference</td>
<td>1.167%</td>
</tr>
</tbody>
</table>

As a result, the deferred tax asset for year 1 is calculated by tax-effecting the $3,000 temporary difference at 1.167%, resulting in a $35 deferred tax asset.

The journal entry to record the tax expense for the year is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Current income tax expense ($16,000 x 4.5%) less equity tax of $500</td>
<td>$220</td>
</tr>
<tr>
<td>Dr Equity tax expense (included in pretax expenses)</td>
<td>500</td>
</tr>
<tr>
<td>Dr Deferred tax asset ($3,000 x 1.167%)</td>
<td>35</td>
</tr>
<tr>
<td>Cr Income taxes payable</td>
<td>$220</td>
</tr>
<tr>
<td>Cr Equity taxes payable</td>
<td>500</td>
</tr>
<tr>
<td>Cr Deferred tax expense</td>
<td>35</td>
</tr>
</tbody>
</table>

Another acceptable approach would be to use the applicable rate that the statute prescribes for the income-based computation, unless the reversals of temporary differences are what cause the income-based tax to exceed the capital-based computation. This approach is consistent with the FASB’s belief that deferred taxes should represent the incremental effect that reversing temporary differences and carryforwards have on future tax amounts (ASC 740-10-10-3). It should be noted that the FASB ultimately decided to use an “applicable rate” concept for deferred taxes, as opposed to measuring deferred tax assets and liabilities at their incremental value. Applying the alternative approach to the fact pattern in Example 1-1 would necessitate scheduling the reversal of the $3,000 temporary difference, as well as require determining the amount of the reversal that would provide incremental benefit in each succeeding year.
1.2.2.2 Gross Receipts Tax

A gross receipts tax is generally based upon a jurisdiction’s definition of “taxable gross receipts.” In devising this tax, many jurisdictions do not take into consideration any expenses or costs incurred to generate such receipts, except for certain stated cash discounts, bad debts, and returns and allowances. Because the starting point of the computation of a gross receipts tax is not “net” of expenses, we believe that a gross receipts tax is not a tax based on income for purposes of determining whether ASC 740 applies. In reaching this conclusion, we drew an analogy between a gross receipts tax and premium taxes that states often levy on insurance companies. A premium tax is reported as an operating expense, not as an income tax. In the case of the Ohio gross receipts tax that was enacted in 2005, the FASB staff informally agreed that a gross receipts tax is not a tax “based on income.”

However, in jurisdictions where the tax is calculated on modified gross receipts, consideration should be given as to whether it is a tax based on income. We believe that a modified gross receipts tax constitutes a tax based on income and should therefore be accounted for in accordance with ASC 740 if it is based on gross receipts that are reduced for certain costs (e.g., inventory, depreciable and amortizable assets, materials and supplies, wages, and/or other expenditures). One example of a tax based on modified gross receipts is Mexico’s flat tax which is broadly based on (i) receipts from the sale or disposition of property (including inventory), (ii) services rendered, (iii) royalties from unrelated parties and (iv) rentals of property. These receipts are offset by expenditures for (i) the acquisition of assets, (ii) services rendered, (iii) royalties to unrelated parties and (iv) rentals of property used in operations. Mexico’s flat tax is therefore considered a tax based on income, accounted for under ASC 740.

1.2.2.3 Single Business Tax

Prior to its repeal in July 2007, the Michigan “Single Business Tax” (SBT) was computed by adding payroll costs to, and subtracting certain capital expenditures from, income for the period. In many cases, the payroll and certain capital expenditures may have been larger than the entity’s income for the period. Notwithstanding that the law itself indicated that the SBT was not an income tax, we believe it met the ASC 740 definition of a “tax based on income.”

Although it appears clear that the legislature’s intent was to assess tax on a value-added basis, as opposed to an income-tax basis, it chose to use federal taxable income as its basis for quantifying the SBT. To this base, specific modifications were made to arrive at the SBT’s tax base. Additions to federal taxable income included items such as interest expense; state and foreign income taxes; interest and dividends from state obligations; federal net operating losses; federal capital loss carryovers or carrybacks; depreciation; compensation expense; and royalties paid. Subtractions included items such as certain dividends received, interest received, income from other entities, and royalties received.

When analyzed at a high level, the calculation of the SBT was similar in form to the calculation of the income-based franchise tax system that some states use. States with income-based taxes commonly use federal taxable income as the base, to which state-specific adjustments are then made. These modifications help the state satisfy its economic goals. Though the SBT was further removed from a pure income tax than the income tax resulting from more-traditional systems of state income tax, we nonetheless believe that the SBT was a tax based on income.
Because an entity may have had losses for both book and tax purposes and still have had a current liability for the SBT, we believe that classifying the related expense as either income tax expense or as a pretax operating expense was acceptable, as long as such classification was applied consistently. Regardless of the SBT’s classification in the income statement, it was an income tax and subject to the principles of ASC 740.

1.2.2.4 Texas Margin Tax

Texas’s “margin tax” is assessed on an entity’s Texas-sourced “taxable margin.” “Taxable margin” equals the lesser of (1) 70 percent of an entity’s total revenue or (2) 100 percent of its total revenue less, at the taxpayer’s annual election, (a) cost of goods sold or (b) compensation, as those terms are defined in the law. As discussed in Section TX 1.2.1, we believe that a tax based on income has a tax base that consists of income less deductible expenses. Because the margin tax has a base that possesses this characteristic, along with other characteristics of a tax based on income, the margin tax should be accounted for under ASC 740. We expect that a majority of companies will pay tax on either “revenue less cost of goods sold” or “revenue less compensation,” since those measures are likely to produce a smaller taxable margin than the “70 percent of total revenue” measure of “taxable margin.” Although this latter measure would not be equivalent to income (i.e., income less expenses), we view it as a maximum-threshold measure within a broader income tax structure. We do not view the Texas margin tax as an overall tax system that assesses tax based on sales or gross receipts (e.g., Ohio’s tax system), which would be characterized as a tax structure that is not based on income.

Because each of the measures of “taxable margin” have their own subset of applicable temporary differences (including the 70 percent of total revenue measure), scheduling may be required if an entity expects to be subject to more than one measure of taxable margin during future years in which it is anticipated that differences between the existing book basis and the tax basis will reverse. When an entity is measuring deferred taxes as part of this scheduling process, the margin tax’s Texas-apportioned enacted tax rate should be applied to the applicable temporary differences associated with the expected measure of taxable margin in a given year. We believe that if an entity expects to be subject to the “70 percent of total revenue” measure of taxable margin, the applicable rate for those revenue-related temporary differences (e.g., differences in recognition between the book basis and the tax basis for bad debts, deferred revenue, etc.) should be 70 percent of the Texas-apportioned enacted tax rate (reflecting the fact that 30 percent of the reversing revenue-related temporary differences would not impact taxes payable).

1.2.2.5 Private Foundation—Excise Tax on Net Investment Income

Some have questioned whether ASC 740 applies to the private foundation excise tax where the foundation reports securities at market value in its financial statements (for tax purposes, only realized gains are taxed, while in the financial statements, unrealized gains/losses are recorded). Even though this tax is considered an excise tax, it is considered an income tax for purposes of ASC 740, because the tax computation is based on an “income-type” number.

Accordingly, deferred taxes should be provided on private foundations’ untaxed, unrealized appreciation of securities. However, if the foundation is in a net unrealized depreciation position, it should consider the relevant tax law when assessing the realizability of the deferred tax assets. For example, under the U.S. tax code, capital losses for private foundations can be offset only by capital gains generated in the
same year. There is no carryforward or carryback ability for capital losses; therefore, it is generally not appropriate to record a deferred tax asset for capital losses as there is no assurance of realization.

ASC 740-10-10-3 requires deferred taxes to be established using the rate that is expected to apply in the period that the temporary difference is expected to reverse. Private foundations have the ability to affect the rate that is used for their excise tax. For instance, if grants are increased by a certain amount, excise tax for the current year is computed at 1 percent rather than at the normal rate of 2 percent. However, in future years, the rate reverts to 2 percent, unless the grant-increase test is again met for those years. Accordingly, a question has arisen regarding the appropriate rate that should be used to record deferred taxes.

We believe that in the situation described above, the appropriate rate to record deferred taxes would be the 2 percent rate, because that is the normal enacted tax rate. Use of the 1 percent rate results from particular circumstances under the client’s control, which allows a temporary variation in the rate. Those circumstances consist of the requirement that during the tax year an entity make grant payments exceeding a base-period amount (and other requirements that are not relevant here). If the requirements are met during a year, the lower rate applies to that year’s tax. However, the lower rate will apply only to gains on securities sold during that year. As sales of securities held at year-end can occur only in subsequent years; as of the date of the year-end balance sheet, it cannot be known whether the foundation will later qualify for the lower rate. This is true even if the foundation has consistently qualified for the lower rate in previous years. Thus, for purposes of computing the deferred tax liability, a rate of 2 percent should be used.

1.2.2.6 The American Jobs Creation Act of 2004 Tonnage Tax

Example 1-2: The American Jobs Creation Act of 2004 Tonnage Tax

Background/Facts:
The American Jobs Creation Act of 2004 (the Act) permits qualifying corporations to elect to be taxed under a tonnage tax regime on their taxable income from certain shipping activities in lieu of the U.S. corporate income tax or, for foreign corporations, the gross transportation tax.

The tonnage tax is calculated by multiplying the maximum corporate tax rate (35 percent) by the notional shipping income for the year. Notional shipping income is based on the weight (net tonnage) of each qualifying vessel and the number of days that the vessel was operated as a qualifying vessel during the year in U.S. foreign trade.

Accordingly, an electing corporation’s total tax for the year would be equal to the tonnage tax plus the income tax on nonqualifying activities.

No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the tax imposed. Therefore, a company in a loss position will still owe the tonnage tax.

Qualifying companies may switch to this method of taxation by filing an election with the IRS. A corporation making the election must do so before the due date (including extensions) of the income tax return for the year for which the corporation elects to be subject to the tonnage tax regime. An election may be made prior to the filing of such return by filing a statement with the IRS.

(continued)
Questions:
Should the tonnage tax be accounted for as an income-based tax pursuant to ASC 740 or as a non-income-based tax (e.g., an excise tax)? During what reporting period should the company account for the election?

Analysis/Conclusion:
We believe the appropriate treatment is to account for the tonnage tax as a non-income-based tax because the tax calculation is based on the tonnage of a company’s qualifying vessels and is not directly tied to the income of the corporation. ASC 740-10-05-1, supports this view, indicating that an income tax is based on a company’s revenues, expenses, gains, or losses that are included in its taxable income. ASC 740-10-20 defines taxable income as “the excess of taxable revenues over tax deductible expenses.” Thus, inherent in the ASC 740 notion of an income tax is the concept that taxes on income are determined after deducting expenses and losses from gross revenues and gains.

It should be noted that we view the election of the tonnage tax as a change in tax status for a corporation. See Chapter TX 8 for a discussion of changes in the tax status of an entity.

Lastly, if significant, disclosure should be included in a company’s financial statements once the decision has been made that the company will file the election.

1.2.3 Credits and Other Tax Incentives

There are many credits and other tax incentives available for amounts spent that qualify under various governmental (U.S. and foreign) programs. These programs may take many forms, including programs related to research and development, alternative fuels, renewable energy and emissions allowances. These programs often include tax credits, incentives or rebates, designed to foster infrastructure, research, and other targeted business investment. In some cases, these credits and incentives are transferrable or refundable.

While credits and incentives often arise in the tax laws and may be claimed on a tax return, a number of features can make them more equivalent to a government grant or subsidy. Therefore, each credit and incentive must be carefully analyzed to determine whether it should be accounted for under ASC 740 or whether it constitutes a government grant, in substance, and thus is subject to other guidance.

Several questions should be considered when analyzing whether a credit or other tax incentive should be accounted for under ASC 740 or not:

• Is there a direct relationship between the benefit received and taxable income or the income tax liability otherwise due?
• How is the benefit claimed?
• If there is more than one manner in which the benefit may be obtained, is the election irrevocable?
• Can the benefit be sold?
• Is the benefit refundable? For example, if a benefit claimed on an income tax return exceeded tax otherwise due (including as a result of subsequent loss carryback), would the benefit nonetheless be refundable?
• Is the benefit taxable? Does taxability depend upon the manner in which the benefit is obtained?
The application of income tax accounting is generally warranted if a particular credit or incentive can be claimed only on the income tax return and can be realized only through the existence of taxable income. Where there is no connection to income taxes payable or taxable income and where the credits are refundable, we believe the benefit should generally be accounted for under an income recognition model.

Some credits or other tax incentives may be refundable either through the income tax return or in some other manner (e.g., direct cash from the government) at the option of the taxpayer. In general, we believe that, regardless of the method a company chooses to monetize the benefit, if there is no direct linkage to a company's income tax liability, the accounting would be outside the scope of ASC 740. There may be some exceptions to this general analysis. For example, if the method of monetizing the benefits could result in significantly different taxation of the benefit, it may be that the method of monetizing will impact the accounting for these benefits.

In some cases, the benefit received under these programs may be taxable and the taxability might vary depending on the manner chosen to obtain the benefit. This may impact the analysis of the accounting treatment of a particular credit or incentive. In this regard, it is also important to understand if the choice is irrevocable. If so, it might indicate that the taxability could produce a different accounting answer. In these cases, we believe that if a company needs to choose to receive the benefit in a certain way (e.g., as a tax credit) to avoid taxation, the appropriate accounting could be to include it in determining income tax expense.

The following diagram may be helpful in identifying questions to ask when analyzing which accounting model to apply:

```
Administered through Income Tax Return
Yes

Refundable?
Always
Pre-Tax Income
Indifferent
Pre-Tax Income

Disincentive to opt for refundable?
Yes
Pre-Tax Income

Income Tax
No
Pre-Tax Income

Income Tax

Pre-Tax Income
```

1 - 12 / Scope of ASC 740
1.2.4 Attributes of Taxes Not Based on Income

There is the question of whether entities should account for (1) timing differences inherent in the computation of taxes that are not based on income and (2) tax credit carryforwards relating to taxes that are not based on income.

1.2.4.1 Timing Differences Inherent in the Computation of Taxes Not Based on Income

We believe that the effects of timing differences that might be reflected in the computation of a tax that is not based on income should not be reflected in the financial statements as deferred tax assets or deferred tax liabilities because taxes that are not based on income are not within the scope of ASC 740. For example, in the case of a gross receipts tax, there may be differences between when gross receipts are included in GAAP income and when those amounts are included in the taxable base of gross receipts. Although these differences in the timing of recognition between GAAP and tax are analogous to temporary differences as defined in ASC 740, we do not believe that this analogy alone is sufficient to justify recording an asset or a liability.

1.2.4.2 Tax Credit Carryforwards for Tax Regimes Not Based on Income

Similarly, we believe that the analogy to the recording of a deferred tax asset in ASC 740 for credits useable against taxes not based on income is not in itself sufficient to warrant the recording of an asset. FASB Concepts Statement No. 6, Elements of Financial Statements, defines an asset as embodying “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” In many cases, therefore, an asset should not be recorded for non-income tax credit carryforwards, because the future benefit often depends upon a future event (e.g., the generation of future income that is subject to tax). However, we do believe that if a tax benefit can be achieved without future transactions (e.g., if a credit carryforward can be used to offset a tax on outstanding equity), it might be possible to justify recognizing an asset. Entities should make sure they understand the nature of how the carryforward arose and whether incremental benefit will be provided. We generally believe that if credit carryforwards are used but it is expected that new credits will continually replenish them (and be in larger amounts), there would be no incremental tax benefit, since the amount of tax paid would be the same with or without the tax credit carryforwards.

1.3 Accounting by Jurisdiction (Separate Calculation versus Blended Rate)

Although deferred taxes ordinarily must be determined separately for each tax-paying component in each tax jurisdiction, ASC 740-10-55-25 acknowledges that in certain situations the tax computations for two or more jurisdictions can be combined. This is possible when (1) the same operations are taxed in two or more jurisdictions and (2) either there are no significant differences between the tax laws of the jurisdictions (e.g., carryback and carryforward periods are similar, as are the significant components of the tax laws) or any difference in computation would have no significant effect, given the company’s facts and circumstances. In making this determination, companies should also consider the provisions of ASC 740-10-45-6 about the offset of deferred tax liabilities and assets of different jurisdictions.

In practice, many companies employ a “blended rate” approach at the legal-entity level to simplify the income tax calculation for entities operating in multiple jurisdictions (e.g., operating in multiple U.S. states). Management should be able to
support its decision to use a blended rate and must not presume that a blended-rate approach is acceptable. Use of this approach should be continually assessed in light of the considerations enumerated in ASC 740-10-55-25 and other practical considerations. This may make the use of a blended rate unacceptable—especially as more and more states continue to decouple their tax calculations from the U.S. federal tax calculation. Examples of when problems can result from the use of a blended rate include the following:

- When an entity enters or exits a particular jurisdiction.
- When an entity needs to schedule deductible temporary differences and taxable temporary differences in order to determine the realizability of deferred tax assets for a component jurisdiction.
- When there is a change in the assessment of a valuation allowance in one of the component jurisdictions.
- When there is a tax law change that substantially changes the tax structure of one of the component states.
- When there is a tax uncertainty that relates to only one or a subset of jurisdictions.
- When differences would result in the application of ASC 740-20’s intraperiod allocation rules to one blended jurisdiction, as compared to applying those rules to multiple individual jurisdictions.

When jurisdictions are combined for purposes of calculating an income tax provision, some entities choose to employ an aggregate applicable rate (e.g., the federal applicable rate plus the applicable state rate, net of the federal effect at the applicable federal rate). In calculating a state tax provision, an entity’s use of a state rate, net of federal benefit, would be inconsistent with the principles of ASC 740, because the entity would effectively be netting the state tax with the deferred federal benefit. ASC 740-10-55-20 states that deferred state taxes result in a temporary difference for purposes of determining a deferred U.S. federal income tax asset or liability. ASC 740-10-45-6 states that “an entity shall not offset deferred tax liabilities and assets attributable to different tax jurisdictions.” Because ASC 740 does not allow the netting of different tax jurisdictions, a state tax rate should be applied separately to temporary differences; in calculating a temporary difference (for purposes of determining a deferred federal benefit) that arises from deferred state taxes, an entity should use a federal tax rate. As a practical matter, however, consideration of the federal effects of deferred state taxes (i.e., netting) is acceptable if the effects are not material. If the effects could be material, the use of a blended-rate approach may be precluded.

1.4 Applicability of ASC 740 to an Entity's Legal Form

1.4.1 Single-Member and Multiple-Member Limited Liability Companies (under U.S. Tax Law)

Questions often arise regarding how single-member and multiple-member limited liability companies (LLCs) should account for income taxes in their separate financial statements. Neither type of entity is specifically mentioned in ASC 740, but ASC 272, Limited Liability Entities, provides some guidance on accounting for multiple-member LLCs. See Section TX 14.4 for a discussion of the applicability of ASC 740 to the separate financial statements of a single member LLC.
Partnerships

Investments in Partnerships

ASC 740 does not address the accounting for tax effects related to investments in partnerships. This leaves certain questions unanswered. For instance, should the accounting of such investments be determined from the inside basis of the underlying assets, or should they be determined from the outside basis in the partnership interest?

We believe that measurement of deferred taxes related to an investment in a partnership should be based on the difference between the financial statement amount of the investment and its tax basis (that is, the outside basis difference). Deferred taxes are not based on the difference between the book basis and the tax basis within the partnership and, in many cases, are inherent in the outside basis difference. The measurement of deferred taxes using the outside basis of a partnership would be applicable regardless of whether the partnership investment was (1) carried via the cost method or equity method, (2) consolidated, or (3) pro rata consolidated.

See Section TX 11.1.9 for a more detailed discussion of accounting for the outside basis of a partnership investment.

General Application of ASC 740 to the Separate Financial Statements of Partnerships

In the United States, general and limited partnerships (except certain “master limited partnerships” discussed below) are not subject to tax, because their earnings and losses are passed directly to their owners and taxed at that level. ASC 740 does not apply to such partnerships. In certain circumstances partnerships do represent taxable entities under local tax law (e.g., in Puerto Rico), which are responsible for their own entity-level tax on income. In those cases, ASC 740 is generally applicable.

Example 1-3: Partnership Subject to Income Tax

Background/Facts:
The New York City Unincorporated Business Tax (NYC UBT) is imposed on any unincorporated entity (including a partnership, fiduciary or corporation in liquidation) that is required to file Federal Form 1065, U.S. Return of Partnership Income, and is engaged in any trade, business, profession or occupation that is wholly or partly conducted in New York City. Any type of entity listed above and having total gross income exceeding $25,000 will generally be required to file a return on Form NYC-204, NYC Unincorporated Business Tax Return.

Question(s):
Should the NYC UBT be accounted for as an income-based tax pursuant to ASC 740 or as a non-income-based tax? If it is accounted for as an income-based tax, should the unincorporated entity/individual record deferred taxes for temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements?
Analysis/Conclusion:
Although many of the entities that are subject to the NYC UBT might not be taxable for U.S. and state income tax purposes (for example, partnerships), we believe that the NYC UBT is an income-based tax, as defined in ASC 740, because the starting point for determining the taxable income base is the ordinary business income recorded on Federal Form 1065. That income is then adjusted to reflect certain New York City modifications (e.g., add-backs for contributions to partner retirement plans, guaranteed payments to partners for services performed, and income taxes paid to other tax jurisdictions). Accordingly, deferred taxes for the NYC UBT should be established for any taxable or deductible temporary differences related to the entity’s assets and liabilities. The establishment of those deferred tax assets and liabilities, as well as periodic changes in their amounts, should be recorded as part of income tax expense in the income statement, along with the current portion of the UBT incurred in any particular period.

1.4.2.2.1 Master Limited Partnerships

Under the Revenue Act of 1987, publicly traded limited partnerships (“master limited partnerships”) formed after December 17, 1987, are taxable as corporations for post-1987 years. Master limited partnerships that were already in existence on December 17, 1987 became taxable as corporations for years beginning after 1997. Certain limited partnerships have been exempt from both these rules (e.g., partnerships engaged in real estate transactions or in oil and gas activities).

Entities that become taxable after 1997 should provide the appropriate deferred taxes for the impact of post-1997 reversals of current temporary differences.

1.4.2.2.2 Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs)

Other entities, such as regulated investment companies (RICs) and real estate investment trusts (REITs) are not subject to tax (by means of a dividends paid deduction) if distribution requirements and other conditions are met. ASC 740-10-50-16 requires nontaxable RICs and REITs that are publicly held to disclose the fact that they are not taxed. In addition, it requires publicly held nontaxable RICs and REITs to disclose the net difference between their tax bases and the reported amounts of their assets and liabilities. Presumably this disclosure is meant to indicate to an owner (or prospective owner) what future taxable income or deductions, disproportionate to reported amounts, will be generated for his/her ownership interest by the entity’s future operations. However, for some entities, the depreciation or depletion deductions available to individual owners will not be pro rata to ownership interests but will instead reflect the different outside tax bases of the individual owners. Further, each owner’s tax accounting (e.g., depletion calculations for mineral properties) might depend on his or her individual tax position. Thus, the entity itself frequently will not have information about individual owners’ tax bases.

It does not appear that disclosure of the aggregate tax bases would be meaningful in any event, since individual owners will not share the tax bases pro rata. We believe that if these circumstances make it impracticable for an entity to determine the aggregate tax bases of the individual owners, the entity should indicate this in its financial statements and explain that the amount would not be meaningful.

As RICs and REITs do not “pass through” tax losses to owners (as partnerships do), they must disclose the amount of any operating or capital loss carryforward.
1.4.3 State Income Taxes

1.4.3.1 Separate Calculation Versus Blended Rate

See Section TX 1.3, which discusses the considerations outlined in ASC 740-10-55-25 and addresses other practical considerations.

1.4.3.2 Treatment of Apportionment Factors

Many state tax jurisdictions assess a tax based on the portion of taxable income earned in their jurisdiction. The process used to determine a respective state's share of an entity's business is typically referred to as “apportionment.” Although each state has its own laws for determining apportionment, many states use the following three factors in their determination: sales within the jurisdiction compared with total sales; assets within the jurisdiction compared with total assets; and payroll within the jurisdiction compared with total payroll.

In each state that follows an apportionment formula, the calculation of deferred taxes should use the apportionment factors that are expected to apply in future years. All available information should be used in this calculation. In practice, preparers of financial statements often use their current factors or factors shown in their most recently filed tax returns as the primary basis for estimating their future apportionment. While that may be useful as a starting point, the analysis should be adjusted to reflect any anticipated changes and all available information.

1.4.3.2.1 Changes in State Income Tax Rates Caused by Changes in How a State Apportions Income

We believe that when a change in the state rate is attributable to a change in the way a state computes its apportionment factors, the effect of the change should generally be treated as a change in tax rate and recorded entirely under continuing operations, consistent with the treatment of enacted law changes that is described in ASC 740-10-45-15. See Chapter TX 7 for a discussion of changes in tax laws and rates.
Chapter 2: Objectives and Basic Principles
Chapter Summary

In general, when a tax is based on income, most items that enter into pretax accounting income also enter into taxable income in the same year, and vice versa. Some events, however, are recognized for book purposes and for tax purposes in different years. Over time, as these differences reverse, they eventually offset each other. The FASB, and its predecessor, the Accounting Principles Board (APB), have consistently decided that the tax effects of these differences, referred to as deferred taxes, should be accounted for in the intervening periods.
Excerpts from ASC 740

ASC 740-10-10-1:
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.

ASC 740-10-10-2:
Ideally, the second objective might be stated more specifically to recognize the expected future tax consequences of events that have been recognized in the financial statements or tax returns. However, that objective is realistically constrained because:

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.

ASC 740-10-10-3:
Conceptually, a deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. That concept is an incremental concept. A literal application of that concept would result in measurement of the incremental tax effect as the difference between the following two measurements:

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

(continued)
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.

ASC 740-10-25-2:
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.

ASC 740-10-25-3:
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.

(continued)
3. Bad debt reserves for tax purposes of U.S. savings and loan associations (other than qualified thrift lenders) that arose in tax years beginning December 31, 1987. See paragraphs 942-740-25-1 through 25-3 for the specific requirements related to this exception.

4. Policyholders' surplus for 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.

2.1 Objectives of ASC 740

ASC 740-10-10-1 identifies two objectives of accounting for income taxes:

- Recognize the amount of taxes payable or refundable for the current year.
- 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.
2.2 Basic Principles

The FASB concluded that the financial statements should reflect the current and deferred tax consequences of all events (with the only exceptions identified in ASC 740-10-25-3, as discussed in Section TX 2.3) that have been recognized in the financial statements or tax returns. To accomplish this goal, the following basic principles were established:

- A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- 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.
- 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 (ASC 740-10-30-2).

2.3 Exceptions to the Basic Principles

There are certain situations where deferred taxes are either not provided or not determined in the normal manner. Some basis differences are not temporary differences because their reversals are not expected to result in taxable or deductible amounts. In other circumstances, ASC 740-10-25-3 provides certain exceptions to the basic principles of the statement.

2.3.1 “Outside Basis” Differences and U.S. Steamship Exceptions

ASC 740-10-25-3(a) provides that a deferred tax liability should not be recognized for certain specified temporary differences unless it becomes apparent that they will reverse in the foreseeable future. The most notable of these relates to an excess book-over-tax “outside basis” difference of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. The accounting for income taxes related to outside basis differences is discussed at length in Chapter TX 11.

ASC 740-10-25-3(b) (which refers to ASC 995-740-25-2) provides an exception for recording deferred taxes related to deposits in statutory reserve funds of U.S. steamship entities for temporary differences that arose in fiscal years beginning on or before December 15, 1992. However, deferred taxes are required for any temporary differences related to deposits in statutory reserve funds of U.S. steamship entities that arise in fiscal years beginning after December 15, 1992.

2.3.2 Leveraged Leases (ASC 740-10-25-3(c))

ASC 840-10-25-43 defines a leveraged lease as having all of the following characteristics at its inception: (i) it meets the criteria for a direct financing lease, (ii) it involves at least three parties, (iii) the financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor, (iv) 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 elimination.
The accounting model for leveraged leases, prescribed in ASC 840-30, *Capital Leases*, is based on projected after-tax cash flows, and it thus predicts the future actual tax effects arising from the lease. Generally, these tax effects are based on the actual incremental tax effects expected to be realized in each future year as taxable income (loss) resulting from the leveraged lease transaction is reported on the tax return. The tax effects of leveraged leases are typically extremely important to their economics. The accounting model recognizes the importance of those tax effects in determining the pattern of income over the term of the lease.

ASC 740-10-25-3(c) leaves the basic model for accounting for leveraged leases in place. The taxable temporary differences arising from leveraged leases do not enter into the computation of the deferred tax liability. Rather, a deferred tax credit is computed under the ASC 840-30 model.

### 2.3.2.1 Purchased Leveraged Leases

ASC 840-10-25-27, ASC 840-30-25-10, ASC 840-30-30-15 and ASC 840-30-35-32 provide guidance with respect to accounting for leveraged leases acquired in a purchase business combination. ASC 805, *Business Combinations*, generally requires the allocation of the aggregate purchase price of the acquired entity to its individual assets and liabilities based on fair values before tax-effecting. However, the amount of the aggregate purchase price that is allocated to the investment in leveraged leases is determined on a tax-effected basis.

### 2.3.3 Nondeductible Goodwill (ASC 740-10-25-3(d))

The tax treatment (deductible vs. nondeductible) of goodwill may vary depending on the tax laws of the jurisdiction where the goodwill is recorded. In the United States, for example, under the 1993 Tax Act, goodwill that is “acquired” is amortizable for U.S. federal tax purposes over 15 years (goodwill that is “created” by a taxpayer is generally nondeductible).

ASC 805-740-25-3 prohibits the recognition of a deferred tax liability for the reported amount of goodwill (or portion thereof) that is not deductible for tax purposes. Because goodwill is the residual in the purchase price allocation under ASC 805, establishing a deferred tax liability for the basis difference in goodwill would result in an increase in the amount of goodwill. This in turn would require an increase in the deferred tax liability, which would further increase goodwill.

The FASB concluded that the resulting grossing up of goodwill and the deferred tax liability would not add to the relevance of financial reporting. Thus, while it is assumed that other assets and liabilities will be recovered and settled at their carrying amounts, there is in this treatment of goodwill an implicit assumption that its carrying amount will be recovered on an after-tax basis.

**PwC Observation:** Because of ASC 805-740-25-3 an excess of book goodwill over tax-deductible goodwill will not result in the recording of deferred taxes at the date of a business combination. However, if there is an excess of tax-deductible goodwill over book goodwill at the acquisition date, a deferred tax asset should be provided in accordance with ASC 805-740-25-8 through 25-9.
2.3.4 Tax Effects of Intra-entity Transactions (ASC 740-10-25-3(e))

As quoted above, ASC 740-10-25-3(e) prohibits the recognition of a deferred tax asset for basis differences relating to intra-entity (i.e., intercompany) profits. This treatment of intra-entity profit is an exception to the asset and liability approach prescribed by ASC 740. In consolidation, there is a deductible temporary difference for the excess of the buyer's tax basis over the cost to the seller, which normally would require recording a deferred tax asset for the gross deductible difference. But ASC 810-10-45-8 defers the tax paid by the seller and ASC 740-10-25-3(e) prohibits recognition by the buyer of a deferred tax asset for the temporary difference.

2.3.4.1 In General

Ordinarily, there are tax effects when an asset is sold or transferred between affiliated companies that are consolidated for financial statement purposes but file separate tax returns. Under ASC 740-10-25-3(e) and ASC 810-10-45-8 no immediate tax impact should be recognized in the consolidated financial statements as a result of these intra-entity transfers of assets. Furthermore, this exception applies to intra-entity transfers involving affiliated entities domiciled in two different jurisdictions (e.g., a U.S. corporation and a non-U.S. corporation) as well as affiliated entities domiciled in the same jurisdiction but that file separate income tax returns (e.g., two affiliated U.S. corporations that are not included in the same U.S. corporate income tax return and hence are considered separate tax-paying components of the reporting entity's consolidated financial statements).

After the consummation of the transaction, there generally will be no temporary difference in either the seller's or the buyer's separate financial statements. The seller's separate financial statements generally will reflect the profit on the sale and a tax payable on that profit. The buyer's separate financial statements will reflect the asset at the intra-entity transfer price, which will be the buyer's tax basis.

In consolidation, however, the seller's pretax profit will be deferred, and the asset will be carried at its cost to the seller until it is sold to an unrelated third party or otherwise recovered (e.g., amortized, impaired, etc.). Similarly, ASC 810-10-45-8 precludes an entity from reflecting a tax benefit or expense from an intra-entity transfer between entities that file separate tax returns, whether or not such entities are in different tax jurisdictions, until the asset has been sold to a third party or otherwise recovered.

Therefore, the taxes paid (if any) by the seller, as well as any other tax consequences (e.g., as a result of temporary difference reversals), are deferred in consolidation. In addition, no deferred tax asset is recorded in the buyer's jurisdiction for the difference between the tax basis and consolidated carrying amount of the asset. Instead, the tax benefit from any step up in tax basis is recognized as it is realized each period, via deduction on the tax return. This will necessitate tracking intra-entity activity so as not to misstate the deferred taxes.

Special consideration should be given to the effects of changes in measurement of uncertain tax positions when accounting for intra-entity transactions (see Section TX 16.5) and accounting for the release of a valuation allowance concurrent with an intra-entity asset transaction (see Section TX 2.3.4.2.1.2) to ensure that the intra-entity exception in ASC 740-10-25-3(e) is appropriately applied.

We believe the above discussion ordinarily applies to intra-entity transfers of assets, including fixed and intangible assets, but not to the transfer of stock of a subsidiary
(as discussed below). For intra-entity transfers of fixed or intangible assets, the deferred charge is typically amortized as the book basis of the asset is depreciated by the buyer. In the case of an intra-entity transfer of an asset that is not depreciated for book purposes (e.g., an indefinite-lived intangible) but is depreciated by the buyer for tax purposes, we believe that the deferred charge should be amortized over the asset's tax life.

In the narrow case of intra-entity transfers of assets that are not subject to sale in the foreseeable future and are not depreciated for either book or tax purposes, a literal interpretation of ASC 740-10-25-3(e) and ASC 810-10-45-8 would result in an indefinite deferral of the tax effects of the transaction. However, we do not believe that an indefinite deferral is consistent with the intent of ASC 810-10-45-8 which is essentially a matching objective. Further, we do not believe that the guidance contemplated a transaction whereby the tax effects would be indefinitely deferred.

Accordingly, while we will not object in this narrow case to an accounting policy of indefinitely deferring the tax consequences, we believe that another alternative would be to identify a reasonable period of time over which to amortize the deferred charge. One approach would be to consider the overall economics of the transaction. Presumably, the company was willing to incur a tax charge in the seller's jurisdiction because the transferred assets are expected to provide a better “after-tax” return in the buyer's jurisdiction. We believe that it would be appropriate for a company to amortize the tax effects over the period of time in which the transferred asset is expected to generate the return. Another approach might be to look to the tax life of a similar asset in a jurisdiction that provides for tax amortization. Furthermore, in limited circumstances, the tax effects of an intra-entity sale might be recognized immediately as indicated in Example 2-2.

A company should consider the approach chosen as an accounting policy election that is applied consistently to similar transactions. Further, to the extent an intra-entity transaction has tax consequences for both the buying and selling entities, we believe that the approach chosen should be applied consistently to both the buyer and the seller (e.g., we do not believe it would be appropriate for the seller to indefinitely defer the tax effects of the transaction while the buyer amortizes the tax effects over a period of time).

Also, the requirement of ASC 810-10-45-8 that the seller's tax consequences be deferred applies when pretax profit has not already been recognized in the consolidated financial statements in periods prior to the period in which the intra-entity transfer of assets occurs. For example, the pretax effect of changes in the value of certain marketable securities accounted for under ASC 320, Investments—Debt and Equity Securities, as available-for-sale or trading securities would be included in other comprehensive income (for available-for-sale securities) or pretax income (for trading securities) as the securities are marked to market every reporting period. The periodic adjustment would be included in the current and deferred tax calculations. A subsequent transfer of such securities between affiliated entities filing separate income tax returns would be within the scope of ASC 740-10-25-3(e) being that it is an intra-entity transfer of assets. However, such a transfer would not trigger the deferral requirement in ASC 810-10-45-8 because the pretax effects from the securities' mark-to-market adjustments would already have been recognized in prior periods. This is because, for financial statement purposes, the pretax income would already have been recognized in prior periods and any tax currently payable or refundable arising from a taxable transfer would be offset by the reversal of the deferred taxes that had been established in prior periods.
2.3.4.1.1 Deferred Charge Differentiated from Deferred Tax Asset

Taxes paid that result from intra-entity transfers and that are deferred for financial reporting purposes (deferred charges) are different from deferred tax assets recognized under ASC 740-10-30-5. Deferred tax assets are subject to revaluation for tax rate changes and are subject to realizability considerations using the model prescribed in ASC 740. However, the deferred charges are not subject to the realizability model prescribed in ASC 740 nor are they affected by tax rate changes. That is because the deferred tax for an intra-entity transfer represents the deferred tax effect of a past event. The amount will not be changed by future events other than the sale or depreciation, including market write-down or impairment measured on a pretax basis, of the related asset. The only realization test applied would be part of an overall realization test for the related inventory or other asset. Thus, the carrying amounts of the asset and the deferred charge, in total, should not exceed the anticipated after-tax proceeds on sale or other recovery.

2.3.4.1.2 Quantifying the Amount of Tax Deferred under ASC 740-10-25-3(e)

A question may arise as to the amount of tax paid by the seller on the intra-entity profit. We believe that, generally, the profit should be the last item to enter into the seller’s computation of taxes payable in the period of the sale, and the deferred tax should be calculated as the differential in taxes payable with and without the intra-entity profit. If the sale affects deferred tax expense in the seller’s separate statements (e.g., if the tax basis of the asset sold is higher or lower than the seller’s carrying amount prior to the sale), that effect should be deferred in consolidation.

2.3.4.1.3 Intra-entity Intellectual Property Migration Arrangements

Determining whether an arrangement to migrate intellectual property (IP) is an intra-entity transfer of an asset as opposed to merely a license to use the asset is often judgmental and depends on facts and circumstances. To the extent it is determined to be an asset transfer, the exception in ASC 740-10-25-3(e) would apply and any net tax consequences of the transfer (both current and deferred) are suspended in the balance sheet and subsequently amortized to income over the period of economic benefit. Alternatively, if the arrangement constitutes a license, the intra-entity transfer provisions in ASC 740 would not apply and any tax consequences are recognized immediately.

In some cases, the arrangement constitutes an outright sale or an exclusive license for the entire economic life of the IP and there may be little doubt that an asset has been transferred. However, in other cases, it may be difficult to determine whether the arrangement constitutes an in-substance sale of the IP (or a portion thereof) or merely a license to use the IP.

Intra-entity arrangements should be reviewed to determine whether they confer ownership rights and burdens and whether the benefits and risks associated with the IP have been transferred. To be considered an “asset,” consistent with the FASB Concept Statement definition of an asset (CON 6, Elements of Financial Statements), the arrangement should convey probable future economic benefits that are controlled by the entity in the in-bound jurisdiction. One way to think about this is to evaluate whether the holder of the IP would recognize an asset on its separate balance sheet, if it were to prepare one. In this regard, the legal and contractual rights conveyed in the arrangement are the primary considerations.
Further, the relevant income tax laws should also be considered. While not necessarily determinative of the accounting treatment, the characterization of the arrangement under income tax law as either a license or a sale may provide additional clues. This might include, for example, whether the arrangement is considered a sale or disposal in the out-bound jurisdiction and whether tax basis has been created in the in-bound jurisdiction.

There are circumstances, however, when the income tax accounting effect from an intra-entity IP migration would be similar regardless of whether the arrangement constitutes an asset transfer versus a licensing arrangement.

The following example illustrates the accounting for the tax effect of post-acquisition migration of acquired IP:

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**Example 2-1: Accounting for the Tax Effect of Post-Acquisition Migration of Acquired Intellectual Property**

**Background/Facts:**
Company X, a U.S. multinational, acquires in a nontaxable acquisition the shares of Company B, a U.S. company which has developed IP. In acquisition accounting, Company X records the IP at its fair value, determined using an income approach based on expected worldwide revenues. Company X also records a deferred tax liability for the related taxable temporary difference which equals the full carrying value of the IP because the tax basis of the IP is zero. The deferred tax liability effectively represents the expected U.S. tax from the recovery of the IP's carrying value.

Post acquisition, Company X decides to restructure the ownership of the acquired IP consistent with its evolving overall business and tax strategy by providing a non-exclusive license to its Bermuda subsidiary. The non-exclusive license gives the Bermuda subsidiary commercialization rights covering all territories outside the U.S. In exchange, the Bermuda subsidiary would pay royalties to Company X commensurate with the income to be generated outside the U.S. Rather than paying such royalties over time, Company X and its Bermuda subsidiary agree that the Bermuda subsidiary will make a lump-sum payment of all royalties. The lump-sum payment is determined by discounting all expected royalties at an appropriate discount rate. Under U.S. tax law, the lump-sum payment is included in Company X's taxable income upon receipt. If, instead of making a lump-sum payment of all expected royalties, the Bermuda subsidiary were to pay periodic royalties, U.S. tax consequences would occur over time as period royalties are included in taxable income.

**Question:**
How should Company X account for the tax effect related to the intra-entity arrangement?

**Analysis/Conclusion:**
In this fact pattern, we do not believe that there should be any tax provision effect to Company X in the period in which the intra-entity lump sum royalty is paid. (This assumes that the value at which the IP is on the books equals or approximates the value at which it is transferred for tax purposes.) Regardless of whether the arrangement constitutes an intra-entity transfer of an asset or a license, the lump-sum payment has merely accelerated the U.S. tax consequences to Company X of

(continued)
recovering the carrying value of the portion of the IP related to non-U.S. territories which, in turn, causes a partial reversal of the related deferred tax liability. By paying current U.S. tax on the entire value of the non-U.S. rights, Company X will not have to pay a second tax when its Bermuda subsidiary recovers the non-U.S. value through generation of foreign source income. Therefore, the deferred tax liability pertaining to the expected U.S. tax from the recovery of the non-U.S. rights is no longer needed.

If the arrangement constitutes an intra-entity transfer of an asset, the deferral procedures in ASC 740-10-25-3(e) apply and any net tax consequences of the transfer are deferred and amortized to income over the period of economic benefit. Alternatively, if the arrangement constitutes a license, the intra-entity transfer provisions in ASC 740 would not apply.

In this case, the net income statement effect is likely to be zero under either scenario as the current tax expense is offset by a deferred tax benefit from the partial reversal of the deferred tax liability. Importantly, however, this would not be the case if the value assigned for tax purposes at the time of the IP migration differs from the carrying amount, of the IP, if any, on the entity's balance sheet. This might be the case, for example, if the IP was internally generated or acquired at an earlier date.

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2.3.4.2 Certain Exceptions in the Application of ASC 740-10-25-3(e)

2.3.4.2.1 Intra-entity Sale of Subsidiary Stock

When the intra-entity transaction is the sale of stock of a subsidiary, it involves the “outside” tax basis.1 Because both ASC 740-10-25-3(e) and ASC 810-10-45-8 refer to the intra-entity transfer of assets, we do not believe that the exception should be extended to the transfer of stock of a subsidiary (i.e., an outside basis difference). Rather, the guidance related to outside basis differences would be applied in the usual manner (see Chapter TX 11). Accordingly, we believe that any tax paid on the intra-entity transfer of a subsidiary’s stock should not be deferred.

Further, often the fair value of the stock of the subsidiary transferred will become the outside tax basis of that subsidiary and may exceed its outside book basis. The general rule, as addressed in ASC 740-30-25-9, is that a deferred tax asset cannot be recognized for an excess tax-over-book outside basis difference unless it is apparent that reversal will occur in the foreseeable future (e.g., the outside basis difference is deductible in some systematic fashion or the entity is planning to sell the subsidiary in the near future).

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Example 2-2: Application of ASC 740-10-25-3(e), to the Sale of Cost-Method Investments

Background/Facts:
Assume Company X, a U.S. corporation, has a wholly owned holding company in Switzerland (Holdings) that has a wholly owned subsidiary in Brazil and that also owns 5 percent of the stock of an entity in Argentina. Holdings accounts for its investment in the Argentine entity using the cost method. In the current year,

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1 An “outside” basis difference is the difference between the book carrying value and tax basis of an entity.
Holdings sells all of its stock in both the Brazilian subsidiary and the Argentine entity to Company X, recognizing a pretax gain on both transactions, which is appropriately eliminated in consolidation but results in tax payments. Assume that after the intra-entity transfer, Company X does not have a definitive plan to sell either investment outside the group.

**Question:**
What is the appropriate financial statement accounting for the tax consequences of the sale of shares in the Brazilian subsidiary and in the Argentine cost-method investment?

**Analysis/Conclusion:**
Pursuant to ASC 740-10-25-3(e) and ASC 810-10-45-8, no tax benefit or expense should be recognized in the financial statements from an intra-entity sale of assets, until the assets have been sold to a third party or their cost otherwise has been recovered (e.g., amortized, impaired, etc.) in the consolidated financial statements. Rather, the tax consequences should be deferred, similar to the pretax profit that is deferred.

An intra-entity sale of the stock of a subsidiary differs from an intra-entity sale of assets as it involves outside tax basis. ASC 740-10-25-3(e) and ASC 810-10-45-8 both refer to the intra-entity sale of assets; therefore, any tax paid on an intra-entity transfer of a subsidiary’s stock generally should not be deferred.

In the scenario described above, the sale of the Brazilian entity is clearly an intra-entity sale of the subsidiary’s stock and accordingly the tax effects should be recognized immediately. Note that the fair value of the subsidiary transferred in this case becomes the outside tax basis of the subsidiary, which may exceed its outside book basis. In such an instance, a deferred tax asset for the outside basis difference would be recorded only if it was apparent that reversal of the temporary difference would occur in the foreseeable future.

The sale of the Argentine entity is an intra-entity sale of stock; however, the sale is of the stock of a cost-method investment and not of a subsidiary. Ordinarily, the intra-entity sale of a cost-method investment should be treated similar to an intra-entity sale of assets. However, with a cost-method investment, the underlying assets would not be expected to be amortizable for either book or tax purposes. Therefore, absent an anticipated sale of the investment outside the group, application of the tax deferral provisions would result in an indefinite deferral of the prior tax effects of the sale in the consolidated balance sheet. In this case, consistent with the guidance in TX 2.3.4.1 above, we believe it would be acceptable to either (1) indefinitely defer the tax effects until disposition or impairment of the cost method investment or (2) amortize the tax effects over the period of time in which the transferred investment is expected to generate an economic benefit (e.g., through reduced after-tax returns on dividends).

Further, although application of ASC 740-10-25-3(e) and ASC 810-10-45-8 is not optional for transactions within their scope, in this narrow circumstance, by analogy to our view on the intra-entity transfer of shares in a subsidiary, we would also not object to the immediate recognition of the tax effects of the intra-entity sale of a cost-method investment.
2.3.4.2.1 Reversal of Previously Unrecorded Book-Over-Tax Outside Basis Differences

An intra-entity transfer may trigger the reversal of an outside book-over-tax basis difference for which a deferred tax liability had not been provided previously, either because (1) the indefinite reversal criterion (ASC 740-30-25-18) was applicable and previously had been met or (2) the scenario suggested for a domestic subsidiary in ASC 740-30-25-7 previously had been contemplated. In these cases, the tax corresponding to the existing outside basis difference should be charged to expense in the period in which the expectations changed, which may be in advance of the actual intra-entity transaction.

2.3.4.2.2 Release of Valuation Allowance Concurrent with an Intra-entity Asset Transfer

An intra-entity transfer may trigger the release of a valuation allowance. Before the intra-entity asset transfer exception is applied, a company must first determine whether its existing tax attributes are realizable. If a tax benefit from a carryforward is realized, or is considered realizable, the intra-entity deferral provision should not apply to a valuation allowance release and an income tax benefit must be recognized. The tax cost triggered by the asset transfer is then deferred in accordance with the guidance on intra-entity asset transfers in Section TX 2.3.4. See Section TX 5.4.3.3 for a discussion of intra-entity asset transfers considered as part of the valuation allowance assessment.

2.3.4.2.2 Intra-entity Transfers Reported at Predecessor Basis

In preparation for a spin-off transaction, an intra-entity sale may occur to transfer specific assets (e.g., fixed assets or intangible assets) to an entity that will eventually be spun off (i.e., the transferee). When the spin-off occurs, the acquired asset will be recorded at predecessor basis in the separate financial statements of the transferee. A basis difference on the acquired asset would exist (historical cost for book purposes versus fair value of the asset for tax purposes). We believe there are two approaches to considering this basis difference in the separate financial statements of the transferee.

One view is that the transferee could record the deferred tax asset (assuming that the fair value and tax basis is greater than the book basis) on its books. This view ignores the intra-entity exception in ASC 740-10-25-3(e) under the theory that this exception only applies in consolidation. Under this approach, the deferred charge that was originally recorded in the consolidated statements, that included both the transferor and the transferee, is essentially recharacterized as a deferred tax asset within the transferee’s separate, carve-out financial statements. If this view is taken, we believe the corresponding credit, and any tax rate differential, would be recorded within the equity of the transferee in accordance with ASC 740-20-45-11 at the time of the spin.

A second view is that the ASC 740-10-25-3 deferral (previously recorded by the transferor in the consolidated financial statements) is inherited by the transferee at its carrying amount when the transferee leaves the consolidated group. This view is predicated on the fact that the deferral is in effect part of the carrying amount of the assets that are being assumed by the transferee at book value. Under this view, the transferee inherits the deferral and essentially continues the accounting (on its own books) that was previously performed by the transferor.
2.3.5 Certain Foreign Exchange Amounts (ASC 740-10-25-3(f))

ASC 740-10-25-3(f) prohibits the recognition of deferred taxes that, under ASC 830-10, **Foreign Currency Matters**, are remeasured from the local currency to the functional currency using historical exchange rates. This situation can result from either: (1) changes in exchange rates or (2) indexing for tax purposes. ASC 830-10-45-18 provides common nonmonetary balance sheet items that are remeasured using historical exchange rates. See Section TX 11.5 for a discussion of the accounting for foreign exchange movements with respect to ASC 740.

2.4 Other Considerations

2.4.1 Discounting

Although it might seem logical that an asset and liability approach to accounting for the impact of income taxes would give some consideration to the time value of money (i.e., a deduction today is worth more to an entity than a deduction ten years in the future), ASC 740-10-05-07 and ASC 740-10-30-8 specifically preclude entities from present-valuing or discounting when measuring deferred taxes. There are conceptual arguments both for and against discounting deferred taxes for the time value of money. A strong reason not to discount deferred taxes is that such discounting would involve numerous operational issues, including the selection of the appropriate discount rate(s). Most importantly, discounting would routinely require an entity to undertake a detailed analysis of future reversals of temporary differences to determine the future years in which the deferred tax amounts would become taxable or deductible. The FASB did not believe that the benefit of discounting outweighed the effort required to achieve that benefit. As a result, the time value of money is not considered in the accounting for income taxes (aside from an assessment of whether a tax-planning strategy is prudent and feasible). We believe this prohibition on discounting also extends to income tax receivables and payables.

**Example 2-3: Prohibition on Discounting of Income Tax Receivable**

**Background/Facts:**
Company X operates in a tax jurisdiction where carrybacks of net operating losses do not result in a current tax refund, but rather in a credit carryforward. The resulting credit carryforward either will be offset against the tax on taxable income over the subsequent three-year period or will result in a cash refund from the taxing authority if not used during the carryforward period.

As a result of a recent audit, the timing of a deduction taken in a previous period by Company X was disallowed. Company X was allowed to claim the deduction in a more recent period, further increasing its loss for that period. Company X filed an amended return and elected to carryback the incremental loss (as provided for under the relevant tax code), which created a credit carryforward. Due to the large amount of pre-existing net operating loss carryforwards (which the entity had not elected to carryback in the original return for that period) and the forecasted level of financial results, management deemed the recovery of the credit carryforward, through offset against tax on future taxable income, to be remote. Consequently, Company X considered a cash payment by the taxing authority in three years to be virtually certain.

(continued)
Question:
Should the anticipated future receipt of the cash payment be discounted to reflect the time value of money?

Analysis/Conclusion:
No. We believe that discounting this income tax attribute would not be appropriate. We believe that this tax attribute is part of an income-based tax system that is accounted for pursuant to ASC 740. Under ASC 740-10-25-2, the tax attribute gives rise to a deferred tax asset. ASC 740-10-05-07 and ASC 740-10-30-8 prohibit discounting of deferred tax balances in all circumstances. The tax attribute represents a credit carryforward that eventually may result in a cash payment to the company. However, the attribute does not represent a current claim to cash and may in fact be offset against tax on taxable income at any time before the expiration of the three-year carryforward period.

Notwithstanding the conclusion above, even if the credit were deemed to be an “income tax” receivable (akin to a tax settlement receivable) instead of a deferred tax asset, the relevant guidance on discounting would be ASC 835-30, *Imputation of Interest*. While ASC 835-30 generally requires discounting of claims for cash with maturities in excess of a company’s operating cycle, ASC 835-30-15-3(e) explicitly excludes “income tax settlements” from such guidance. In certain situations, however, tax settlements with a local taxing authority may not meet the definition of an “income tax” under ASC 740 and therefore would be within the scope of ASC 835-30.

Example 2-4: Discounting of a Tax Receivable from a Taxing Authority Relating to a Non-Income-Based Tax

Background/Facts:
State X passed a law to replace an income tax with a gross receipts tax (determined not to be subject to ASC 740). As part of the law enacting the gross receipts tax, a new credit was created that would allow certain companies with recorded deferred tax assets relating to net operating loss carryforwards to convert those deferred tax assets into transitional credits to be used to offset future gross receipts tax liabilities. Under the law, transitional credit carryforwards that remained unused after 25 years would become refundable in cash so long as the company remained subject to the gross receipts tax.

Question(s):
Does the transitional credit meet the definition of an asset? If so, how should it be measured?

Analysis/Conclusion:
Statement of Financial Concepts 6 defines an asset, in part, as a probable future economic benefit that resulted from a past event.

We believe the transitional credit arising from the conversion of net operating loss carryforwards can be differentiated from other credits because of the ability of the company to claim a refund for the unused credit after 25 years, regardless of whether any tax liability has been incurred. Because of this feature, the credit is analogous to a receivable to be settled in cash in 25 years, with the ability to receive the benefit (continued).
sooner by means of offset to a gross receipts tax liability. As the credit does not require any future event (the passage of time is not an event) to provide benefit, the transitional credit represents an asset. Although the company must remain subject to the gross receipts tax regime in order to claim the credit, all that is required for the company to meet that criterion is for it to stay in business in State X. The level of gross receipts is not relevant.

Because the transitional credit is analogous to a long-term receivable that does not bear interest, the asset recorded for the transitional credit should be carried at discounted present value consistent with the guidance in ASC 835-30. The present value would be measured by discounting the cash flows based on the timing of the company’s projected utilization of the transitional credit.

2.4.2 Volatility

ASC 740’s focus on the balance sheet ordinarily will not materially impact the relationship between the tax provision and income before taxes in the financial statements. In certain circumstances, however, the income tax expense/benefit may not bear the normal relationship to income before taxes.

A major cause of volatility is new tax laws or legislative changes in tax rates. Such changes in any jurisdiction in which an entity operates could cause an immediate, cumulative adjustment of the deferred tax asset or liability, with a corresponding effect on the tax provision. The deferred tax previously provided on items that will become taxable or deductible in a future year will be adjusted downward or upward to reflect the new laws or rates. This effect of a tax law change is recorded in continuing operations, as required by ASC 740-10-45-15. See Chapter TX 7 for further discussion on the effects of the accounting for changes in tax laws.

A change in the need for a valuation allowance against deferred tax assets (as discussed in Chapter TX 6) also can cause considerable volatility in reported results. In each financial reporting period, an entity must estimate the extent to which deductible differences and carryforwards (that may have been established over a period of a number of years) are more-likely-than-not to be realized (i.e., reduce future taxes payable). Because deductible differences and carryforwards typically originate over a period of years, adjustments to record or release a valuation allowance against deferred tax assets may far exceed the current-year pretax income or loss. When an entity that has been historically profitable incurs a large loss, or when an entity with historical losses is able to demonstrate the ability to sustain profitability, changes in the valuation allowance will magnify the change in the trend of the entity’s operations by adding a deferred tax expense to the pretax loss or by adding a deferred tax benefit to the newly generated pretax income. For additional discussion of valuation allowances, see Chapter TX 5.

2.4.3 Need for Judgment

A significant level of judgment is required in applying ASC 740. For example, when reversals of temporary differences will generate net deductions, either in the aggregate or over a span of future years, the recognition of deferred tax assets is based importantly on management’s assessment of its future prospects. At any reporting date, management would have to assess, for example, whether there was sufficient positive evidence in loss year(s) to recognize at least some of the tax benefit. Furthermore, as the entity starts to earn profits, management would have to assess the amount by which the valuation allowance could be reduced. Such
an assessment would be necessary in each reporting period until the operating loss carryforward was realized or expired unused. While ASC 740 emphasizes the importance of objective evidence in making the assessment, the ultimate conclusion is bound to be subjective in many situations due to inherent estimates in forecasting future events.

The application of judgment is not limited to assessing the need for a valuation allowance. Judgment is required throughout the ASC 740 model. One of the most significant areas of judgment is the accounting for uncertain tax positions. ASC 740 prescribes a two-step approach for the recognition and measurement of tax benefits associated with significant uncertain tax positions taken by an entity that may be challenged and ultimately disallowed in whole or in part. This approach to accounting for uncertain tax positions, described more fully in Chapter TX 16, requires management’s judgment in both the assessment of the technical merits of the underlying tax position (i.e., “recognition”) and in the measurement of the amount of tax benefit (i.e., “measurement”) to be recorded (to the extent the position meets the more-likely-than-not benefit recognition threshold).
Chapter 3:
Temporary Differences
Chapter Summary

Temporary differences are the basis of the deferred tax calculation. A temporary difference exists when any difference between the tax basis of an asset or a liability and its reported amount in financial statements will result in taxable income or deductions upon the reversal of the difference. As discussed in Section TX 3.1, the recognition and measurement model under ASC 740 provides guidance for computing the tax bases of assets and liabilities for financial reporting purposes.

If a basis difference will not affect future taxable income, it is not a temporary difference. ASC 740-10-25-20 presents eight examples of taxable and deductible temporary differences; the first four are temporary differences resulting from items that are included within both pretax income and taxable income but in different periods. The other examples are temporary differences recorded in a business combination; temporary differences created by fixed asset indexation for tax purposes in jurisdictions that allow it; and two different types of temporary differences related to investment tax credits and certain other tax credits. These eight examples are not all inclusive. Other events not described in ASC 740-10-25-20 may give rise to temporary differences. Whatever the event or circumstance, a temporary difference will arise when a basis difference is expected to result in taxable or deductible amounts when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively.
Excerpts from ASC 740

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.

ASC 740-10-25-19:
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.

ASC 740-10-25-20:
An assumption inherent in an entity's statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples include the following:

a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

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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 reduced tax credit (that is, investment tax credit and certain other tax credits) or taking the full tax credit and 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. There may be differences between the tax bases of the assets and the recognized values of assets acquired and liabilities assumed in a business combination. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

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ASC 740-10-25-21:
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.

ASC 740-10-25-22:
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.

ASC 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 (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.

ASC 740-10-25-24:
Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting.

ASC 740-10-25-25:
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.

(continued)
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.

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.

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.

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).

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 nets assets of the acquired entity.

### 3.1 Temporary Difference—Defined

The definition of a temporary difference per ASC 740-10-20 is 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. ASC 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 ASC 740-10-05-10 and ASC 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.

Chapter TX 16, Accounting for Uncertainty in Income Taxes, includes a comprehensive analysis of the accounting for uncertainty in income taxes. While generally beyond the scope of this chapter, the recognition and measurement model affects the deferred tax calculation. That is, the tax bases of assets (including carryforwards) and liabilities are based on amounts that meet the recognition threshold and are measured pursuant to the measurement requirements. A tax basis computed pursuant to the recognition and measurement model may be different from a tax basis computed for and reported on a filed or expected-to-be-filed tax return. The model makes it clear that the tax basis that meets its recognition and measurement principles is the basis that should be used to calculate a temporary difference. Because many companies will start with a tax basis taken (or expected to be taken) on a tax return (because that information is more readily available), adjustments may be necessary to properly reflect the tax basis pursuant to the model. The following example illustrates the effect that a tax basis computed pursuant to the recognition and measurement model has on temporary differences and the deferred tax calculation:

Example 3-1: Temporary Differences and Tax Bases

Background/Facts:
A fixed asset was placed in service in a prior period with a cost basis for book and tax purposes of $2,000. In the current reporting period, the fixed asset has a book basis of $1,600 and zero tax basis (i.e., for book purposes, the asset is being depreciated over 10 years in equal amounts, while for tax purposes it was depreciated over two years). Hence, the $1,600 basis difference is attributable to accelerated depreciation deductions for tax purposes. However, under the recognition and measurement model for unrecognized tax benefits, the greatest amount of tax depreciation that should have been recorded on the prior and current tax returns cumulatively as of the reporting date is $800, not $2,000.

Question(s):
What is the fixed asset tax basis for financial statement purposes? What is the relevant temporary difference for the deferred tax calculation?

Analysis/Conclusion:
The tax basis for financial statement purposes is $1,200, which is the difference between the $2,000 cost basis and the $800 total tax depreciation deduction under the recognition and measurement principles. Therefore, the temporary difference relating to the fixed asset is $400, which is the difference between the $1,600 book
basis reported in the financial statements and the $1,200 tax basis. Assuming an applicable tax rate of 35 percent, a deferred tax liability of $140 (i.e., 35 percent multiplied by the temporary difference of $400) would be recorded. In addition, a liability for unrecognized tax benefits of $420 is recognized (tax basis of $1,200 less tax basis on the tax return of $0 multiplied by 35 percent). See Chapter TX 16 for further discussion of the recognition and measurement model for unrecognized tax benefits.

3.2 Examples of Temporary Differences

As previously noted, the first four examples of temporary differences in ASC 740-10-25-20 result from items that are included within both pretax income and taxable income, but in different periods (for example, an asset is depreciated over a different period for book than for tax purposes). The remaining four examples illustrate other events that create book and tax basis differences, which are discussed below.

3.2.1 Business Combinations (ASC 740-10-25-20(h))

ASC 740 mandates that deferred taxes be provided for temporary differences that arise from a business combination. The differences between the book basis (as determined under ASC 805, *Business Combinations*) and the tax basis (as determined under the tax law and considering ASC 740’s recognition and measurement model) of the assets acquired and liabilities assumed will be temporary differences that result in deferred tax assets and liabilities. Section TX 10.4 discusses the accounting for deferred taxes in business combinations.

3.2.2 Indexation (ASC 740-10-25-20(g))

Fixed asset temporary differences are impacted by indexation in tax jurisdictions where the tax law allows the tax basis of assets to be indexed and when the tax returns are filed in the functional currency. The benefit of the upward revaluation of the tax basis will be recognized immediately if it satisfies the realization test. The tax laws of only a few countries permit indexing (other than countries that are hyperinflationary, which must use the U.S. dollar as the functional currency). As discussed in Section TX 2.3.5 and Section TX 11.5.5, if a company’s functional currency is not the local currency, the company must exclude the impact that indexing has on the tax basis from its determination of deferred taxes. Therefore, while some countries (e.g., hyperinflationary countries) typically provide for indexing, deferred taxes would not consider the effect of indexing on a tax basis.

3.2.2.1 Temporary Differences Related to U.K. Buildings

Deferred tax accounting related to U.K. buildings is complicated because U.K. buildings, with a limited exception, are not depreciated for tax purposes, although the tax basis is deducted in determining capital gain or loss upon disposal. The tax basis for determining capital gain is the original cost of the building plus indexation.

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1. This discussion is limited to U.K. buildings, and does not apply to land, fixtures or other types of property, plant and equipment that are not subject to the unique rules applicable to office, industrial and agricultural buildings in the U.K.

2. If a building was acquired prior to March 31, 1982, companies can use a “March 82 value,” instead of its actual original cost, when calculating capital gain or loss on disposal. This is the market value of the property as of March 31, 1982.
for changes in the retail pricing index; however, the tax basis for determining any capital loss is limited to the original cost\(^2\) of the building. Therefore, indexation cannot create or increase a capital loss. The discussion herein is divided into two types of commercial real estate: office buildings, and industrial and agricultural buildings. Separate analysis is needed because changes to U.K. tax law enacted in 2008 phased out tax depreciation through 2011 for industrial and agricultural buildings.

Office Buildings:

Deferred tax assets recorded for U.K. office buildings may potentially have two components. First, there is a deferred tax asset (DTA) arising from book depreciation (because there is no tax depreciation). Second, there may be an incremental DTA arising from indexation. That is, an incremental DTA may be recorded in addition to the regular DTA from book depreciation if the expected tax on disposition after considering indexation would be less than the expected tax without considering indexation.

Therefore, the primary accounting issue needing consideration is whether the tax basis created by indexation will provide an incremental tax benefit upon ultimate disposition. The answer depends on whether the building is expected to be sold for gain. We believe there are two acceptable alternatives to determine the expected capital gain and the effect of indexation:

- **Alternative 1:** determine the selling price (fair market value) and the indexed tax basis as of the current balance sheet date.
- **Alternative 2:** estimate the selling price and the projected future indexed tax basis of the building at the projected time of sale.

Mechanically, the calculation of the gain or loss under the two alternatives is the same. The difference is the use of an estimated sale price and an indexed tax basis as of the current balance sheet date (alternative 1) versus at an estimated future date (alternative 2). While either of the two alternatives is acceptable, the remaining discussion herein is limited to alternative 1 because, in practice, most companies follow this alternative.

The following example demonstrates the analysis required to determine whether indexation provides an incremental tax benefit.

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**Example 3-2: U.K. Buildings—Temporary Differences**

A U.K. office building is purchased in 1999 for £100. As of December 31, 2000, the book value of the building (net of accumulated depreciation) is £90. Accordingly, there is a book-tax basis difference at the balance sheet date is £10 (the difference between the original cost and the carrying amount, which is related to accumulated depreciation).

\(\text{(continued)}\)

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\(^2\) If a building was acquired prior to March 31, 1982, companies can use a “March 82 value,” instead of its actual original cost, when calculating capital gain or loss on disposal. This is the market value of the property as of March 31, 1982.
The reporting entity needs to determine whether there is an incremental deductible temporary difference arising from indexing and it follows alternative 1 (i.e., selling price and indexed tax basis are determined as of the current balance sheet date).

The table below illustrates whether indexing provides incremental tax benefit at various levels of current balance-sheet-date projected selling prices and indexing:

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Tax Basis (i.e., Cost)</td>
<td>Net Book Value (i.e., Cost Less Depreciation)</td>
<td>Deductible Temporary Difference</td>
<td>Indexed Tax Basis (at the Current Balance Sheet Date)</td>
<td>Potential Incremental Temporary Difference (D - A)</td>
<td>Projected Selling Price (at the Current Balance Sheet Date)</td>
<td>Gain With Indexing (Excess, if Any, of F Over D)</td>
<td>Gain Without Indexing (Excess, if Any, of F Over A)</td>
<td>Incremental Temporary Difference From Indexing Tax Basis (Excess, if Any, of H Over G)</td>
<td>Total Deductible Temporary Difference (C + I)</td>
</tr>
<tr>
<td>£100</td>
<td>£90</td>
<td>£10</td>
<td>£105</td>
<td>£5</td>
<td>£125</td>
<td>£20</td>
<td>£25</td>
<td>£5</td>
<td>£15</td>
</tr>
<tr>
<td>100</td>
<td>90</td>
<td>10</td>
<td>105</td>
<td>5</td>
<td>100</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>100</td>
<td>90</td>
<td>10</td>
<td>140</td>
<td>40</td>
<td>130</td>
<td>0</td>
<td>30</td>
<td>30</td>
<td>40</td>
</tr>
</tbody>
</table>

There are also ancillary issues to consider:

- **Prohibition of Discounting**—the prohibition in ASC 740 on discounting deferred taxes is not changed with respect to the DTA recorded for indexation.

- **Valuation Allowance**—a valuation allowance would be provided if DTAs are not expected to be realized. In the case of U.K. buildings, because capital gains can be used to offset ordinary (trading) current-year losses, the reduction of a capital gain on a specific building (e.g., as a result of indexing) may not reduce future tax payable. As a result, the realization assessment of capital loss items cannot be done in isolation from the realization assessment of ordinary losses. The reporting entity must project overall income in the U.K. jurisdiction to support realization of the deferred tax asset. If, when estimating future taxes, capital losses will not be utilized, a valuation allowance is required to the extent that consideration of the balance-sheet-date DTAs increases the unused losses from all sources (i.e., ordinary or trading and capital losses).

- **Use of Indexing to Reduce a Deferred Tax Liability (DTL)**—Occasionally, a company sells a building and reinvests the proceeds in a replacement building, which will also be used in the business. In the U.K., any capital gain can be “rolled over” (i.e., applied to reduce the tax basis of the new building). As a result, a taxable temporary difference (the excess of cost over tax basis) arises for the new building. A deferred tax liability would be established. The temporary difference would generally reverse based on the future book depreciation of the replacement asset to be recognized subsequent to the balance sheet date.

For example, assume the sale of a building gives rise to £1 million capital gain for tax purposes. That gain is “rolled over” so that a replacement building costing £10 million has a tax basis of £9 million. For ASC 740 purposes, there will initially be a taxable temporary difference of £1 million for which a deferred tax liability would be recorded upon the “roll over,” and it will be deemed to reverse over the period it will take for the original book cost to be depreciated to a net book value of £9 million.
The question is whether the taxable temporary difference can be reduced in future years not only by book depreciation, but also by tax indexing when it is expected to provide incremental tax benefit. We believe that the annual indexation amount, which is tied to future years' inflation rates, is a discrete event and should not be anticipated for purposes of not recognizing a deferred tax liability. Rather, the existing tax basis of the asset must be considered when an entity measures the temporary difference and the impact of indexation on deferred taxes should be recognized in each future year when the annual indexation rate is determined.

Industrial and Agricultural Buildings:

The 2008 U.K. Finance Act phases out tax depreciation on industrial and agricultural buildings over a four-year period from 2008 to 2011, and allows for losses on the sale of industrial and agricultural buildings to be treated as capital losses (previously these losses were treated as ordinary losses). Because tax depreciation will not be allowed starting from 2012, the accounting issue needing consideration is whether temporary differences that originated from depreciation should be reversed. The assessment was required when the 2008 Finance Act was enacted.

We accepted two supportable alternatives for determining the amount of deferred taxes related to industrial and agricultural buildings. The alternative selected is an accounting policy choice which should be applied consistently.

• Alternative A—Under Alternative A, the only relevant tax basis, after the depreciation phase-out period, for which temporary differences should be calculated, is the tax basis on sale. ASC 740 presumes that any sale will be at book value. However, the relevant tax basis assumed to exist on sale depends on whether the sale is expected to produce gain or loss. If the sale is expected to produce gain (i.e., the adjusted book basis is greater than the original cost adjusted for indexation), the tax basis is assumed to be the original cost adjusted for indexing. If the sale is expected to produce a loss (i.e., the adjusted book basis is less than the adjusted tax basis), the tax basis is assumed to be the adjusted tax basis (original cost less accumulated tax depreciation). A deferred tax liability that arose from prior book-tax depreciation differences would be retained if a gain is expected. Conversely, a deferred tax asset (subject to realization assessment) would exist if a loss is expected. However, if neither gain nor loss is expected (i.e., when the adjusted book basis is less than the original cost adjusted for indexation, but greater than the adjusted tax basis) no deferred taxes would be needed because there would be no anticipated tax consequences for the presumed sale at book value.

• Alternative B—Under Alternative B the adjusted tax basis continues to be the relevant tax basis to use to determine which temporary differences should be calculated because the potential future tax benefit that the company would be entitled to upon abandonment of the building (i.e., capital loss) has been reduced by the tax depreciation already taken. This alternative is supported by ASC 740-10-25-20(d), which indicates that expenses that are deductible before they are recognized in financial income are temporary differences, and that, in this case, amounts received upon the future recovery of the book value of the building will exceed the remaining tax basis and consequently will be taxable when the asset is recovered. Under this alternative, the accounting for existing and additional depreciation-related temporary difference does not change as a result of the enactment of the U.K. Finance Act of 2008.

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3 This may occur, for example, as a result of a revaluation arising from a non-taxable business combination.
The following example highlights the differences between Alternative A and Alternative B:

Assume a company has an industrial building with an original cost adjusted for indexation of £1,200, adjusted book basis of £1,000 and an adjusted tax basis of £700. Using these facts, prior to enactment of the Finance Act, a deferred tax liability would have been recorded for the tax effect of the £300 taxable temporary difference (i.e., no impact for indexing on the deferred taxes).

Following Alternative A, the company assumes sale of the building at the book value. Accordingly, because the book basis is greater than the tax basis, but less than the original cost adjusted for indexation, the sale is not expected to produce gain and therefore the deferred tax liability is no longer necessary and can be reversed.

Following Alternative B, the adjusted tax basis is still relevant. Therefore, a deferred tax liability should continue to be provided. This depreciation-related temporary difference will reverse as the building is depreciated for book purposes.

Under both alternatives, continued book depreciation will eventually result in an adjusted tax basis in excess of the book basis. A deferred tax asset (subject to realization assessment) would be recorded for the deferred tax asset arising from book depreciation. Additionally, the accounting related to the incremental DTA from indexation, discussed in the context of U.K. office buildings, would also be considered. The alternative used to determine the expected capital gain and the effect of indexation for office buildings is considered an accounting policy choice which should be consistently applied to agricultural and industrial buildings.

3.2.3 Temporary Differences Related to Investment Tax Credits (ASC 740-10-25-20(e) and (f))

1. The “deferral” method, under which the tax benefit from an investment tax credit (ITC) is deferred and amortized over the book life of the related property.

2. The “flow-through” method, under which the tax benefit from an ITC is recorded immediately in the period that the credit is generated (to the extent permitted by tax law).

ASC 740-10-25-46 indicates that the deferral method is preferable. The use of one of these methods would reflect a choice of accounting policy, which should be consistently applied.

When the deferral method is elected, the tax benefit from ITCs is typically reflected in pretax income (i.e., as a reduction of depreciation expense). However, we are aware of another acceptable interpretation under which the tax benefit is recognized in the income tax provision over the life of the asset. That is, instead of reducing the cost basis of the qualifying asset, a deferred credit is recognized for ITCs. The deferred credit is released to the income statement through the income tax provision over the life of the qualifying asset. An entity should adopt an accounting policy relating to the manner of applying the deferral method.

What differentiates an ITC from other income credits and from grants is not always easy to discern, because they often share at least a few characteristics. Considerable care should be taken in assessing whether a particular credit should be accounted for as an investment credit, an income tax credit, a non-income tax credit, or a governmental grant. Refer to Section TX 1.2.3 for discussion of the determination of whether credits and other tax incentives should be accounted for under ASC 740.
In accordance with ASC 740-10-25-20(e) and 25-20(f), a temporary difference may arise when accounting for an ITC depending on which accounting method is selected and the extent, if any, to which the tax law requires that the company reduce its tax basis in the property. In applying the deferral and flow-through methods, we believe there are two alternative methods of accounting for any resulting temporary difference:

1. The “gross-up” method, under which deferred taxes related to the temporary difference are recorded as adjustments to the carrying value of the qualifying assets.\(^4\)

2. The “income statement” method, under which deferred taxes related to the temporary difference are recorded in income tax expense.\(^5\)

Similar to the choice between the deferral and flow-through methods, the use of one of these accounting methods reflects a choice of accounting policy that should be consistently applied.

The following examples illustrate application of these methods:

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**Example 3-3: Accounting for Investment Tax Credits with No Tax Basis Reduction**

**Facts/Question:**
Company A is entitled to an ITC for 30% of the purchase price of certain qualifying assets. The ITC can be used to reduce the company’s income tax obligation in the year certain criteria are met. However, the tax law does not result in a reduction to the tax basis of the qualifying assets as a result of claiming the ITC. The applicable tax rate is 40%.

On January 1, 2010, Company A purchases $100 of qualifying assets (i.e., property). The assets will be depreciated for both financial statement and tax purposes on a straight-line basis over a 5-year period.

How should Company A account for the ITC?

**Analysis/Conclusion:**
As discussed in Section TX 3.2.3, there are two acceptable methods of accounting for ITCs:

1. The deferral method; and
2. The flow-through method.

In accordance with ASC 740-10-25-20(e) and 25-20(f), a temporary difference may arise when accounting for an ITC depending on which accounting method is selected and the extent, if any, to which the tax law requires that the company reduce its tax basis in the property.

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\(^4\) The gross-up method is supported by reference to ASC 740-10-25-49 through 25-55; ASC 740-10-45-22 through 45-24; and ASC 740-10-55-171 through 55-182.

\(^5\) The income statement method is conceptually consistent with the flow-through method, which ASC 740-10-25-46 identifies as an allowable method of accounting for investment tax credits.
Further, as discussed in TX 3.2.3, in applying the deferral and flow-through methods we believe there are two alternative methods of accounting for the resulting temporary differences:

1. The gross-up method; and
2. The income statement method.

Both the choice between the deferral method and the flow-through method, and the choice between the gross-up method and the income statement method represent accounting policy choices which should be applied consistently.

The Deferral Method:

As discussed in TX 3.2.3, the deferral method is preferable. Under the deferral method, the ITC received ($30) is reflected as a reduction in income taxes payable and the carrying value of the qualifying assets. This will result in less depreciation expense over the life of the asset and higher pre-tax income than would be the case under the flow-through method. The deferral method will result in less of a benefit to income taxes (as compared to the flow-through method) over the life of the asset.

In this example, a deductible temporary difference arises since the recorded amount of the qualifying assets will be reduced by $30, the amount of the ITC, to $70 while the tax basis is not reduced by the ITC. The accounting for the temporary difference depends upon whether the company uses the gross-up or income statement method.

a. **The gross-up method.** As a result of the adjustment described above, there is a deductible temporary difference of $30 related to the qualifying assets. Under the gross-up method, the related deferred tax asset (DTA) would give rise to a reduction in the recorded amount of the qualifying assets which, in turn, would increase the deductible temporary difference related to the qualifying assets. To avoid this iterative process, the amounts assigned to the qualifying assets and the related DTA can be determined using the simultaneous equations method. In this example, the simultaneous equations method yields a DTA of $20 and a reduction to the recorded amount of the qualifying assets of $20. Thus the qualifying assets should be recorded at $50 ($100 purchase price less the $30 ITC less the $20 DTA determined here) together with a DTA of $20. Under the gross-up method, the following journal entries are recorded at the time the ITC is received, January 1, 2010:

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\begin{align*}
&\text{Dr Income tax payable/cash} \quad \$30 \\
&\text{Cr PP&E} \quad \$30 \\
&\text{To record the receipt of the ITC}
\end{align*}
\]

\[
\begin{align*}
&\text{Dr Deferred tax asset} \quad \$20 \\
&\text{Cr PP&E} \quad \$20 \\
&\text{To record the deferred tax asset based on the simultaneous equations method}
\end{align*}
\]

In the subsequent years, 2010 through 2014, the following entries are recorded:

\[
\begin{align*}
&\text{Dr Depreciation expense} \quad \$10 \\
&\text{Cr Accumulated depreciation} \quad \$10 \\
&\text{To record annual depreciation expense over the book life of the asset}
\end{align*}
\]

(continued)
b. **The income statement method.** Under the income statement method, there is no use of the simultaneous equations method. The *deductible temporary difference* of $30 results in the recognition of a $12 DTA and a corresponding immediate benefit in the income tax provision. Under the income statement method, the following entries are recorded at the time the ITC is received, January 1, 2010:

- **Dr Income tax payable/cash $30**
  - Cr PP&E $30
  - *To record the receipt of the ITC*

- **Dr Deferred tax asset $12**
  - Cr Deferred tax expense $12
  - *To record the deferred tax benefit related to the ITC*

In the subsequent years, 2010 through 2014, the following entries are recorded:

- **Dr Depreciation expense $14**
  - Cr Accumulated depreciation $14
  - *To record annual depreciation expense over the book life of the asset*

- **Dr Income tax payable/cash $8**
  - Cr Current income tax expense $8
  - *To record current benefit from depreciation (tax depreciation expense, $20, x 40 percent tax rate)*

- **Dr Deferred tax expense $2.4**
  - Cr Deferred tax asset $2.4
  - *To adjust the deferred tax asset based on book and tax depreciation*

The Flow-Through Method:

Under the flow-through method the ITC received ($30) is reflected in a reduction to income taxes payable and a current income tax benefit. In this example, under the flow-through method the gross-up and income statement methods are not applicable because the ITC does not result in a change in the tax basis of the qualifying assets and, therefore, *there is no resulting temporary difference*. The following journal entries are recorded under the flow-through method:

- **Dr Income tax payable/cash $30**
  - Cr Current income tax expense $30
  - *To record the receipt of the ITC at January 1, 2010*

(continued)
Dr Depreciation expense $20
Cr Accumulated depreciation $20
*To record annual depreciation expense over the book life of the asset (i.e., for the years December 31, 2010 through December 31, 2014)*

Dr Income tax payable/cash $8
Cr Current income tax expense $8
*To record current benefit from depreciation (tax depreciation expense, $20, x 40 percent tax rate) over the tax life of the asset (i.e., for the years December 31, 2010 through December 31, 2014)*

A Comparison of the Financial Statement Impact of the Methods:

The following table demonstrates the cumulative impact to the various income statement captions under each of the methods during the life of the qualifying assets:

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Flow-through—Gross-up</th>
<th>Deferral—Gross-up</th>
<th>Deferral—Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax income (depreciation expense)</td>
<td>$(100)</td>
<td>$(50)</td>
<td>$(70)</td>
</tr>
<tr>
<td>Income tax benefit related to credit</td>
<td>30</td>
<td>0</td>
<td>12</td>
</tr>
<tr>
<td>Income tax benefit related to depreciation</td>
<td>40</td>
<td>20</td>
<td>28</td>
</tr>
<tr>
<td>Net Income</td>
<td>$(30)</td>
<td>$(30)</td>
<td>$(30)</td>
</tr>
</tbody>
</table>

**Example 3-4: Accounting for Investment Tax Credits with Tax Basis Reduction**

**Facts/Question:**
Company A is entitled to an ITC for 30% of the purchase price of certain qualifying assets. The ITC can be used to reduce the company’s income tax obligation in the year certain criteria are met. However, the tax law requires that the tax basis of the qualifying assets be reduced by 50% of the ITC (e.g., a $30 ITC reduces the tax basis by $15). The applicable tax rate is 40%.

On January 1, 2010, Company A purchases $100 of qualifying assets (i.e., property). The assets will be depreciated for both financial statement and tax purposes on a straight-line basis over a 5-year period.

How should Company A account for the ITC?

**Analysis/Conclusion:**
As discussed in Section TX 3.2.3, there are two acceptable methods of accounting for ITCs:

1. The deferral method; and
2. The flow-through method.

In accordance with ASC 740-10-25-20(e) and 25-20(f), a temporary difference may arise when accounting for an ITC depending on which accounting method is selected and the extent, if any, to which the tax law requires that the company reduce its tax basis in the property. In a scenario where the tax law requires that the tax basis be

(continued)
reduced, the application of the deferral method will result in a deductible temporary difference if the amount of the basis reduction required is less than the amount of the ITC. Alternatively, application of the flow-through method will result in a taxable temporary difference.

Further, as discussed in TX 3.2.3, in applying the deferral and flow-through methods we believe there are two alternative methods of accounting for the resulting temporary differences:

1. The gross-up method; and
2. The income statement method.

Both the choice between the deferral method and the flow-through method, and the choice between the gross-up method and the income statement method represent accounting policy choices which should be applied consistently.

The Deferral Method:

As discussed in TX 3.2.3, the deferral method is preferable. Under the deferral method, the ITC received ($30) is reflected as a reduction in income taxes payable and the carrying value of the qualifying assets. This will result in less depreciation expense over the life of the asset and higher pre-tax income than would be the case under the flow-through method. The deferral method will result in less of a benefit to income taxes (as compared to the flow-through method) over the life of the asset.

In this example, a deductible temporary difference arises because the recorded amount of the qualifying assets will be reduced by $30, the amount of the ITC, to $70 while the tax basis is reduced by $15 (50% of the ITC) to $85. The accounting for the temporary difference depends upon whether the company uses the gross-up or income statement method.

a. **The gross-up method.** As a result of the adjustments described above, there is a deductible temporary difference of $15 related to the qualifying assets. Under the gross-up method, the related DTA would give rise to a reduction in the recorded amount of the qualifying assets which, in turn, would increase the deductible temporary difference related to the qualifying assets. To avoid this iterative process, the amounts assigned to the qualifying assets and the related DTA can be determined using the simultaneous equations method. In this example, the simultaneous equations method yields a DTA of $10 and a reduction to the recorded amount of the qualifying assets of $10. Thus, the qualifying assets should be recorded at $60 ($100 purchase price less the $30 ITC less the $10 DTA determined here) together with a DTA of $10. Under the gross-up method, the following journal entries are recorded at the time the ITC is received, January 1, 2010:

\[
\begin{align*}
\text{Dr Income tax payable/cash} & \quad \$30 \\
\text{Cr PP&E} & \quad \$30 \\
\text{To record the receipt of the ITC} & \quad \\
\end{align*}
\]

\[
\begin{align*}
\text{Dr Deferred tax asset} & \quad \$10 \\
\text{Cr PP&E} & \quad \$10 \\
\text{To record the deferred tax asset based on the simultaneous equations method} & \quad
\end{align*}
\]

(continued)
In the subsequent years, 2010 through 2014, the following entries are recorded:

Dr Depreciation expense $ 12
Cr Accumulated depreciation $ 12
To record annual depreciation expense over the book life of the asset

Dr Income tax payable/cash $6.8
Cr Current tax expense $6.8
To record current benefit from depreciation (tax depreciation expense, $17, x 40 percent tax rate)

Dr Deferred tax expense $ 2
Cr Deferred tax asset $ 2
To adjust the deferred tax asset based on book and tax depreciation

b. The income statement method. Under the income statement method, there is no use of the simultaneous equations method. The deductible temporary difference of $15 results in the recognition of a $6 DTA and a corresponding immediate benefit in the income tax provision. Under the income statement method, the following entries are recorded at the time the ITC is received, January 1, 2010:

Dr Income tax payable/cash $ 30
Cr PP&E $ 30
To record the receipt of the ITC

Dr Deferred tax asset $ 6
Cr Deferred tax expense $ 6
To record the deferred tax benefit related to the ITC

In the subsequent years, 2010 through 2014, the following entries are recorded:

Dr Depreciation expense $ 14
Cr Accumulated depreciation $ 14
To record annual depreciation expense over the book life of the asset

Dr Income tax payable/cash $6.8
Cr Current tax expense $6.8
To record current benefit from depreciation (tax depreciation expense, $17, x 40 percent tax rate)

Dr Deferred tax expense $1.2
Cr Deferred tax asset $1.2
To adjust the deferred tax asset based on book and tax depreciation

The Flow-Through Method:

Under the flow-through method the ITC received ($30) is reflected in a reduction to income taxes payable and a current income tax benefit. While, under the flow-through method, there is no reduction to the recorded amount of the qualifying assets as a direct result of receiving the ITC, in this example the tax basis of the qualifying assets is reduced by 50% of the amount of the ITC. Therefore, the recorded amount of the qualifying assets remains at $100 while the tax basis is reduced to $85, resulting in a taxable temporary difference of $15. The accounting for the related deferred tax liability depends upon whether the company uses the gross-up or income statement method.

(continued)
a. **The gross-up method.** As a result of the adjustment described above, there is a taxable temporary difference of $15 in the qualifying assets. Under the gross-up method, the related DTL would give rise to an increase in the recorded amount of the qualifying assets, which, in turn, increases the taxable temporary difference related to the qualifying assets. As described under the deferral method, to avoid this iterative process, the simultaneous equations method is used to determine the related DTL and recorded amount of the qualifying assets. In this example, the simultaneous equations method will result in recording the qualifying assets at $110, with a DTL of $10. Under the gross-up method, the following journal entries are recorded:

- Dr Income tax payable/cash $30
  Cr Current tax expense $30
  *To record the receipt of the ITC at January 1, 2010*

- Dr PP&E $10
  Cr Deferred tax liability $10
  *To record the deferred tax liability based on the simultaneous equations method*

- Dr Depreciation expense $22
  Cr Accumulated depreciation $22
  *To record annual depreciation expense over the book life of the asset (i.e., for the years December 31, 2010 through December 31, 2014)*

- Dr Income tax payable/cash $6.8
  Cr Current tax expense $6.8
  *To record current benefit from depreciation (tax depreciation expense, $17, x 40 percent tax rate) over the tax life of the asset (i.e., for the years December 31, 2010 through December 31, 2014)*

- Dr Deferred tax liability $2
  Cr Deferred tax expense $2
  *To adjust the deferred tax asset based on book and tax depreciation for the years December 31, 2010 through December 31, 2014*

b. **The income statement method.** Under the income statement method, there is a $15 taxable temporary difference resulting in the recognition of a $6 DTL and a corresponding immediate expense in the income tax provision. Under the income statement method, the following journal entries are recorded:

- Dr Income tax payable/cash $30
  Cr Current tax expense $30
  *To record the receipt of the ITC at January 1, 2010*

- Dr Deferred tax expense $6
  Cr Deferred tax liability $6
  *To record the deferred tax liability related to the book-over-tax basis difference at January 1, 2010*

- Dr Depreciation expense $20
  Cr Accumulated depreciation $20
  *To record annual depreciation expense over the book life of the asset (i.e., for the years December 31, 2010 through December 31, 2014)*

(continued)
Dr Income tax payable/cash $6.8
   Cr Current tax expense $6.8
To record current benefit from depreciation (tax depreciation expense, $17, x 40 percent tax rate) over the tax life of the asset (i.e., for the years December 31, 2010 through December 31, 2014)

Dr Deferred tax liability $1.2
   Cr Deferred tax expense $1.2
To adjust the deferred tax asset based on book and tax depreciation for the years December 31, 2010 through December 31, 2014

A Comparison of the Financial Statement Impact of the Methods:

The following table demonstrates the cumulative impact to the various income statement captions under each of the methods during the life of the qualifying assets:

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Flow-through—Gross-up</th>
<th>Flow-through—Income Statement</th>
<th>Deferral—Gross-up</th>
<th>Deferral—Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax income (depreciation expense)</td>
<td>$(110)</td>
<td>$(100)</td>
<td>$(60)</td>
<td>$(70)</td>
</tr>
<tr>
<td>Income tax benefit related to credit</td>
<td>30</td>
<td>30</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Income tax benefit related to depreciation</td>
<td>44</td>
<td>34</td>
<td>24</td>
<td>28</td>
</tr>
<tr>
<td>Net Income</td>
<td>$(36)</td>
<td>$(36)</td>
<td>$(36)</td>
<td>$(36)</td>
</tr>
</tbody>
</table>

3.2.3.1 Foreign Investment Tax Credits and Grants

Similar treatment is appropriate for ITCs earned in foreign tax jurisdictions. Some foreign countries make investment grants that do not depend on tax reductions for realization and that might not be taxable. It appears that deferred grants generally should be treated as temporary differences in the computation of deferred foreign tax, potentially with the flow-through effect (described previously) for U.S. investment credits.

The following example illustrates the calculation of the temporary differences associated with foreign grants:

Example 3-5: Temporary Differences Associated with Foreign Grants

**Background/Facts:**
Company A receives a government grant that will fully reimburse it for the acquisition of a $100 fixed asset. The applicable tax law requires that the grant proceeds reduce the tax basis of the fixed asset; in this instance, the tax basis is reduced to zero and will not provide any future tax deductions from depreciation or upon sale. For financial reporting purposes, Company A records the fixed asset at $100 and records the $100 of grant proceeds as a deferred revenue liability. The deferred revenue will be recognized over a time period and pattern consistent with the fixed...
asset depreciation. Thus, at the date of acquisition of the asset/receipt of the grant, Company A has (1) a taxable temporary difference resulting from the excess of the book basis of the fixed asset ($100) over its tax basis ($0) and (2) a deductible temporary difference resulting from the excess of the book basis of the deferred revenue liability ($100) over its tax basis ($0).

**Question:**
Should the temporary differences associated with the fixed asset and deferred revenue be netted or evaluated individually in determining deferred tax balances?

**Analysis/Conclusion:**
We believe that either approach is acceptable. Company A needs to elect an accounting policy and consistently apply it. As discussed above, two separate temporary differences exist. However, in an analogous situation, ASC 740-10-25-20(f) indicates that investment tax credits are viewed as a reduction of the cost of the related asset for tax purposes. This would seem to indicate that the temporary differences associated with the fixed asset and deferred revenue may be netted and compared with the tax basis. In this instance, there would be no net book or tax basis associated with the fixed asset, and no deferred tax balances would be required.

In this fact pattern, there would be no practical difference between the two approaches. Deferred tax liabilities related to fixed assets are generally noncurrent, and because the deferred revenue will be recognized over a time period and pattern consistent with the fixed asset depreciation, the related deferred tax asset also would be classified as noncurrent. Thus, the balance sheet presentation would be the same under both methods. Also, because the temporary differences will reverse in exactly offsetting amounts in all future periods, there would be no difference in the tax provision under the net and gross methods. The only difference between the two methods is disclosure of a deferred tax asset and a deferred tax liability in the tax footnote under the “gross” approach.

### 3.2.3.2 Effect on Leases

The ASC 740 treatment of the deferred investment credit will affect the after-tax income patterns for direct-financing leases. For direct-financing leases, practice mostly has been to defer the investment credit and amortize it as additional return on the lessor’s investment. Thus, if there is no need for a valuation allowance in any period, there would be (1) a tax benefit reflected in income in the period that the investment credit is generated and used and (2) offsetting tax charges in later periods.

For leveraged leases, deferral of any available investment credit is a condition for using the ASC 840-10 leveraged-lease model. Section TX 2.3.2 discusses the effect of treating the deferred investment credit from a leveraged lease as a temporary difference.

### 3.2.4 Debt Instruments

Differences frequently arise between the financial reporting basis and the tax basis of debt instruments. These basis differences must be assessed to determine whether a temporary difference exists for which a deferred tax asset or liability should be provided. Often, the determination of whether a basis difference is a temporary difference will depend on the manner in which the liability is expected to be settled and whether the settlement method is within the company’s control.
3.2.4.1 Contingently Convertible Debt

A company issues contingently convertible debt that is convertible into common stock once the common stock reaches a target market price. In lieu of deducting the stated rate of interest actually paid to the note holders, the tax law allows the company, in certain cases, to deduct interest equal to that of comparable nonconvertible fixed-rate debt. Total interest deductions for tax purposes will therefore exceed total interest expense recognized for financial reporting purposes. However, interest deductions in excess of the stated rate will be recaptured for tax purposes, in whole or in part, if the debt is retired (either through redemption or at maturity) or converted to stock with a value of less than the adjusted tax basis of the debt.

Does the excess interest deduction result in a taxable temporary difference for which a deferred tax liability should be provided? In this example, reversal of the difference (i.e., recapture of the excess interest deduction) is not within the company’s control because conversion is at the option of the holder and, even upon conversion, interest recapture is dependent on the market value of the common stock at that time. We believe that a deferred tax liability should be recorded for the tax effect of redeeming the debt at its stated amount. Upon conversion of the notes, the deferred tax liability would be reversed, with a corresponding credit to additional paid-in capital for the tax effect of the conversion.

3.2.4.2 Convertible Debt and Call Option

A company purchases, in conjunction with issuing a convertible debt instrument, a call option to buy the same number of its own shares that it would have to issue if the holders elect to convert their interest to equity. The purchase of a call option is recorded in stockholder’s equity at inception and is not marked-to-market in subsequent periods consistent with ASC 815-40, Derivatives and Hedging. From a tax perspective, a purchased call option is treated as an original-issue discount and, as such, is (1) deductible as interest expense (in addition to cash interest) during the periods the liability is outstanding and (2) integrated with the stated principle resulting in an adjusted issue price (i.e., tax basis) that is lower than the liability’s carrying amount. The questions that arise are whether the future tax benefits from the original-issue discount represent a deductible temporary difference, consistent with ASC 740-10-25-20, and, in making this determination, should management’s expectation as to whether the holder will elect to convert its interest to equity factor into the analysis.

We believe that the reversal of the original-issue discount basis difference is not within the control of the issuer; instead, it is the holder of the note who controls whether to hold the debt or convert to equity; therefore, a deductible temporary difference exists. At inception, a deferred tax asset will need to be recognized through stockholder’s equity consistent with ASC 740-10-25-20, and, in making this determination, should management’s expectation as to whether the holder will elect to convert its interest to equity factor into the analysis.

ASC 470-20-15 clarifies that convertible debt instruments that may be settled in cash upon conversion, including instruments settled partially in cash, are not considered debt instruments within the scope of ASC 470-20. ASC 470-20-25 and 30 clarify that issuers of such instruments would have to account for the liability
and equity components of the instrument separately and in a manner that reflects interest expense at the interest rate of similar nonconvertible debt. That is, issuers of such instruments need to allocate the proceeds from issuance of the instrument between the liability component and the embedded conversion option (i.e., the equity component). This allocation is first done by determining the carrying amount of the liability component based on the fair value of a similar liability excluding the embedded conversion option, and then allocating to the embedded conversion option the excess of the initial proceeds ascribed to the convertible debt instrument over the amount allocated to the liability component. That excess is reported as a debt discount and is initially recognized in additional paid-in capital. In subsequent periods, it is amortized as interest cost over the instrument’s expected life using the interest method.

From a tax accounting perspective, the application of ASC 470-20 will often result in a basis difference associated with the liability component. The basis difference is measured as the difference between the liability component’s carrying value (i.e., the stated principle amount or par value adjusted for the debt discount created under the provisions of ASC 470-20) and the convertible debt instrument’s tax basis (which would generally be its original issue price adjusted for any original-issue discount or premium). While the debt discount is accreted to income, it is not considered deductible interest for tax purposes. Consequently, the accretion of the debt discount would result in tax consequences (i.e., a portion of the book interest expense would not be deductible) and the basis difference created by a debt discount is a temporary difference (consistent with ASC 740-10-25-20 and ASC 740-10-55-51). At inception, a deferred tax liability needs to be recorded through additional paid-in capital. In subsequent periods, the deferred tax liability will be reduced and a deferred tax benefit will be recognized through earnings as the debt discount is amortized to pre-tax income.

ASC 470-20 may apply to certain convertible debt instruments that contain contingent interest provisions (contingently convertible debt). It may also apply to convertible debt instruments for which the issuer purchases a call option on its own shares. Both of these instruments enable the issuer to receive additional tax deductions (in addition to cash interest) that may be more comparable with the tax benefit an issuer would expect to receive on nonconvertible debt. Companies that issue these forms of convertible debt will have to record deferred tax liabilities for the debt discount that arises as a result of applying the accounting model in the FSP in addition to recording deferred tax assets for tax original-issue discounts and deferred tax liabilities for potential recapture of interest deductions. While these temporary differences relate to the same liability and can be tracked and computed on a combined/net basis, companies may choose to separately track the temporary differences and the deferred tax amounts in their income tax provision work papers or tax accounting systems.

ASC 470-20 is effective for fiscal years beginning after December 15, 2008 and for interim periods within those fiscal years. It is required to be applied retrospectively to convertible debt instruments that are within the scope of this guidance and were outstanding during any period presented in the financial statements. A cumulative effect adjustment must be recognized as of the beginning of the first period presented.
3.2.4.3 Debt Instruments with Temporary Differences That May Not Result in Future Deductible Amounts

A company issues discounted convertible debt, which, for financial reporting purposes, is accreted to face value through a charge to interest expense over the life of the debt. For example, a company issues debt with a face value of $100 in exchange for $80 cash. The tax basis of the debt is $80. The book basis of the debt is also initially $80. However, for book purposes, the debt must be accreted to $100. In certain tax jurisdictions, the tax law allows deductions if the debt is extinguished by repurchase or repayment at maturity, but does not allow deductions if the debt is converted into equity. For book purposes, the debt is converted at its carrying value on the conversion date.

This leads to two questions: (1) is there a future deductible temporary difference between the book basis and tax basis of the debt, to the extent that the discount has been accreted for book purposes and (2) does the answer change if management expects the holders to convert the debt into equity (i.e., in which case there would be no future tax deduction)?

The FASB staff addressed this matter and indicated that a temporary difference exists to the extent that the debt has a different basis for book and tax purposes, irrespective of expectations that the holders are likely to convert. The FASB staff further indicated that ASC 740-10-25-30 would not apply in this situation (see Section TX 3.3 for a discussion of this guidance). The staff believes that the notion of “control” is implicit in the term “expects,” which is used in connection with management’s expectations regarding officer’s life insurance. Therefore, because the holders of the convertible debt (not management) control the outcome (debt vs. equity), it would not be appropriate to analogize this temporary difference to cash surrender value. Further, we believe that if the debt is ultimately converted to equity, the corresponding charge to reverse the deferred tax asset would be to shareholders’ equity in accordance with ASC 740-20-45-11(c), even though the tax benefit from establishing the deferred tax asset was originally credited to the income statement.

3.2.4.4 Convertible Debt with a Beneficial Conversion Feature and Detachable Warrants

ASC 740-10-55-51 concluded that the initial difference between the book value of convertible debt issued with a beneficial conversion feature (BCF) and its tax basis is a temporary difference. A resulting deferred tax liability should be recorded with an offset to additional paid-in capital in accordance with ASC 740-20-45-11(c). Pursuant to ASC 250-10, Accounting Changes and Error Corrections, the guidance should be applied by retrospective application to all instruments with a BCF accounted for under ASC 470-20, Debt. Therefore, this guidance would also be applicable to debt instruments that were converted (or extinguished) in prior periods, but are still presented in the financial statements.

For example, assume a company issues convertible debt with detachable warrants for total consideration of $200. Pursuant to ASC 470-20, $160 of the proceeds are allocated to the convertible debt and $40 of the proceeds are allocated to the warrants (additional paid-in capital). The company also records a BCF of $40 that further reduces the initial carrying amount of the debt to $120. Assume that (1) the conversion feature does not require bifurcation under ASC 815-10, (2) the warrants are accounted for as permanent equity, and (3) the company’s tax rate is 40 percent.
In this example, recognition of the BCF creates a $40 difference between the $120 financial reporting amount and the $160 tax basis of the debt. For convertible debt subject to ASC 470-20, this difference will reverse either through amortization of the discount or upon conversion or settlement of the debt. Pursuant to ASC 740-10-55-51, a $16 deferred tax liability should be established ($40 x 40%) upon issuance of the debt and warrants. The offset should be recorded to additional paid-in capital.

As the BCF is amortized, the related deferred tax liability is released to income. Because the BCF amortization is not a tax-deductible expense, the release of the deferred tax liability offsets the current tax expense.

### 3.2.4.5 Tax Implications of Induced Conversions ofConvertible Debt

Under ASC 470-20 an induced conversion results in an inducement charge that is measured as the fair value of the equity securities or other inducement consideration issued in excess of the fair value of the equity securities, which are issuable pursuant to the original conversion terms. However, a taxable gain could result from an induced conversion transaction if the carrying value of the debt were to exceed the market value of the equity securities issued. A loss for tax purposes cannot result from such a transaction. ASC 740-20-45-11(c) indicates that the tax effect of an increase or decrease to contributed capital is charged or credited directly to shareholders’ equity. Accordingly, the taxes paid on the tax gain resulting from conversion should be charged to equity.

Assume, for example, the following fact pattern:

- An entity issues a $1,000 convertible bond with a 6 percent coupon rate.
- The bond is originally convertible into twenty-five shares of common stock.
- The market price of the stock at the date on which the bond was issued is $40.
- Subsequently, the market price of the stock drops to $20, and the entity offers an additional fifteen shares of stock in order to induce conversion.
- The tax rate is 40 percent.

For accounting purposes, the entity in the above example recognizes a $300 income statement charge (fifteen incremental shares at $20 per share) as a result of the inducement. For tax purposes, however, the difference between the carrying amount of the debt ($1,000) and the fair value of the equity securities issued (40 shares at $20 per share, or $800) is a $200 taxable gain. A tax benefit should be recognized in relation to the inducement expense recorded for financial reporting purposes if the inducement results in an incremental tax savings to the entity.

The FASB staff addressed this and agreed that both the actual taxes paid on the gain ($200 x 40%, or $80) and the taxes “avoided” by issuing the inducement shares ($300 x 40%, or $120) should be charged to equity. The latter portion is determined by applying a with-and-without approach to the inducement portion of the transaction. If there was no inducement, 25 shares would have been issued with a value of $500, as opposed to the $1,000 carrying value. This would result in a $500 tax gain. That is, without the inducement, the tax expense would have been $200 (tax gain of $500 x 40%); with the inducement, the tax expense would only be $80. Thus, the inducement produces a $120 benefit that should be allocated to continuing operations, with a corresponding charge to shareholders’ equity.
If, in the above fact pattern, the stock price decreased to $30 instead of $20, and the entity decided to issue an additional fifteen shares to induce conversion, there would be no actual tax consequences because the fair value of the equity securities ($1,200) would be greater than the tax basis of the debt. A loss for tax purposes cannot result from such a transaction. However, a $100 tax benefit would be recognized in the income statement, with a corresponding tax charge recorded in equity. The $100 tax benefit represents the tax expense avoided on what would otherwise have been a $250 taxable gain if there had been no inducement (the 25 shares would have been issued with a value of $750, as opposed to the $1,000 carrying value).

### 3.2.5 Low-Income Housing Credits

Section 42 of the Internal Revenue Code provides a low-income housing credit (LIHC) to owners of qualified residential rental projects. The LIHC is generally available from the first year the building is placed in service and continues annually over a ten-year period, subject to continuing compliance with the qualified property rules. Generally, the LIHC will affect the computation of the current tax provision, rather than the deferred tax provision, in the year that the credit is actually used on the taxpayer’s tax return. However, the LIHC is subject to annual limitations, and any unused portion of the credit can be carried forward for twenty years. An LIHC carryforward should be recognized as a deferred tax asset and evaluated for realization like any other deferred tax asset. The full amount of the LIHC that is potentially available over the ten-year period should not be included in the tax provision in the initial year that the credit becomes available, because the entire amount of the credit has not been “earned” and, thus, is not available to offset taxable income in the year that the qualified property is placed in service.

While some would argue that the LIHC is similar to the ITC and that the full amount of the credit should be recognized in the year that the qualified housing is placed in service, we believe that the differing tax laws applicable to these credits necessitate a distinction in the recognition criteria for financial statement purposes. ITC is generally available to offset taxable income in the year that the qualified asset is placed in service and is subject to certain recapture provisions. Conversely, only a portion of the LIHC is available to offset taxable income in each year over a ten-year period and is subject to recapture during a fifteen-year compliance period. While each credit may be affected by recapture in future years, we believe that the initial recognition of the credit for financial statement purposes should be based on when the credit is actually available to offset taxable income in the tax return.

ASC 323-740, Investments-Equity Method and Joint Ventures reached several consensuses related to the accounting (by investors) for investments in limited partnerships that are formed to hold qualified affordable housing projects and distribute tax benefits to investors, including (1) the restricted conditions under which an entity may elect to account for its investment in an affordable housing project by using an “effective yield” method and, alternatively, (2) when the investment should be accounted for under the equity or cost method.
PwC Observation: On April 17, 2013, the FASB issued an exposure draft of a proposed Accounting Standard Update (ASU) to revise the criteria required to achieve the “effective yield” method for LIHC investments. The proposed ASU is a result of an EITF project on accounting for LIHC investments. If ultimately ratified, the ASU would modify the existing requirements such that more LIHC investments would potentially qualify for the “effective yield” method than would be the case under current requirements. The ASU would also change the manner in which the effective yield method is computed by including “other tax benefits” (i.e., tax losses) along with the tax credits in calculating the yield. Additionally, the ASU is expected to provide principles for disclosures of the investor’s impact from LIHC investments. Entities that currently own a LIHC investment or expect to invest in a LIHC investment should monitor the status of the EITF project.

It should be noted that the application of ASC 810-10, Consolidation may impact the accounting for investments in entities that hold investments in LIHC projects, because such entities may constitute variable interest entities. See Section TX 11.1.10.1.

3.2.6 Synthetic Fuels Projects

Section 29 of the Internal Revenue Code, which has been redesignated as Section 45K, was enacted as part of the Crude Oil Windfall Profit Tax Act of 1980 to provide a tax credit based upon the production and sale of qualified fuels extracted or developed from non-conventional sources including liquid, gaseous, or solid synthetic fuels produced from coal. As a consequence of the available tax incentives, companies have developed projects to produce and sell solid synthetic fuels (“Synfuel”).

Given the tax-motivated nature of these investments, companies often desire to account for their investments in Synfuel projects (including the pretax effects) within income tax expense on the income statement. Some have proposed using the effective yield method by analogy to ASC 323-740-25-1. However, when the EITF reached the consensus on this issue, the SEC Observer stated that the staff believes it would be inappropriate to extend the effective yield method to analogous situations.

In response to the SEC concerns raised in connection with the use of the effective yield method, some practitioners have proposed accounting for investments in Synfuel projects under the equity or cost method (depending on the respective ownership interest), but presenting both the pretax results and tax credits on a net basis within income tax expense. This approach was discussed with the SEC staff who indicated their belief that there is no basis for netting pretax results of operations within the income tax line (presumably unless GAAP otherwise permits doing so). Rather, these investments should be accounted for under ASC 970-323, Real Estate, and ASC 323-10 in the conventional manner. In addition, the staff noted that there may be a need for additional transparency in these cases (in terms of enhanced disclosure in both the footnotes and in MD&A).

3.2.7 Subsidies Related to Medicare Part D

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 provided for a tax-free subsidy to plan sponsors (i.e., employers) under certain circumstances, while payments for retirees’ health benefits remained fully deductible by the plan sponsor (i.e., plan sponsors received a tax deduction when they paid...
retiree health benefits, including prescription drug benefits, even though they would not be taxed on any subsidy received under the Act).

In March 2010, President Obama signed into law legislation that effectively resulted in these subsidy payments being taxable in tax years beginning after December 31, 2012. The Patient Protection and Affordable Care Act (the PPACA) contained a provision that changes the tax treatment of the subsidy by requiring the subsidy received to be offset against the amount of retiree health care payments that would be eligible for a tax deduction. Thus, the change in tax treatment does not actually affect the taxation of the subsidy itself. Instead, the subsidy received will reduce the employer’s tax deduction for the costs of retiree health care.

As a result of this change, the deferred tax asset on the employer’s balance sheet associated with the subsidy was required to be reduced. Although the law did not become effective until tax years beginning after December 31, 2012, under ASC 740, the impact of the change in tax law was immediately recognized in continuing operations in the financial reporting period that included the enactment date (i.e., the date signed into law by President Obama).

**PwC Observation:** The 2003 Act raised practical issues regarding tracking and allocating the tax effect of the impact of the subsidy. While the FASB did not provide any guidance on how to best track this difference, one approach employers followed was to perform an annual “with-and-without subsidy” calculation of the APBO, retirement benefit expense, and the accrued liability. Under that approach, employers made two calculations of the APBO, expense, and liability, beginning in the period that the subsidy was first accounted for, either through a plan amendment or an actuarial gain. Such a dual calculation was then made in all future years during which there was a subsidy. While the majority of expected future subsidies reflected in the benefit obligation will become taxable as a result of the PPACA, subsidies prior to the 2013 effective date will continue to be tax-free. Therefore, employers should continue to apply the “with-and-without” subsidy model between enactment and the effective date. These calculations will need to be adjusted to reflect the fact that subsidies received after the effective date will now be taxable. DataLine 2010-19, *Elimination of Tax Deduction Related to Medicare Part D Subsidy: Accounting for the Impact*, provides additional guidance on accounting for this tax law change.

### 3.2.8 IRC Section 162(m) Limitation

The tax deduction that an employer is eligible for under IRC Section 83(h) may be subject to certain limitations. One limitation is the million-dollar limitation, established by IRC Section 162(m), which provides that, for public companies, the annual compensation paid to individual covered employees in excess of $1 million during the taxable year is not tax deductible. In general, the $1 million limitation does not apply to performance-based compensation. A determination regarding which employees qualify as covered employees is made as of the last day of the taxable year. Covered employees include the chief executive officer and the company’s four other most highly-compensated officers, pursuant to the SEC’s rules for executive-compensation disclosures in the annual proxy statement.

If annual compensation includes both cash compensation and stock-based-compensation (other than performance-based compensation), then a company should first assess whether or not a covered employee’s compensation will be subject to the Section 162(m) limitation. The anticipated effect of the Section
162(m) limitation should be considered, using one of three methods (as discussed below), when recognizing deferred tax assets for awards that may be subject to the limitation. The selection of a method should be treated as the election of an accounting policy and should be applied consistently.

We believe that any of the following approaches would be acceptable for determining whether a deferred tax asset should be recorded for stock-based compensation that is subject to the IRC Section 162(m) limitation:

- The impact of future cash compensation takes priority over stock-based-compensation awards. For example, if the anticipated cash compensation is equal to or greater than the total tax-deductible annual compensation amount ($1 million) for the covered employee, an entity would not record a deferred tax asset associated with any stock-based-compensation cost for that individual.

- The impact of the stock-based compensation takes priority over future cash compensation and a deferred tax asset would be recorded for the stock-based compensation up to the tax deductible amount.

- Prorate the anticipated benefit of the tax deduction between cash compensation and stock-based compensation and reflect the deferred tax asset for the stock-based-compensation award based on a blended tax rate that considers the anticipated future limitation in the year such temporary difference is expected to reverse.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“Act”) was signed into law to provide emergency liquidity to the U.S. economy. Under the Act’s Troubled Asset Relief Program (TARP), the U.S. Department of Treasury is authorized to purchase troubled assets directly from financial institutions or through auction. Entities that participate in the TARP or other government programs may be subject to new executive compensation restrictions and corporate governance standards.

### 3.3 Basis Differences That Will Reverse with No Tax Consequence

ASC 740-10-25-30 discusses the concept of basis differences that do not result in a tax effect when the related assets or liabilities are recovered or settled. As noted in the definition of a temporary difference, events that do not have tax consequences when a basis difference reverses do not give rise to temporary differences.

#### 3.3.1 Excess Cash Surrender Value of Life Insurance

The excess of the cash surrender value of life insurance (a book asset) over the premiums paid (the tax basis) is a basis difference, which is typically not a temporary difference. When a company owns a life insurance policy, management typically intends to maintain the policy until the death of the insured, in which case the proceeds of the policy would not be taxable for regular tax purposes. ASC 740-10-25-30 cites this as an example of a basis difference that does not result in a tax effect when it reverses (because the proceeds are not taxable).

Implicit in the words “expected to be recovered” is the notion of an employer’s control over the decision to surrender or hold the policy until the death of the employee. If an employer corporation does not expect to keep an insurance policy in force until the death of the insured, it must record a deferred tax liability for the excess book-over-tax basis because the basis difference in this circumstance will be taxable when it reverses. Additionally, if a company previously believed it would keep a policy in force until the insured’s death but no longer believes that it will do so,
then it must recognize a deferred tax liability on the basis difference even if it expects to keep the policy in force for a number of years. A company's ability to control the decision about holding a policy until the death of the insured may be affected by the existence of any employee cancellation option.

There may be alternative minimum tax (AMT) income during the holding period and upon receipt of death proceeds. If this is the case, no deferred tax liability should be established. If the intent is to surrender the policy for its cash value, a deferred tax liability should be provided for the tax that will be paid on the excess of the cash surrender value over cumulative premiums paid. No deduction is available for regular tax purposes; however, there may be a deduction for AMT, if, upon surrender of a policy, cumulative premiums exceed the cash surrender value.

3.4 Issues to Be Considered in Identifying Temporary Differences

As noted earlier in the chapter, a temporary difference is a difference between the tax basis (determined under the tax law and taking into consideration the recognition and measurement model of ASC 740) of an asset or a liability and its reported amount in the statement of financial position that 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. Because the definition of a temporary difference hinges on the difference between the book basis and tax basis of an item, the comparison of a GAAP-compliant balance sheet with a balance sheet that is prepared on a tax basis is often the best way to identify temporary differences. In many instances, there will be both a book and a tax basis (e.g., in the case of fixed assets). In other instances, there will be a GAAP basis and no tax basis, as in the case of GAAP expense accruals that are not tax deductible until they are paid. In yet other instances, there may be a tax basis but no GAAP basis, as in the case of organizational costs expensed for GAAP purposes but capitalized and amortized for tax purposes. Sections TX 3.4.1 to 3.4.5 discuss certain types of temporary differences.

3.4.1 Basis Differences That Are Not Accounted for Under the Basic Model for Deferred Taxes

ASC 740-10-25-3 lists the exceptions to the use of the comprehensive model for recognizing deferred taxes. These exceptions, which also are discussed in Section TX 2.3, include:

- Indefinite reinvestment exceptions for an investment in a subsidiary or a corporate joint venture that is essentially permanent in duration.
- Transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship entities.
- Accounting for leveraged leases, as required by ASC 840-10.
- Prohibition against recognizing a deferred tax liability related to goodwill (or a portion thereof) for which amortization is not deductible for tax purposes.
- For income taxes paid on intercompany profits on assets remaining within the group, prohibition against recognizing a deferred tax asset for the difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements under ASC 810.
- Prohibition against recognizing a deferred tax liability or asset for differences related to assets and liabilities that, under ASC 830-10, Foreign Currency Matters
are remeasured from the local currency into the functional currency using historical exchange rates and that result from (1) changes in exchange rates or (2) indexing for tax purposes.

In addition, ASC 718-20-55-20 prohibits the recording of a deferred tax asset for windfall benefits that do not reduce taxes payable.

A tax-planning strategy cannot be used to avoid recording deferred taxes. ASC 740-10-55-46, states:

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 ASC 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 ASC 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.

3.4.2 Temporary Differences Where Reversal Might Not Occur in the Foreseeable Future

The ASC 740 model does not take into account the timing of reversal. Although a company might be able to delay a tax effect indefinitely, the ability to do so is not a factor in determining whether a temporary difference exists. ASC 740-10-55-63 addressed this issue and stated in part:

Under the requirements of this Topic, deferred tax liabilities may not be eliminated or reduced because an entity may be able to delay the settlement of those liabilities by delaying the events that would cause taxable temporary differences to reverse. Accordingly, the deferred tax liability is recognized. If the events that trigger the payment of the tax are not expected in the foreseeable future, the reversal pattern of the related temporary difference is indefinite and the deferred tax liability should be classified as noncurrent.

As stated in Section TX 3.4.1, the only exceptions to the recognition of deferred taxes on temporary differences are listed in ASC 740-10-25-3, and in ASC 718-20-55-20. Thus, although it might be necessary to record a temporary difference that might not reverse in the foreseeable future, the determination that the temporary difference was indefinite (i.e., the reversal was not expected in the foreseeable future) could impact the assessment of whether (1) there would be a source of income to realize a deferred tax asset or (2) a deferred tax liability would provide a source of income to recognize other deferred tax assets. See Section TX 5.4 for additional discussion.

3.4.3 Consideration of Settlement at Book Carrying Value

ASC 740-10-25-20 notes that, inherent in an entity’s statement of financial position is the assumption that the reported amounts of assets will be recovered and the reported amounts of liabilities will be settled. Consequently, in the case of financial statement assets that do not have a corresponding tax basis (e.g., intangible assets established in a nontaxable business combination), there is the presumption that,
if the asset were to be recovered at its book carrying value, the gain on the sale proceeds would represent a future tax effect that must be accounted for.

3.4.4 Temporary Differences Not Identified with an Asset or a Liability

Some temporary differences result from events that have been recognized in the financial statements, but are based on provisions of the tax law. Such temporary differences will be taxable or deductible in the future and therefore cannot be identified with a particular asset or liability for financial reporting purposes. For example, a temporary difference arises when a long-term contract is accounted for by the percentage-of-completion method for financial reporting and under the completed-contract method for tax purposes, with income on the contract deferred until contract completion. Hence, a temporary difference arises from the deferred income, and a deferred tax liability is required even though such temporary difference is not identified with a particular liability for financial reporting. Another example is organizational costs that are expensed as incurred for financial reporting, but are capitalized and amortized for tax purposes (ASC 740-10-25-24 through 25-26).

3.4.5 U.S. Federal Temporary Differences Relating to State Income Taxes

Example 3-6: Effect of State Temporary Differences on the Federal Tax Calculation

As referenced in ASC 740-10-55-20, the following addresses the treatment of the effect that state temporary differences have on the calculation of federal tax.

Question:
State income taxes are deductible for U.S. federal income tax purposes. Does a deferred state income tax liability or asset give rise to a temporary difference for purposes of determining a deferred U.S. federal income tax liability or asset?

Answer:
Yes. 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.
Chapter 4: Recognition and Measurement
Chapter Summary

To achieve the objectives stated in ASC 740-10-10 entities must compute deferred taxes to account for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. The basic model for the recognition and measurement of deferred taxes consists of a five-step approach that accomplishes three primary objectives: (1) identification of all temporary differences, tax loss carryforwards, and tax credit carryforwards; (2) measurement of temporary differences using the proper applicable tax rate; and (3) assessment of the need for a valuation allowance.

Deferred tax asset and liability balances and the corresponding deferred tax expense recognized in the financial statements are determined for each tax-paying component in each jurisdiction.
Excerpts from ASC 740

ASC 740-10-25-29:
Except for the temporary differences addressed in paragraph 740-10-25-3, which shall be accounted for as provided in that paragraph, an entity shall recognize a deferred tax liability or asset for all temporary differences and operating loss and tax credit carryforwards in accordance with the measurement provisions of paragraph 740-10-30-5.

ASC 740-10-30-2:
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.

ASC 740-10-30-3:
Total income tax expense (or benefit) for the year is the sum of deferred tax expense (or benefit) and income taxes currently payable or refundable.

ASC 740-10-30-4:
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 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.

ASC 740-10-30-5:
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).

(continued)
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.

4.1 Basic Approach for Deferred Taxes

The tax provision for a given year as computed under ASC 740 represents not only the amounts currently due, but also the change in the cumulative future tax consequences of items that have been reported for financial reporting purposes in one year and taxable income purposes (i.e., deferred tax) in another year. ASC 740 computes the current and deferred tax amounts separately, and the sum of the two equals the total provision. The total tax expense computed under the principles of ASC 740 (i.e., the sum of the current and deferred provisions) is meant to match the components of pretax income with their related tax effects in the same year, regardless of when the amounts are actually reported on a tax return. Because the tax provision reflected in the financial statements is typically computed several months before the actual tax return is filed, it may be necessary to develop systems and processes that allow the entity to determine which filing positions it would take based on information available at the time the provision is calculated.

In ASC 740, the computation of the tax provision focuses on the balance sheet. A temporary difference is created (1) when an item has been treated differently for financial reporting purposes and for tax purposes in the same period and (2) when an item is expected to reverse in a future period and create a tax consequence. The FASB believes that the tax effect of these differences, referred to as deferred taxes, should be accounted for in the intervening periods. A deferred tax asset or liability is computed based on the difference between the book basis for financial reporting purposes and the tax basis of the asset or liability.

This asset and liability method, required by ASC 740, measures the deferred tax liability or asset that is implicit in the balance sheet; it is assumed that assets will be realized and liabilities will be settled at their carrying amounts. If the carrying amounts of assets and liabilities differ from their tax bases, implicit future tax effects will result from reversals of the book-and tax-basis differences as a consequence of the enacted tax laws.

The basic ASC 740 model is applied through the completion of the following five steps:

Step 1: Identify temporary differences and tax loss carryforwards. There are two categories of these items: (1) taxable temporary differences that will generate future tax (i.e., deferred tax liabilities) and (2) deductible temporary differences that will reduce future tax (i.e., deferred tax assets).
**PwC Observation:** Temporary differences are most commonly identified and quantified by (1) preparing a tax balance sheet and comparing it with the financial statement balance sheet and (2) reviewing the reconciliation of book income with taxable income (which, for U.S. corporate taxpayers with total assets of $10 million or more, can be found at Schedule M-3 of Form 1120 of the tax return). Chapter TX 3 discusses the identification of temporary differences and offers examples of those most commonly encountered.

Example 4-1 illustrates the identification of temporary differences and measurement of future tax consequences.

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**Example 4-1: Identifying Temporary Differences**

Assume that to date tax depreciation has exceeded book depreciation. As a result, the book basis of the asset is greater than the tax basis. If the asset is recovered at its book carrying amount, taxable income will be the amount by which the book basis exceeds the tax basis (i.e., the taxing authority would consider the tax basis, as opposed to the book basis, to determine if there is taxable income). Because the proceeds received (i.e., asset recovered at the book amount) exceed the tax basis, taxable income exists for that difference. The primary goal of the asset and liability method is to measure the future tax impact of future taxable income or deductions. Taxable differences, like those described in this example, cause deferred tax liabilities.

<table>
<thead>
<tr>
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<th>Fair Value</th>
<th>Tax Basis</th>
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<tbody>
<tr>
<td>Historical basis</td>
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<td>$1,000</td>
</tr>
<tr>
<td>Depreciation to date</td>
<td>(300)</td>
<td>(400)</td>
</tr>
<tr>
<td>Basis at balance sheet date</td>
<td>$ 700</td>
<td>$ 600</td>
</tr>
</tbody>
</table>

**Recovery of basis difference through sale:**

If the asset were sold for its book basis of $700, there would be a taxable gain of $100.

**Recovery of basis through operations:**

- Recovery of the book basis through book depreciation: $700
- Future tax depreciation (represents future tax deductions): (600)
- Excess future book over tax depreciation (future increase to taxable income) [Steps 1 & 2 below]: $100
- Applicable tax rate (assumed) [Step 3 below]: 35%
- Deferred tax liability [Step 4 below]: $35

**Step 2: Identify tax loss carryforwards and tax credits.** An entity may have all or a combination of federal, state and local, and foreign tax loss carryforwards and certain tax credits. Tax-loss carryforwards typically include net operating losses (NOLs) and capital losses, which, depending on the relevant jurisdiction’s applicable tax law, may be carried back to prior period(s) and/or forward to future period(s) to offset taxable income. Tax credits may include the U.S. federal and state research and experimentation credit (R&E credit), foreign tax credits (U.S. or other jurisdictions), the U.S. federal alternative minimum tax credit (AMT credit), investment tax credits,
and potentially other tax credits. Depending on the relevant jurisdiction’s applicable tax law, tax credits may be carried back to prior period(s) and/or forward to future period(s) to offset tax payable. Tax credits generally provide a “dollar-for-dollar” benefit against tax payable.

Step 3: Determine which applicable rate should be used in deferred tax calculations. The applicable tax rate is the enacted tax rate based on enacted tax law, which should be applied when temporary differences reverse or are settled. Section TX 4.2 discusses several factors that should be considered in determining the applicable rate.

Step 4: Calculate the deferred tax assets and liabilities. This entails multiplying the gross temporary differences and tax loss carryforwards by the applicable rate and adding the resulting product to the tax credit carryforwards.

When tax laws are enacted and the change in tax rate is effective for future years, the year in which taxable and deductible temporary differences are expected to be reported on the tax return can affect the measurement of the tax asset or liability. This is because the applicable tax rate would be different depending on the year of expected reversal. If temporary differences are expected to reverse during years in which different levels of tax rates are expected to be applied based on varying levels of income (i.e., graduated rates), the year in which an item is expected to reverse could affect the measurement of the deferred tax asset or liability.

Step 5: Evaluate the need for a valuation allowance. Under ASC 740, deferred tax assets resulting from deductible temporary differences must be recorded, and the recorded assets must undergo a more-likely-than-not (i.e., over 50 percent probability) realization/impairment test. A valuation allowance must be established for deferred tax assets if it is more-likely-than-not that they will not be realized. While this may appear to be a relatively low threshold, ASC 740-10-30-23, prescribes that, in assessing the need for a valuation allowance, evidence should be weighted to the extent that it is objectively verifiable. Section TX 5.1 discusses factors to consider in the evaluation of the need for a valuation allowance.

4.2 Applicable Tax Rate

Excerpts from ASC 740

ASC 740-10-30-8:
Paragraph 740-10-10-3 establishes that the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Deferred taxes shall not be accounted for on a discounted basis.
ASC 740-10-30-9: Under tax law with a graduated tax rate structure, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by entities for which graduated tax rates are not a significant factor. Entities for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized. See Example 16 (paragraph 740-10-55-136) for an illustration of the determination of the average graduated tax rate. Other provisions of enacted tax laws shall be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

4.2.1 General Considerations

The applicable tax rate, which is used to measure deferred tax assets and liabilities, is the enacted tax rate that is expected to apply when temporary differences are expected to be settled or realized. An entity may utilize different applicable tax rates for several reasons, such as the type of temporary difference (e.g., ordinary income, capital gain), the jurisdiction of the temporary difference (e.g., domestic versus foreign or federal versus state) or the period during which the temporary difference is settled or realized (e.g., carryback or carryforward periods). For example, when there is an enacted change in tax rates, the applicable tax rate could be the pre-change or the post-change tax rate depending on when the future reversals are expected to occur. Moreover, in some jurisdictions, capital gains are taxed at a different rate than ordinary income. As a result, determining which applicable tax rate is appropriate may depend on the method of recovery and the inherent character of the income.

PwC Observation: ASC 740-10-30-8 makes it clear that the applicable rate applied to taxable or deductible temporary differences must be the jurisdiction’s enacted tax rate, and not some form of effective tax rate.

4.2.2 Graduated Tax Rates

Before the appropriate applicable rate can be identified, it must be determined whether graduated tax rates are a significant factor. Under current U.S. federal tax law, for example, all taxable income must be taxed at a single flat rate of 35 percent if taxable income exceeds a certain amount. If taxable income neither meets nor exceeds this threshold, then consideration must be given to the impact of graduated tax rates.
When graduated tax rates are a significant factor, deferred taxes may need to be computed using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods during which the deferred tax assets and liabilities are expected to be realized or settled (e.g., when income levels are expected to fluctuate in and out of different tax brackets). Graduated tax rates are likely to be a significant factor for smaller U.S. entities or the specific operations of a larger entity in certain tax jurisdictions. Example 4-2 demonstrates the application of graduated tax rates in the United States.

Example 4-2: Determining the Applicable Rate if Graduated Rates Are a Significant Factor (ASC 740-10-55-136 through 55-138)

In Jurisdiction X, enacted tax rates are currently 15 percent for the first $50,000 of taxable income, 25 percent for the next $25,000, 35 percent for the next $25,000, 39 percent for the next $235,000, and 34 percent for $335,000 to $10 million of taxable income. This example assumes that no income is subject to a special tax rate (e.g., a capital gain tax rate if different than the ordinary income tax rate).

The average graduated rate will differ depending on the expected level of annual taxable income (including reversing differences) in the next three years, which, in this example, is the number of years over which the reversal of existing temporary difference is expected. The average tax rate will be one of the following:

- 15 percent if the estimated annual level of taxable income in the next three years is $50,000 or less.
- 18.33 percent if the estimated annual level of taxable income in the next three years is $75,000.
- 22.25 percent if the estimated annual level of taxable income in the next three years is $100,000.
- 28 percent if the estimated annual level of taxable income in the next three years is $150,000.

Because temporary differences may reverse in different periods and estimated taxable income may fluctuate in each period, more than one applicable tax rate may be appropriate at each balance sheet date. Future taxable income cannot be forecasted with precision and detailed scheduling of future taxable income and reversals might not produce more reliable amounts. For this reason, making an aggregate calculation using a single applicable rate based on the estimated average annual taxable income in future years is typically sufficient. If annual taxable income is expected to be $150,000 over the next three years, a rate of 28 percent would be used to measure the existing temporary differences that are expected to reverse over the next three years. This is acceptable even though the expected reversal of those temporary differences could occur in one year for which the tax rate is 15 percent and in another year for which the tax rate is 39 percent.

However, situations may arise in which a specific applicable rate should be used for specific reversals of temporary difference. For example:

- If an unusually large temporary difference is expected to reverse in a single year, it may be appropriate to determine the expected applicable rate that applies to future taxable income in that specific year, since use of an average rate may result in a materially inaccurate deferred tax balance.

(continued)
If future taxable income (excluding reversals) is expected to reach an unusual level in a single year, it may be appropriate to apply that applicable tax rate to all reversals expected in that year.

Judgment should be applied to determine when the use of a specific applicable tax rate is appropriate.

The lowest graduated tax rate (other than zero) should be used whenever the estimated average graduated rate would otherwise be zero (e.g., when losses are anticipated).

4.2.3 Determining the Applicable Rate

The applicable tax rate is based on the period in which the reversal of the temporary difference is expected to impact taxes payable (or refundable), and not only on the period in which the temporary difference is expected to reverse. That is, the period in which the temporary difference reverses may not be the period in which the temporary difference impacts tax payable or refundable. The examples below illustrate this distinction.

Example 4-3: Determination of the Applicable Tax Rate if Changes in Tax Rate Are Phased-In (ASC 740-10-55-129 through 55-130)

Background/Facts:
Assume that 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 each future tax return for the fourth, fifth, and sixth years. Enacted tax rates are 35 percent for Years 1 through 3, 40 percent for Years 4 through 6, and 45 percent for Year 7 and thereafter.

Question:
Which applicable tax rate should be utilized?

Analysis/Conclusion:
The tax rate 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 impacts taxes payable for Years 1 through 3, Years 4 through 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 the fourth, fifth, and sixth years. However, if tax losses are expected in Years 4 through 6, the tax rate will be one of the following:

- 35 percent if a tax benefit for those tax losses in Years 4 or 5 will be realized by means of a loss carryback to the second and third years.
- 45 percent if a tax benefit for those tax losses in Years 4 through 6 will be realized by means of a loss carryforward to Year 7 and thereafter.
Example 4-4: Determination of Applicable Tax Rate if Tax Rates Change
(ASC 740-10-55-131 through 55-135)

Background/Facts:
Assume that enacted tax rates are 30 percent for Years 1 through 3, and 40 percent for Year 4 and thereafter. At the end of Year 3 (the current year), an entity has $900 of deductible temporary differences, which are expected to result in tax deductions of approximately $300 on each future tax return for the fourth, fifth, and sixth years.

Question:
Which applicable tax rate should be utilized?

Analysis/Conclusion:
The answer depends on how and when a tax benefit or loss is expected. The tax rate will be 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 will be 30 percent if the entity expects to realize a tax benefit for the deductible temporary differences via a loss-carryback refund.

Determining the applicable rate can be even more complicated. The tax effects of temporary difference reversals are ordinarily determined on an incremental basis (assuming that graduated rates are not a significant factor). For example, assume that a company (1) expects to have pretax book earnings of $50 in a future year and (2) anticipates that existing net deductible differences of $200 will reverse in that year, resulting in a taxable loss of $150 for that future year. Assume also that the future year has a different enacted tax rate than the years in the carryback period because an existing law changes the tax rate applicable to that future year. In this case, the deferred tax asset related to the deductible temporary difference, which will result in a future year's taxable loss and will be carried back (i.e., $150), should be recorded at the applicable rate in the carryback period (i.e., pre-rate-change period). The portion of the deductible temporary difference that shelters the pretax book income from current-year tax (i.e., $50) or would result in a net operating loss carryforward (because the losses in the carryback period cannot be absorbed) should be recorded at the future applicable rate (i.e., the post-rate change).

If there are two applicable rates for the net reversals and those reversals are expected in a particular year, the decision to apply the current or future rate to deductible and taxable differences (to the extent that they offset each other) will be arbitrary. Regardless of which applicable rate is applied, the effect is the same: The entity discloses in the footnotes to the financial statements the deferred tax assets and liabilities.

4.2.4 Complexities in Determining the Applicable Tax Rate

4.2.4.1 Ordering Effects

In some jurisdictions, capital gains are taxed at a lower rate than ordinary income (e.g., capital gains are taxed at 15 percent and the ordinary income tax rate is 30 percent). Determining the applicable tax rate to apply to the gross temporary
difference can be complicated if, in some jurisdictions, an ordinary loss can be offset by a capital gain that occurs in the same year. This might be viewed as (1) the ordinary loss attracting a tax benefit only at the capital gain rate (e.g., measurement of a deferred tax benefit resulting from an ordinary loss of $100, for example, would be $15 instead of $30 if the ordinary loss is expected to offset capital income), or as (2) the capital gain being taxed at the rate applicable to ordinary income (e.g., measurement of a deferred tax liability resulting from a gross taxable temporary difference of $100 that is expected to reverse as capital gain income would be $30 instead of $15 if the expected capital gain income is offset by ordinary loss).

When determining the applicable tax rate in such circumstances, the reversal of a temporary difference (e.g., an ordinary loss carryforward of $100 or a taxable temporary difference of $100 that is expected to reverse as capital gain income) is considered the last item to enter the calculation of taxable income in the period during which a temporary difference is expected to reverse. For example, if at the reporting date, $100 of gross taxable temporary difference is expected to result in capital gain income in a subsequent period, the capital gain income of $100 is the last amount to enter the calculation of the subsequent period’s taxable income. If an ordinary loss is expected in a subsequent period and the ordinary loss is sufficient to offset the expected capital gain resulting from the reversal of the temporary difference, the ordinary income tax rate (e.g., 30 percent) would be used to record the deferred tax liability (e.g., $30 deferred tax liability). If, however, the ordinary loss is insufficient to absorb an additional $100 of capital gain income, the capital gain income tax rate (e.g., 15 percent) would be used to record the deferred liability (e.g., $15 deferred tax liability). Similarly, the deferred tax benefit resulting from $100 of ordinary loss carryforward that is expected to offset ordinary and capital taxable income in a subsequent period would be measured at the capital income tax rate (e.g., 15 percent) to the extent that it is expected to offset capital gain income after any capital loss is considered.

4.2.4.2 Undistributed Earnings

The applicable rate related to undistributed earnings should reflect any dividends-received deductions, deductions or credits for foreign taxes, or withholding taxes (ASC 740-10-55-24). For example, in the U.S. jurisdiction, if taxable differences reverse into dividend income generated from a nonsubsidiary U.S. corporation taxed at 35 percent, that income will result in a dividends-received deduction (DRD) of 70 percent or 80 percent, depending on the level of ownership (i.e., only 30 percent or 20 percent, respectively, of the dividend income is taxed). If a reversal of the temporary difference occurs when taxable income enables the use of the deduction, the entity can incorporate the DRD in measuring its deferred tax liabilities by using an applicable rate of 10.5 percent (i.e., statutory rate of 35 percent less 70 percent DRD) or 7 percent (i.e., statutory rate of 35 percent less 80 percent DRD), respectively.

The above approach is complicated by the fact that the applicable tax rate applied to the taxable temporary difference is generally the tax rate before application of existing credit carryforwards (e.g., operating loss carryforwards, capital loss carryforwards, and foreign tax credits or FTCs). Unlike a DRD that is incorporated into the tax rate applied to the deferred tax liabilities, deferred tax assets are separately recorded for existing credit carryforwards. Therefore, while existing credit carryforwards may be used to offset the deferred tax liability for taxable differences associated with unremitted earnings from a nonsubsidiary U.S. corporation, the tax rate applied to the temporary difference would not incorporate the expected use of the credit carryforwards because the credit carryforwards are separately recorded as deferred tax assets.
4.2.4.3 Special Deductions

ASC 740-10-25-37 and 740-10-30-13 stipulate that the tax benefit of special deductions should be recognized no earlier than the year in which the deductions can be taken on the tax return. ASC 740 does not define “special deductions,” but offers three examples: (1) statutory depletion, (2) special deductions available for certain health benefit entities, and (3) special deductions for small life insurance companies. Other accounting literature provides two more examples of special deductions: (1) ASC 942-740-35-1 through 35-3 indicate that the percentage-of-taxable-income-bad-debt deduction for an S&L is also a special deduction, and (2) the FASB concluded in ASC 740-10-55-29 that the IRC Section 199 deduction for qualified domestic production activities also qualifies as a special deduction.

As discussed in ASC 740-10-55-30, an entity estimating future taxable income to determine the applicable rate should consider future special deductions in its deferred tax computations if graduated rates are a significant factor or if the entity is assessing the need for a valuation allowance and must consider future taxable income (excluding reversals of temporary differences). Therefore, although tax benefits from special deductions are recognized no earlier than the year in which the special deductions are deductible on a tax return, they affect the calculation of deferred taxes because their future tax benefit is implicitly recognized in the determination of the average graduated tax rate and the assessment of the need for a valuation allowance.

If the special deduction is statutory depletion, the estimates of future taxable income will be reduced by the total future statutory depletion that is expected to be deductible in future years on all properties, not just the statutory depletion related to the carrying amount of properties on the balance sheet date (i.e., the total statutory depletion includes both the current depletion and the to-be-acquired statutory depletion). Because percentage depletion generally is not limited by the adjusted basis in the property, it is possible that the taxpayer’s aggregate deductions for depletion will exceed the property’s adjusted basis.

As with other assets and liabilities, the temporary difference related to properties for which statutory depletion is available should be measured as the difference between the tax basis of the asset and its reported amount in the financial statements. As noted above, the entity should recognize the tax benefit of the special deduction no earlier than the year in which the deductions can be made on the tax return. Accordingly, a deferred tax liability should be recognized for this temporary difference, even though it is probable that future tax depletion will exceed book depletion. The tax basis in a depletable property represents the historical-cost basis of the property less the property’s aggregate deductions for depletion that the entity reports on its tax returns. The tax basis of the property, however, cannot be reduced below zero. Consider the following example.

Example 4-5: Special Deduction for Depletion

**Background/Facts:**
An entity acquires a depletable property for $10,000, and no difference in the book basis and the tax basis exists at the time of acquisition. For book purposes, the entity uses a depletion method that results in a $1,000 annual depletion expense. For
tax purposes, cost depletion is calculated as $1,000 annually; percentage depletion is $4,000 in the first year and $7,000 in the second year. For the first two years, percentage depletion is fully deductible.

**Analysis/Conclusion:**
At the end of Year 1, there is a $3,000 temporary difference (i.e., $9,000 net book value less $6,000 adjusted tax basis). At the end of Year 2, there is an $8,000 temporary difference (i.e., net book value of $8,000 less adjusted tax basis of zero). The cost-depletion amounts do not affect the determination of temporary differences because actual depletion deductions were based on percentage-depletion amounts that had actually been deducted in the taxpayer's tax returns.

Further, the $1,000 excess statutory depletion created in Year 2 (i.e., the amount of depreciation claimed in excess of the existing tax basis) was not included among the items used to calculate the temporary difference because the property's tax basis cannot be reduced below zero. However, excess statutory depletion is an AMT preference item that may affect the calculation of deferred taxes and the assessment of the valuation allowance.

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### 4.2.4.4 Tax Holidays

In certain jurisdictions, tax holidays (i.e., periods of full or partial exemption from tax) are provided as an incentive for certain entities. The FASB added commentary around the issue concerning tax holidays \(^1\)—whether a tax asset should be established for the future tax savings of a tax holiday on the premise that such savings are akin to an NOL carryforward. By concluding that a deferred tax benefit should not be recorded, the FASB distinguished between two types of tax holidays: one that is generally available to any entity within a class of entities and one that is controlled by a specific entity that qualifies for it. The first type was likened to a general exemption from taxation for a class of entities creating nontaxable status, while the second type was perceived to be “unique” because it was not necessarily available to any entity within a class of entities and, as a result, might conceptually require the recognition of deferred tax benefits. As discussed in ASC 740-10-25-35 through 25-36, the FASB decided to prohibit recognition of a deferred tax asset for any tax holiday (including those considered “unique”) because of the practical problems associated with (1) distinguishing between a general tax holiday and a unique tax holiday and (2) measuring the deferred tax asset associated with future benefits expected from tax holidays.

In order to properly account for a tax holiday, careful consideration must be given to the specific aspects of the tax holiday, including the approval process, terms, and conditions. In general, the effects on existing deferred income tax balances resulting from the initial qualification for a tax holiday should be treated in a manner similar to a voluntary change in tax status, which under ASC 740-10-25-33, is recognized on the approval date or on the filing date if approval is not necessary. Therefore, the effects of a tax holiday (or extension of a tax holiday) should be recognized in the deferred tax computation upon receipt of the last necessary approval for the tax holiday (or extension).

In addition, differences often exist between the book basis and tax basis on balance sheet dates within the holiday period. Consistent with ASC 740-10-30-8, if these differences are scheduled to reverse during the tax holiday, deferred taxes should

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\(^1\) ASC 740-10-25-35 through 25-36.
be measured for those differences based on the conditions of the tax holiday (e.g., full or partial exemption). That is, “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.” If the differences are scheduled to reverse after the tax holiday, deferred taxes should be provided at the rate that is expected to be in effect after the tax holiday expires. The expiration of the holiday is similar to an enacted change in future tax rates, which must be recognized in the deferred tax computation. Tax-planning actions to accelerate taxable income into the holiday or to delay deductions until after the holiday would only be considered if the entity has committed to their implementation and such implementation is within the entity’s control. This is illustrated in the following example.

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**Example 4-6: Tax Holiday—Scheduling Temporary Differences**

**Background/Facts:**
A foreign government grants a company a tax holiday. During the holiday, the company will be 100 percent exempt from taxation. Upon expiration of the holiday, the company will be subject to taxation at the statutory rate. The company is scheduling the reversal of existing temporary differences related to depreciable assets to determine whether any are expected to reverse after the tax holiday for which deferred taxes should be provided.

**Question:**
Should the company consider future originating differences related to its existing fixed assets when scheduling the reversal of existing temporary differences?

**Analysis/Conclusion:**
ASC 740-10-55-22 provides some ground rules for scheduling temporary differences. Among those ground rules are: (i) the method used should be systematic and logical; (ii) minimizing complexity is an appropriate consideration in selecting a method; and (iii) the same method should be used for all temporary differences within a particular category.

When scheduling the reversal of depreciable asset temporary differences to determine whether any are expected to reverse (and in what amount) after the expiration of a tax holiday, we believe that either of two approaches would be acceptable. One approach would consider future originating differences and the other would not. We believe that both methods are systematic and logical and can be reasonably supported.

A method that considers originating differences is based upon the view that future originating differences are inherent in the asset that exists at the balance sheet date and, therefore, should not be ignored.

A method that does not consider originating differences is based upon the view that only differences that exist at the balance sheet date should be considered. This method is consistent with the guidance in ASC 740-10-55-14, which indicates future originations and their reversals are a factor to be considered when assessing the likelihood of future taxable income. By implication, they would not be considered part of the reversal of the temporary difference existing at the balance sheet date. A method that does not consider originating differences may also minimize the complexity of the calculation.

(continued)
Consider the following scenario:

Company A acquires a depreciable asset for $120 on January 1, 2008. The asset will be depreciated over 6 years for financial reporting and 3 years for tax purposes. Company A has been granted a four-year tax holiday by the government in the foreign country in which the asset was acquired and, therefore, will not pay taxes until 2012. The tax rate that will apply after expiration of the tax holiday is 40%.

<table>
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<th>December 31</th>
<th>Book Basis</th>
<th>Tax Basis</th>
<th>Basis Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$100</td>
<td>$80</td>
<td>$20</td>
</tr>
<tr>
<td>2009</td>
<td>80</td>
<td>40</td>
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</tr>
<tr>
<td>2010</td>
<td>60</td>
<td>0</td>
<td>60</td>
</tr>
<tr>
<td>2011</td>
<td>40</td>
<td>0</td>
<td>40</td>
</tr>
<tr>
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</tr>
<tr>
<td>2013</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

As of December 31, 2008, Company A has a book-over-tax basis difference in the depreciable asset of $20. At the end of the tax holiday, the basis difference will have increased to $40.

If Company A considers originating differences, it would record a deferred tax liability (“DTL”) of $8 ($20 x 40%) at December 31, 2008. This method could be described as a LIFO approach whereby, the last originations are considered the first to reverse. Company A would not record a DTL on the entire $40 basis difference that will exist at the end of the tax holiday because only $20 of that basis difference exists at the balance sheet date. At December 31, 2009, Company A would increase its DTL by $8 to $16 ($40 x 40%). Company A would not adjust the DTL again until 2012. Beginning in 2012, Company A would presumably begin to pay taxes and the DTL would reverse in 2012 and 2013.

If Company A does not consider originating differences, it would not record a DTL at December 31, 2008. The $20 basis difference that exists at December 31, 2008, is assumed to reverse on a FIFO basis in 2011. At December 31, 2009, Company A would record a DTL of $8 because $20 of the book over tax basis is expected to reverse after the tax holiday expires in 2012. At December 31, 2010, Company A would increase its DTL by another $8 to $16 because $40 of the book over tax basis is expected to reverse after the tax holiday expires in 2012. Company A would not adjust the DTL again until 2012. Beginning in 2012, Company A would presumably begin to pay taxes and the DTL would reverse in 2012 and 2013.

In circumstances in which the tax holiday is contingent on meeting a certain status or maintaining a certain level of activities, an entity must make the determination as to whether or not it has met the requirements to satisfy the conditions of the holiday. If a company has initially met such conditions and expects to continue to meet them, it should measure its temporary differences using the holiday tax rate. If the entity later determines that it no longer meets the necessary conditions of the tax holiday (e.g., it is no longer able to maintain a required level of activity within the tax jurisdiction), it would need to remeasure its deferred taxes at the statutory rate and recognize an additional tax liability for any potential retroactive effects in the period that the determination is made.
Example 4-7: Tax Holiday

Background/Facts:
A foreign government grants a company a ten-year tax holiday, which starts when the company begins to generate taxable income. During the holiday, the company will be 100 percent exempt from taxation. The company currently expects that it will incur losses for the next five years and, therefore, believes that it should only tax-effect temporary differences that reverse after fifteen years. The company has taxable temporary differences related to property, plant, and equipment.

Question:
Is the applicable exemption period ten years or fifteen years?

Analysis/Conclusion:
The company should view the tax holiday as ten years, not fifteen years. To do otherwise would be tantamount to anticipating future tax losses, an action that ASC 740-10-25-38, precludes. Accordingly, temporary differences should be scheduled for each balance sheet date, and only those differences that reverse in periods after the tax holiday should be tax-effected. In this case, the applicable tax holiday on each balance sheet date would remain ten years, as long as the company incurs losses.

4.2.4.5 Nonamortizing/Nondepreciating Assets

For assets that are amortized or depreciated for financial reporting purposes, the assumption is that the carrying value of the asset will be recovered over time through revenues, which are typically taxed at the ordinary rate. Accordingly, deferred tax assets and liabilities that result from temporary differences relating to such items are normally recognized at the ordinary tax rate.

However, for assets that are not amortized or depreciated for financial reporting purposes (e.g., land, indefinite-lived intangible assets, and tax-deductible goodwill), the assumption is that the asset will not decline in value (i.e., any revenues generated by the asset are not a recovery of the asset’s carrying value). The carrying value of the asset is not scheduled to be recovered at any specific time in the future. In fact, the asset will have an indefinite life. ASC 740-10-25-20 requires one to assume that the carrying value of an asset will be recovered and therefore does not allow the consideration of future impairments. The carrying value of an asset that is not being amortized for financial reporting purposes can only be recovered through a future sale.

In jurisdictions where the ordinary tax rate and capital gains tax rate differ, the applicable tax rate for a temporary difference relating to an asset that is not being depreciated or amortized for financial reporting purposes would be the tax rate (i.e., ordinary or capital gains) applicable to the expected recovery of the asset (e.g., a future sale of the asset).

It should also be noted that taxable temporary differences related to assets that are not amortized or depreciated for financial reporting purposes generally cannot be used as a source of taxable income to support the realization of deferred tax assets relating to the reversal of deductible temporary differences. Implications of the valuation allowance associated with such taxable temporary differences, which are referred to as “naked credits,” are discussed in Section TX 5.4.2.1.
Examples 4-8 and 4-9 illustrate the appropriate applicable tax rate for indefinite-lived intangible assets in a jurisdiction where the capital gains tax rate differs from the ordinary rate.

### Example 4-8: Determining the Applicable Tax Rate for an Indefinite-Lived Intangible Asset Generated in a Nontaxable Business Combination

**Background/Facts:**
A business combination is structured as a nontaxable purchase with a carryover tax basis for the individual assets. An indefinite-lived intangible asset with no tax basis is included among the acquired assets.

**Question:**
Which rate should be applied to an indefinite-lived intangible asset acquired in a nontaxable business combination?

**Analysis/Conclusion:**
If the asset is sold for an amount equivalent to the value assigned to the asset in the business combination, a gain would result and would be taxed at the capital gains tax rate. If graduated rates exist or if enacted tax rates reflect increases or decreases in future years, management must estimate when it is likely to sell the intangible asset (which may be in the distant future). This determination will dictate which rate should be used to record the deferred tax liability at inception.

### Example 4-9: Determining the Applicable Tax Rate for an Indefinite-Lived Intangible Asset Generated in a Taxable Business Combination

**Background/Facts:**
A business combination is structured as a taxable purchase. The basis assigned to an acquired indefinite-lived intangible asset is the same for financial reporting and tax purposes.

**Question:**
Which rate should be applied to an indefinite-lived intangible asset acquired in a taxable business combination?

**Analysis/Conclusion:**
In this case, no deferred tax liability would be recorded at the time of the business combination. However, because the indefinite-lived intangible asset is amortized for tax purposes, a taxable temporary difference would arise. If the amortization recognized for tax purposes would be “recaptured” at the ordinary tax rate in the event of a sale, the applicable tax rate would be the ordinary tax rate. The post-acquisition amortization for tax purposes would produce a current tax benefit at the ordinary tax rate, while an equal and offsetting deferred tax liability would be recognized via the ordinary tax rate if “recapture” is required. If upon the sale of the asset the tax amortization is not “recaptured” at the ordinary tax rate, the deferred tax liability must be recorded at the capital-gains tax rate, even though the current tax benefit from amortization is recorded at the ordinary income tax rate.
If circumstances change and the indefinite-lived asset is subsequently determined to have a finite useful life, the asset would be amortized or depreciated for book purposes prospectively over its estimated remaining useful life. Under this scenario, the asset would be recovered by means of revenue that is taxable at the ordinary tax rate over the asset's amortization period. Accordingly, the deferred tax liability would be remeasured at the ordinary tax rate if it was previously measured at a different rate.

4.2.4.6 “Worthless” Deferred Tax Assets

When deductions or loss carryforwards are expected to expire unutilized, it is generally not appropriate to use zero as the applicable tax rate. Rather, a deferred tax asset should be recorded at the applicable tax rate and a valuation allowance of an equal amount would be provided. However, in certain rare situations it may be appropriate to use a zero rate or to write off the asset against the valuation allowance. This reduces the valuation allowance and the number of gross deferred tax assets that are disclosed.

A write-off might be appropriate if, for example, an entity has a loss carryforward that has not yet expired in a country where the entity no longer conducts its business. As with many other areas of ASC 740, this determination requires the use of professional judgment and a careful consideration of the relevant facts and circumstances.

Certain carryforwards (e.g., certain AMT carryforwards and foreign tax credit carryforwards) may have a corresponding, full valuation allowance. We believe that if there is only a remote likelihood that such an entity will ever utilize those carryforwards, it is acceptable for the entity to write off the deferred tax assets against the valuation allowance, thereby eliminating the need to disclose the gross amounts.

In the United States, IRC Section 382 imposes under certain circumstances a limitation on the utilization of net operating losses, credit carryforwards, built-in losses and built-in deductions after an ownership change. When this (or a similar) limitation may mathematically preclude use of a portion of a carryforward or a deductible difference, it is appropriate for an entity to write off the deferred tax asset. If carryforwards and built-in losses are subject to the same aggregate limitation, the estimate of the “permanent” loss of tax benefits should be reflected as an unallocated reduction of gross deferred tax assets.

4.2.4.7 Dual-Rate Jurisdictions

Certain foreign jurisdictions tax corporate income at different rates, depending on whether (and, in some cases, when) that income is distributed to shareholders. For example, assume that a jurisdiction has a tax system under which (1) undistributed profits are subject to a corporate tax rate of 45 percent and (2) distributed income is taxed at 30 percent. Entities that paid dividends from previously undistributed income received a tax credit (or tax refund) equal to the difference between (1) the tax computed at the “undistributed rate” in effect during the year in which the income was earned (for tax purposes) and (2) the tax computed at the “distributed rate” in effect during the year in which the dividend was distributed.

Under ASC 740-10-25-39 through 25-41, the financial statements of an entity subject to such a foreign jurisdiction should not recognize an asset for the tax
benefits of future tax credits that will be realized when the previously taxed income is distributed. Rather, those tax benefits should be recognized as a reduction of income tax expense in the period during which the tax credits are included in the entity’s tax return. Accordingly, the entity should use the undistributed rate to measure the tax effects of temporary differences.

Under ASC 740-10-25-41, for purposes of preparing consolidated financial statements, a parent company with a foreign subsidiary that is entitled to a tax credit for dividends paid should recognize based on the distributed rate (1) the future tax credit that will be received when dividends are paid and (2) the deferred tax effects related to the operations of the foreign subsidiary. However, the undistributed rate should be used in the consolidated financial statements if the parent, as a result of applying the indefinite reversal criteria of ASC 740-30-25-17, has not provided for deferred taxes on the unremitted earnings of the foreign subsidiary.

Although not specifically addressed by the FASB, we believe that such treatment should also be applied by investors measuring the tax effects of a corporate joint venture in a jurisdiction in which the distributed rate differs from the undistributed rate because ASC 740-10-25-3 specifically extends the application of the indefinite reversal criteria to an investment in a foreign corporate joint venture that is essentially permanent in duration.

ASC 740-10-25-39 through 25-41 was written within the context of a German tax regime in which the “undistributed” rate was higher than the “distributed” rate. (That German tax regime is no longer in effect.) Conversely, in certain jurisdictions, the “distributed” rate exceeds the “undistributed” rate, and additional taxes are due whenever income is distributed to shareholders. In these situations, we believe that it is preferable to use the “distributed” rate to (1) record a liability for any additional taxes that would be owed when earnings are ultimately distributed and (2) to tax-effect temporary differences.

Support for this conclusion can be found in ASC 830-740-25-6 through 25-8, which describe an analogous situation whereby a revaluation surplus in Italy becomes taxable upon liquidation or distribution of earnings associated with the revaluation surplus to shareholders. For that situation, it was concluded that a deferred tax liability should be provided on the revaluation surplus. In 2002, the AICPA’s International Practice Task Force (IPTF) considered the impact of a tax regime in South Africa that imposed two corporate taxes, a primary tax imposed at the normal corporate statutory rate when income was earned and a secondary tax imposed upon distribution of accumulated earnings. Such a tax regime was effectively a dual corporate tax system. In deliberating whether the lower “undistributed” tax rate or the higher “distributed” tax rate should be used to record deferred taxes, the IPTF concluded that, while use of the higher “distributed” rate was preferable, use of the lower “undistributed” rate was acceptable if accompanied by the appropriate incremental disclosures. The SEC staff observer advised the IPTF that it would not object to either view.

The SEC staff also agreed with the IPTF’s conclusion that entities subject to the South African tax regime should provide a series of incremental disclosures. Those disclosures must include a description of the tax concept (i.e., what it is and how it

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2 The South African tax regime considered back in 2002 by the IPTF & SEC is no longer in effect.
works), how the entity is accounting for the tax (i.e., “undistributed” vs. “distributed” tax rate), the basis on which tax liabilities have been computed, and the amount of undistributed earnings on which a secondary tax (or similar tax) has been made. If the lower “undistributed” rate is used, however, incremental disclosures are required. These disclosures include the following:

- A statement that requires (1) the company to pay additional taxes at the applicable tax rate on all distributions of dividends and the additional taxes to be recorded as an income tax expense in the period during which the company declares the dividends.
- A statement that clarifies when the additional taxes will be owed to the government.
- The amount of retained earnings that, if distributed, would be subject to the tax.

Further, when dividends are declared, the additional tax must be separately presented in the effective rate reconciliation (even if such amounts might satisfy the materiality criteria in Rule 4-08(h) of Regulation S-X, which would otherwise allow the tax to be combined with other items).

Example 4-10 illustrates the application of the above guidance.

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**Example 4-10: Use of Distributed and Undistributed Tax Rates as Applicable Rates**

In Country X, certain resident corporations are liable for regular corporate income tax at a rate of 30 percent and for a secondary tax calculated at 12.5 percent of distributed earnings (i.e., dividends) net of the secondary tax liability, which the company can declare during any dividend cycle. Mechanically, the secondary tax creates an effective tax rate of 37.38 percent on distributed earnings.

In our opinion, it is preferable to use the “distributed” rate to record the tax effects of temporary differences when it is higher than the “undistributed” rate. However, it is also acceptable to recognize a liability at the “undistributed” rate as long as appropriate disclosures are provided. No matter which approach is followed, companies should disclose a description of the tax concept (i.e., what it is and how it works) and how they are accounting for the tax. They should identify the basis on which tax liabilities are computed and any undistributed earnings on which a secondary tax provision is made.

In Country Y, companies are subject to a 25 percent income tax rate plus an additional 10 percent corporate income tax assessment if their taxable income is not distributed before the end of the subsequent year. The additional tax assessment is due in the second subsequent year (i.e., “undistributed” rate of 35 percent is higher than “distributed” rate of 25 percent). Provided that a company has no means of mitigating the effect of the additional tax, the company should follow the guidance in ASC 740-10-25-39 through 25-41 to account for the additional 10 percent.

Under that guidance, tax is provided at the undistributed rate (in this case 35 percent) in the period during which the income is earned. Any reduction in the liability that will arise when the income is ultimately distributed is not anticipated, but is instead recognized in the period during which the distribution plan becomes final. Disclosures that specify what the tax is and how it works are recommended.
4.2.4.8 Hybrid Tax Systems

Determining the applicable rate for hybrid tax systems can be difficult. For example, Mexico’s flat tax regime interacts with the regular income tax system, operates as a marginal tax, and has many similarities to an Alternative Minimum Tax (“AMT”) system (see Section TX 4.2.5 for a more detailed discussion of AMT considerations). However, unlike the AMT, the flat tax is not creditable against the regular income tax liability, is not carried forward indefinitely, and does not operate like a prepayment of the regular income tax liability. In these situations, we generally believe that deferred taxes should be calculated in accordance with the regime (i.e., flat tax or regular income tax) the entity expects to be subject to. If an enterprise expects to alternate between regimes, a hybrid approach may be necessary. In such cases, it is often necessary to schedule temporary difference reversals in order to properly state deferred tax balances.

Section TX 1.2.2.1 offers information on determining the applicable rate for tax regimes that levy tax based on the higher of a capital-based or an income-based tax.

4.2.4.9 Foreign-Branch Operations

Under the U.S. federal income tax system, a branch represents a U.S. corporate entity that physically conducts its business in another country. The branch income and losses are generally taxable in the branch home country based on the local country’s tax law and in the United States based on U.S. federal income tax law. Under U.S. federal tax law, local country taxes imposed on the branch are considered foreign taxes of the U.S. corporation, which may deduct them as a business expense or claim them as direct, creditable foreign taxes of a U.S. corporation. That is, the U.S. corporation branch owner can deduct foreign branch taxes (i.e., a tax benefit measured at 35 percent) or receive U.S. foreign tax credits (i.e., tax benefit measured at 100 percent), which, subject to limitations, can offset the U.S. federal income tax imposed on the branch income.

Because the branch is taxed in two jurisdictions under two different tax regimes, we would expect the entity to have one set of temporary differences for the U.S. return (i.e., those temporary differences would be included in the deferred tax computation for the U.S. consolidated tax group) and another set of deferred taxes for foreign tax purposes. It should be noted that, conceptually, U.S. federal deferred tax consequences arising from a business operation located in a foreign branch are similar to the U.S. federal tax consequences arising from a business operation located in a U.S. state and local jurisdiction. Therefore, the deferred foreign tax asset or liability resulting from the application of ASC 740 will be a temporary difference in the computation of the deferred U.S. tax because the deferred foreign asset or liability has a book basis but no U.S. tax basis (i.e., for U.S. tax purposes, foreign deferred taxes of the branch do not enter the computation of U.S. taxable income until they become current taxes).

Under U.S. tax law, when a deferred foreign tax asset is recovered, it reduces the foreign branch local country current taxes and consequently the foreign taxes deductible by or creditable to the U.S. corporation. Conversely, when a deferred foreign tax liability is settled, it increases foreign branch local country current taxes and foreign taxes deductible by or creditable to the U.S. corporation. Therefore, a foreign deferred tax liability recorded at the branch level would give rise to a U.S. deferred tax asset, while a foreign deferred tax asset recorded at the branch level would give rise to a U.S. deferred tax liability. When future realization of a foreign deferred tax asset is not more-likely-than-not (i.e., less than 50 percent likely) and a
4.2.4.10 Aggregating Computations for Separate Jurisdictions

While deferred taxes are usually determined separately for each tax-paying component in each tax jurisdiction, ASC 740-10-55-25 acknowledges that there may be situations in which the tax computations for two or more jurisdictions can be combined. See Section TX 1.3 for a discussion of when jurisdictions can be combined for the purposes of applying ASC 740.

4.2.5 Alternative Minimum Tax Considerations

4.2.5.1 AMT—General Background

The corporate alternative minimum tax (AMT) is a separate, parallel U.S. tax system that was enacted in 1986 to ensure that corporations do not avoid their fair share of tax by utilizing certain provisions in the tax law.

As a separate parallel tax structure, the amounts of carrybacks and carryforwards for alternative minimum taxable income (AMTI) are determined separately from the amounts of carrybacks and carryforwards for regular tax. The amount of tax computed under AMT rules in a given year is called the tentative minimum tax (TMT). If TMT is higher than the regular tax in a given year, an AMT payment is required for the TMT in excess of the regular tax. In turn, any AMT paid generates a credit carryforward (AMT credit), which can be applied to reduce the regular tax in any future year to the amount of the TMT computed for that year. A carryforward of the AMT credit is not limited to any specific time frame.

In general, the AMT taxes a broader income base at a lower rate. Although companies may find themselves temporarily or indefinitely subject to the AMT, ASC 740-10-30-10 through 30-11 specifically state that the applicable tax rate for the U.S. federal jurisdiction is the regular tax rate, not the AMT rate.

4.2.5.2 The Interaction of AMT with ASC 740 Accounting

Excerpts from ASC 740

ASC 740-10-30-10:
In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 740-10-30-5(d) through (e).

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 740-10-30-12:
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.

ASC 740-10-55-31:
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.

(continued)
ASC 740-10-55-32:
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.

ASC 740-10-55-33:
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.

The AMT is considered in the ASC 740 deferred tax computation in two ways. First, an AMT credit carryforward existing on the balance sheet date is a deferred tax asset subject to the assessment for realization. Section TX 5.4.2.2.6 discusses considerations for assessing the need for a valuation allowance against AMT credit carryforwards.

Second, the AMT may make it more-likely-than-not that some regular-tax-deductible differences and carryforwards will not be fully realized. The possibility that some deferred tax assets might not be realizable must be considered by an entity that (1) is currently paying AMT, or expects to pay AMT in the future, and (2) has significant deductible temporary differences or carryforwards for regular tax purposes. Deferred taxes must be recorded for regular-tax temporary differences at the regular tax rate. If the regular-tax-deductible differences and carryforwards offset taxable differences, a benefit at the regular tax rate is assured. This excludes the possible effect of the 90 percent limitation on use of NOL carryforwards against AMTI because a deferred tax liability has been recorded at the regular tax rate. However, if the regular-tax-deductible differences must be used against future taxable income, excluding reversals, and if it is likely that the entity will be an AMT taxpayer
indefinitely, it may be appropriate to establish a valuation allowance to reduce the net deferred tax asset to the benefit amount that will be realized in the computation of TMT (i.e., the AMT rate applied to the AMT temporary differences).

When the regular-tax-deductible differences reverse, the excess of the tax benefit computed at the regular rate may be converted into an AMT credit carryforward and, as a result, the company may avoid the valuation allowance if it anticipates that the AMT credit carryforward will be used. This may be the case if the expected future AMT position will result from future origination of timing differences between regular taxable income and AMTI, which will reverse and cause regular tax in future years to exceed TMT.

For example, if an entity has an NOL carryforward in excess of taxable temporary differences, the tax effect of the NOL can generally be recognized as an asset if the NOL will fully offset the taxable temporary differences. There is an exception: If an entity believes that it will be unable to use the “future” AMT credit carryforward that would be generated if the limitation were applied and the AMT were paid, it cannot recognize the tax effect of the NOL as an asset. Instead, the valuation allowance should be increased so that the net deferred tax liability equals the amount of AMT that the entity (1) expects to pay on existing taxable temporary differences and (2) expects that it will be unable to recoup through realization of the related AMT credit carryforward. The valuation allowance keeps net deferred tax assets from being provided at a rate in excess of the expected future impact of the reversals.

As discussed above, an AMT taxpayer must provide tax on taxable differences at the regular tax rate. Some companies are in an AMT position because of permanent differences between regular taxable income and AMTI; they may expect that condition to continue indefinitely (i.e., indefinite AMT taxpayers). This requirement may cause such a taxpayer to state its deferred tax liability at an amount in excess of the expected future impact of the reversals.

An indefinite AMT taxpayer will also generate AMT credit carryforwards to reduce in the overall deferred tax computation, the deferred tax liability computed at the regular tax rate. If the taxpayer has been subject to AMT for many years, the deferred tax asset for AMT credit carryforwards may be sufficient to reduce the deferred tax liability to the AMT rate that is applied to AMT differences. Example 4-11 illustrates how this “mechanism” works.

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**Example 4-11: Alternative Minimum Tax**

**Background/Facts:**

A life insurance company that qualifies as “small” under the tax law has a $1,000 depreciation-related taxable temporary difference. Its applicable “regular” tax rate is 35 percent. As explained in ASC 740-10-25-37 and ASC 740-10-30-13, the benefit of a special deduction is not reflected in the company's determination of the applicable tax rate. Therefore, the company must recognize a $350 deferred tax liability for this temporary difference.

As a “small” life insurance company, the company may take a 60 percent special deduction on its regular taxable income. However, the deduction is an AMT preference item and, as such, must be added back to regular taxable income when the company is determining AMTI.

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Prior to 1998, a life insurance company would always be considered an AMT taxpayer as long as it qualified as “small.” That was because the regular tax on any amount of income before the special deduction (i.e., 35 percent of the difference between 100 percent and 60 percent [or 14 percent]) was always going to be less than the AMT on that amount (i.e., 20 percent). For 1998 and subsequent years, however, a gross receipts test was added to the AMT provisions, whereby a company that meets certain requirements will not be subject to the AMT. Consequently, a life insurance company that qualified as “small” was no longer subject to the AMT automatically.

Assume that a company has $400 of existing AMT credit carryforwards at the end of the current period and that it reasonably expects to qualify as a “small” life insurance company for the foreseeable future. The company’s expectations are (1) that it will be taxed at AMT rates for the foreseeable future and (2) that it will never be able to utilize its AMT credit carryforwards.

**Analysis/Conclusion:**

Because the company was required to measure its deferred tax liability at the regular tax rate, rather than at the AMT rate, it may assume that it will have an equal amount of regular tax in excess of the AMT and that it may use the amount to recognize a deferred tax asset for existing AMT credit carryforwards.

The company in this example is required to recognize a $350 deferred tax liability, even though it reasonably expects that the reversal of the taxable temporary difference will result in only $200 of tax at the AMT rate. As a result, the company is permitted to assume that it will have $150 of excess regular tax in the future. This, in turn, allows $150 of the existing AMT credit carryforward to be recognized as a deferred tax asset.

In this example, the company achieves the “expected” result—a $200 net deferred tax liability. It should be noted, however, that the “expected” result would not have been achieved if the company did not possess at least $150 of existing AMT credit carryforwards. For example, if the company’s AMT credit carryforward at the end of the current period were only $100, its deferred tax asset would be only $100, and $250 would be the amount of its net deferred tax liability. Thus, the “mechanism” does not provide full relief until existing AMT credits are sufficient to draw down the deferred tax liability from the regular rate to the AMT rate.

Operating loss and foreign tax credit carryforwards for the AMT, rather than for regular tax purposes, are ignored unless a company is estimating future TMT and assessing the valuation allowance for regular-tax-deductible differences/loss and for AMT credit carryforwards.
Chapter 5: Valuation Allowance
Chapter Summary

Evaluating the need for and amount of a valuation allowance for deferred tax assets often requires significant judgment and extensive analysis of all the positive and negative evidence available to determine whether all or some portion of the deferred tax assets will not be realized. A valuation allowance must be established for deferred tax assets when it is more-likely-than-not (a probability level of more than 50 percent) that they will not be realized. In general, "realization" refers to the incremental benefit achieved through the reduction in future taxes payable or an increase in future taxes refundable from the deferred tax assets, assuming that the underlying deductible differences and carryforwards are the last items to enter into the determination of future taxable income.
Excerpts from ASC 740

ASC 740-10-30-16:
As established in paragraph 740-10-30-2(b), there is a basic requirement to reduce the measurement of deferred tax assets not expected to be realized.

ASC 740-10-30-17:
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.

ASC 740-10-30-18:
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.

(continued)
ASC 740-10-30-19:
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.

ASC 740-10-30-20:
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.

ASC 740-10-30-21:
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.

ASC 740-10-30-22:
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:

(continued)
a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures

b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset

c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

ASC 740-10-30-23:
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.

ASC 740-10-30-24:
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.

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

5.1 Assessing the Need for a Valuation Allowance

ASC 740's valuation allowance assessment is at once subjective as well as mechanical. A number of factors entering into the assessment are highly subjective: assessing whether the weight of available evidence supports the recognition of some or all of an entity's deferred tax assets; determining how objectively verifiable an individual piece of evidence is, and thus how much weight should be given to the evidence; and establishing the reversal patterns for existing temporary differences. However, once those determinations have been made, the process of computing the valuation allowance that should be recorded is mechanical. This mechanical process is important and will have an impact when the weight of available evidence suggests that income in applicable future periods will be insufficient to support the realization of all deferred tax assets. In circumstances where a partial valuation allowance is warranted, the valuation allowance required generally must be supported through detailed scheduling of reversals of temporary differences.
Some have used formulas as a starting point to determine the valuation allowance. These can be good techniques to organize the thought process for evaluating the need for a valuation allowance, but they are not a substitute for reasoned judgment. The valuation allowance recorded should be based on management’s judgment of what is more-likely-than-not considering all available information, both quantitative and qualitative. An approach in which a valuation allowance is determined by reference to a certain percentage of an entity’s deferred tax assets would not be appropriate.

Ultimately, the realization of deferred tax assets will depend on the existence of future taxable income, sources of which are covered in Section TX 5.4.

5.1.1 Evidence to Be Considered

ASC 740-10-30-17 states that “all available evidence shall be considered in determining whether a valuation allowance for deferred tax assets is needed.” This includes historical information supplemented by all currently available information about future years. Many events occurring subsequent to an entity’s year-end but before the financial statements are released that provide additional evidence (negative or positive) regarding the likelihood of realization of existing deferred tax assets should be considered when determining whether a valuation allowance is needed.

Items that clearly represent subsequent-period events (e.g., the tax effects of a natural catastrophe, such as an earthquake or a fire) should be recognized in the period in which they occur, because that is when the pretax effect, if any, will be recorded. In addition, the effects on the valuation allowance assessment of certain fundamental transactions, such as an initial public offering, other major financing transactions, or a business combination, should not be taken into account until the transactions are complete.

PwC Observation: Judgment should be exercised when financial statements are issued long after the balance sheet date. The longer after the balance sheet date the financial statements are released, the more difficult it becomes to assess whether new information represents a subsequent-year event or whether it should be considered as part of the prior period’s valuation allowance assessment. We generally do not believe that the delayed issuance of a set of financial statements should result in a different assessment of whether a valuation allowance is required.

Example 5-1: NOL Carryforward Limitations Due to a Pending Business Combination

Background/Facts:
Corporation A had previously generated net operating losses (NOLs) that resulted in a $20 million deferred tax asset (DTA). Based on the operations of Corporation A, the NOLs are expected to be fully utilized within the carryforward period; therefore, no valuation allowance has been recorded. Corporation A has negotiated and agreed to the terms of a merger with Corporation B. The merger is expected to be consummated in January 2013. It is anticipated that the merger will trigger a limitation under IRC Section 382, which restricts how much of Corporation A’s premerger NOLs can be utilized in a given year. Because of this anticipated limitation,
Corporation A believes that only $5 million of the NOL-related DTA will be utilized after the business combination is consummated.

**Question:**
Should Corporation A consider the anticipated impact of the merger (i.e., Section 382 limitation) in its evaluation of the need for a valuation allowance on December 31, 2012?

**Analysis/Conclusion:**
No. The tax effects of a business combination should not be recognized before the transaction has been consummated. However, Corporation A should consider whether the financial statements should include additional disclosure of the merger's potential tax consequences (e.g., the merger's effect on the existing NOLs), in accordance with guidance included in ASC 275 Risks and Uncertainties.

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**Example 5-2: How Much Hindsight Should be Used in the Determination of the Need for a Valuation Allowance When Assessing the Need for a Valuation Allowance as Part of a Restatement of Prior Results?**

**Background/Facts:**
Company A is restating its financial statements for the prior three years (2002-2004) for items unrelated to taxes. Prior to the restatement and the commensurate filing of amended tax returns, Company A was profitable for each of the three years in the restated period and as a result had no valuation allowance recorded against any of its existing deferred tax assets. After taking into consideration the pretax accounting entries, Company A now reflects a significant loss for the year-ended December 31, 2002, which is of sufficient size to put it into a three-year cumulative loss position at December 31, 2002. On a restated basis, Company A reports a loss for 2003, but in 2004, it returned to significant profitability.

At December 31, 2002, Company A had a post-restatement deferred tax asset relating primarily to net operating losses that will expire in 20 years. If the financial results at December 31, 2002 included the restatement items, there would have been significant uncertainty as to whether Company A would return to profitability in future periods.

As part of the restatement, Company A is reviewing whether it requires a valuation allowance on the restated accounts for the years presented.

**Question:**
Can Company A utilize the knowledge of the profitable results in 2004 as positive evidence in evaluating whether a valuation allowance is considered necessary for the 2002 restated accounts?

**Analysis/Conclusion:**
ASC 740-10-30-17 states, “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.” We believe that the “all available evidence” standard applies to the information that would have been available at the time of the original issuance of the financial statements.

(continued)
In the case above, although Company A returned to significant profitability in 2004, only information available as of the original issuance date of the financial statements should be used in determining the valuation allowance as of the end of 2002.

ASC 740-10-30-21 states, “Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years.” Due to the uncertainty of future GAAP income that existed at December 31, 2002, positive evidence of sufficient weight was not available to overcome the significant negative evidence of cumulative losses at December 31, 2002.

In determining whether the valuation allowance is still necessary as of December 31, 2003, and December 31, 2004, respectively, Company A should re-evaluate the need for a valuation allowance based on all evidence that would have been available at the time of the issuance of the original 2003 and 2004 financial statements. It is conceivable that Company A, in its restated financial statements, would report a valuation allowance in 2002 and a reversal of the valuation allowance in 2004 based on the weight of available evidence available at the time the original financial statements were issued—even though both years are within the restatement period.

### 5.1.2 Weighting of Available Evidence

ASC 740-10-30-5(e), requires an entity to assess the need for a valuation allowance. It reads as follows:

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 should be sufficient to reduce the deferred tax asset to the amount that is more-likely-than-not to be realized.

While ASC 740’s “more-likely-than-not” threshold for recognition of an allowance is a lower asset impairment threshold than other asset impairment thresholds within the U.S. GAAP framework, the prescribed weighting of evidence as mandated by ASC 740-10-30-23, makes the recognition of a deferred tax asset for an entity that has exhibited cumulative losses in recent years quite difficult.

**PwC Observation:** In accordance with the asset impairment threshold under the U.S. GAAP framework, a loss should not be accrued until it is probable (a higher threshold than the more-likely-than-not threshold prescribed under ASC 740) that an asset has been impaired and the amount of the loss can be reasonably estimated. As defined in ASC 740-10-30-5 more-likely-than-not is a likelihood of more than 50 percent. Therefore, using the same information about the results of future operations, incongruent results may arise when an entity performs its asset impairment analysis versus its valuation allowance assessment. It is not uncommon for an entity to record a valuation allowance against its net deferred tax assets while other assets (e.g., fixed assets, investments, and accounts receivable) are not impaired.

ASC 740-10-30-23 reads:

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.

**PwC Observation:** In prescribing the manner in which available evidence should be weighted, ASC 740-10-30-23 largely shapes the way in which evidence should be assessed. As a result, what has already occurred (and thus can be objectively verified) carries more weight than what may occur (i.e., projections of future income, which are not readily and objectively verifiable). In assessing the need for a valuation allowance, each piece of evidence should be evaluated in light of the extent to which it is objectively verifiable and should be weighted accordingly.

### 5.1.3 Cumulative Losses and Other Negative Evidence

#### 5.1.3.1 General

ASC 740-10-30-21 indicates that it is difficult to avoid a valuation allowance when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include:

- Losses expected in early future years.
- A history of potential tax benefits expiring unused.
- Uncertainties whose unfavorable resolution would adversely affect future results.
- Brief carryback, carryforward periods in jurisdictions where results are traditionally cyclical or where a single year's reversals of deductible differences will be larger than the typical level of taxable income.

**PwC Observation:** Despite the Board's decision to prohibit anticipation of the tax consequences of future tax losses (ASC 740-10-25-38), it is appropriate for management to consider future losses in determining whether, or to the extent, future taxable income is expected to exist (e.g., a tax-planning strategy that would serve only to reduce a future-year expected loss would not provide a source of income for realization of deferred tax assets).

Of the negative evidence cited, “cumulative losses in recent years” probably will have to be considered most frequently. ASC 740 deliberately does not define this term. Generally, we believe that the guideline, not a “bright line” but a starting point, should be cumulative pretax results as adjusted for permanent items (e.g., nondeductible goodwill impairments) for three years (the current and the two preceding years). This measure generally would include discontinued operations, other comprehensive income (OCI) and extraordinary items, as well as all other so-called “nonrecurring” items, such as restructuring or impairment charges. That is, all items, other than the cumulative effect of accounting changes, should be included in the determination of cumulative losses.

While such items may not be indicative of future results, they are part of total results, and there may be discontinued operations, OCI, extraordinary items, and other nonrecurring charges in future years. Also, while otherwise arbitrary, three years generally seems to be a long enough period to not be overly influenced by one-time events, but not so long that it would be irrelevant as a starting point for gauging the
future. Further, we believe it is appropriate to conclude that there are cumulative losses in situations where an entity is projecting near-term future operating losses that will put it in a three-year cumulative loss position. In addition, the impact of a profitable discontinued operation should be carefully evaluated when the ongoing businesses otherwise would have had a cumulative loss.

This suggested guideline is admittedly an arbitrary measure and judgment is necessary to determine the weight given to the results of this specific calculation. However, as discussed above, ASC 740-10-30-23 requires that the weight given to the potential effect of negative and positive evidence “be commensurate with the extent to which it can be objectively verified.” Moreover, it indicates that “a cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome.” The FASB in its deliberations has indicated that an entity would need objective positive evidence of sufficient quality and quantity to support a conclusion that, based on the weight of all available evidence, a valuation allowance is not needed.1

**PwC Observation:** A projection of future taxable income is inherently subjective and generally will not be sufficient to overcome negative evidence that includes cumulative losses in recent years, particularly if the projected future taxable income is dependent on an anticipated turnaround to operating profitability that has not yet been demonstrated.

When considering cumulative losses, it may be necessary to segregate earnings (losses) subject to capital gain rules from those subject to taxes at ordinary rates. This concept is illustrated in the following example:

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**Example 5-3: Considerations When Evaluating the Need for a Valuation Allowance on Deferred Tax Assets that are Capital in Nature**

**Background/Facts:**
Corporation X (“Corp X”) has a history of profitable operations and is projecting continued profitability from its operations. Consequently, Corp X determined that no valuation allowance was necessary for its deferred tax assets in prior periods. However, in the current year, Corp X generated unrealized and realized losses on its portfolio of available-for-sale (“AFS”) equity securities.

As of the end of the current year, Corp X has recorded a deferred tax asset for (1) accumulated capital loss carryforwards, (2) net unrealized losses on AFS equity securities that, if sold, would result in additional capital losses and (3) temporary differences (for example, reserves) subject to ordinary income tax rates. Under the tax law, Corp X can only utilize capital losses to offset realized capital gains. A net capital loss in a particular year may be carried back 3 years and forward 5 years.

(continued)

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1 ASC 740-10-30-23.
Corp X has generated the following gains/(losses) in recent years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Realized Gain/(Loss)</th>
<th>Unrealized Gain/(Loss)</th>
<th>Total Capital Gain/(Loss)</th>
<th>Ordinary Income/(Loss)</th>
<th>Total Income/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>$20</td>
<td>$50</td>
<td>$70</td>
<td>$300</td>
<td>$370</td>
</tr>
<tr>
<td>20X6</td>
<td>$40</td>
<td>$40</td>
<td>$80</td>
<td>$400</td>
<td>$480</td>
</tr>
<tr>
<td>20X7</td>
<td>$(50)</td>
<td>$50</td>
<td>$0</td>
<td>$300</td>
<td>$300</td>
</tr>
<tr>
<td>20X8</td>
<td>$(150)</td>
<td>$(200)</td>
<td>$(350)</td>
<td>$(200)</td>
<td>$(150)</td>
</tr>
</tbody>
</table>

On the basis of total income, Corp X is not in a cumulative loss position. Although Corp X has generated capital gain income in the past, the realized and unrealized losses generated in the current year that are capital in nature were significant enough to put Corp X into a cumulative loss position related to its assets that are capital in nature. Corp X expects to generate capital gains in the future, which is why it continues to stay invested in the market; however, management realizes that the assessment of whether or when such gains would occur is inherently subjective in nature.

**Question:**
Can Corp X consider its expectation that it will generate future capital gains during the relevant carryforward period(s) when analyzing the need for a valuation allowance on its deferred tax assets that are capital in nature?

**Analysis/Conclusion:**
In assessing the need for a valuation allowance, ASC 740-10-30-17 indicates that all available evidence should be considered. However, the weight given to the positive and negative evidence should be commensurate with the extent to which the information can be objectively verified (ASC 740-10-30-23).

Because a portion of the deferred tax assets are capital in nature, Corp X must assess the realizability of these deferred tax assets separately from the deferred tax assets that are ordinary in nature. Although Corp X has not incurred cumulative losses in recent years in total, as presented above, Corp X has incurred cumulative losses related to its assets that are capital in nature. As discussed in ASC 740-10-30-21, cumulative losses in recent years represent negative evidence that is difficult to overcome. As a result, the positive evidence needed to overcome the significant negative evidence of cumulative losses must be objectively verifiable. Expectations about the future are inherently subjective, and therefore they generally will not be sufficient to overcome negative evidence that includes cumulative losses in recent years.

In this case, Corp X determined that its history of ordinary income combined with its expectations of future ordinary income provided sufficient evidence that no valuation allowance was necessary for its deferred tax assets that are ordinary in nature. However, Corp X determined that it would not be able to rely on its ability to generate capital gains in the future given the significant capital losses generated in the current year (which gave rise to cumulative losses of a capital nature) and, therefore, must look to other sources of capital gain income (e.g., tax-planning strategies or carryback availability). Because Corp X did not have any other sources of capital gain income, it determined that a full valuation allowance was required on its deferred tax assets that are capital in nature.
The existence of cumulative losses (or lack thereof) is only one piece of evidence that should be considered in assessing the need for a valuation allowance. While ASC 740-10-30-21 states that it will be difficult for positive evidence to overcome the types of negative evidence cited, ASC 740-10-30-22 gives examples of positive evidence that might be necessary to avoid a valuation allowance when there is such negative evidence: a firm sales backlog of profitable orders, unrealized (and unrecognized) appreciation in net assets, and a strong earnings history exclusive of a loss that can be demonstrated to be an aberration.

**PwC Observation:** It is important to note that a mere backlog of orders is generally not sufficient. In addition to being able to evidence a backlog, management must be able to objectively support that the existing backlog of orders will be profitable and accretive to earnings.

Management’s belief that the tax assets will be realized is not by itself sufficient, objective positive evidence to overcome objective negative evidence, such as recent losses. Indeed, management may conclude that, while it believes that the deferred tax assets will be realized, the weight of objective evidence requires a valuation allowance. In these circumstances, public entities should be mindful that the SEC does not allow assertions, whether stated or implied, in the forepart of the prospectus for a public offering or a periodic report (e.g., Form 10-K) that are inconsistent with the assumptions used in the preparation of the financial statements.

When there are cumulative pretax losses (as defined above) and either future taxable income (exclusive of reversing temporary differences and carryforwards) or tax-planning strategies are being considered to support some or all of the deferred tax assets (i.e., to avoid a valuation allowance), PwC engagement teams are required to consult with the Accounting Services Group within PwC’s National Professional Services Group. This consultation requirement is applicable in the first reporting period in which a company that has (or expects to have) cumulative losses (as defined above) proposes to recognize some or all of its net deferred tax assets without an offsetting valuation allowance.

The consultation requirement applies to any tax jurisdiction or tax-paying component of an entity that has (or is expected to have) cumulative losses over a three-year period (or a shorter period if operations commenced less than three years ago). For this purpose, “tax-paying component” encompasses situations where separate tax returns are filed in a given jurisdiction or where income and losses are required to be tracked by type or character—e.g., capital versus ordinary or “life” versus “non-life” for an insurance company.

Once a PwC engagement team has satisfied the consultation requirement with regard to a company with cumulative losses, there is no requirement to re-consult in any subsequent reporting period unless the factors relied upon to support the original conclusion have failed to materialize or are no longer supportable or new information that previously was not considered constitutes additional negative evidence. Consider the following scenarios:

- Scenario 1: In Year 1, a company initially encounters a situation in which it has a three-year cumulative loss driven almost entirely by a significant restructuring charge that the company viewed as non-recurring. The company has a backlog of customer contracts and is able to forecast profitable operations over the next year or so. On that basis, the company believes its deferred tax assets are more-likely-than-not to be realized in Year 1. The engagement team consults in that period
with the National Professional Services Group and agrees with the company’s determination. While still in a three-year cumulative loss in the subsequent year (i.e., Year 2), the company was able to achieve the forecasted results used in the prior year assessment of deferred tax assets. In this scenario, the engagement team would not be required to consult in Year 2 because there has not been a deterioration or significant change in the facts and circumstances relied upon to support the conclusion in the reporting period when the client first entered into the cumulative loss position.

- Scenario 2: Assume the same Year 1 facts as in Scenario 1; however, in the subsequent year (i.e., Year 2), the company missed its forecast due to the loss of a significant customer and a further round of restructuring charges. The company continues to believe it can rely upon future projections of income to support the deferred tax assets in Year 2. In this scenario, the engagement team would be required to consult in Year 2 due to the deterioration in facts, even if the company believed its outlook has improved since the prior year.

- Scenario 3: In Year 1, a company initially encounters a situation in which it has a three-year cumulative loss and supports its deferred tax assets by relying upon a tax-planning strategy that includes the sale of appreciated non-core assets. The engagement team consults in Year 1 with the National Professional Services Group and agrees with the company’s determination. The company had projected minimal profitability; however, such future income was not considered objectively verifiable and therefore was not relied on to support the deferred tax assets in Year 1. In the subsequent year, the company achieves its forecast but is still in a cumulative loss position. The company determines that the value of the non-core assets has deteriorated but has identified another tax-planning strategy that includes the capitalization of intercompany debt. Reliance on a new tax-planning strategy represents a significant change in facts from the original consultation in Year 1. As a result, the engagement team would be required to consult in the reporting period such change in facts occurs (i.e., in Year 2).

The scenarios above are meant to illustrate the application of the consultation requirement and are not a complete list of all potential situations.

5.1.3.2 Examples of Situations Where Positive Evidence Outweighed Significant Negative Evidence

We have dealt with several situations where it was determined that positive evidence outweighed significant negative evidence so that no, or only a small, valuation allowance was necessary. Each of these situations is based on specific facts and circumstances. Similar situations may not necessarily result in the same conclusions.

1. An entity underwent a leveraged buyout (LBO) and incurred a large amount of debt as a result of that transaction. For several years after the LBO, the entity incurred substantial losses. Without the interest expense on the LBO-related debt, however, the entity would have been profitable.

Recently, the entity had an initial public offering (IPO) of equity securities. The proceeds of the IPO were used to completely pay off the LBO debt.

After the IPO and the related payoff of the LBO debt, the entity concluded that future income would preclude the need for a valuation allowance for its NOL carryforward deferred tax asset.
PwC Observation: The above situation demonstrates the concept of “core earnings.” Absent the interest expense from the LBO, the company consistently demonstrated the ability to operate at a profit. While the company still had to overcome the significant negative evidence that resulted from cumulative losses in recent years, the company’s objectively verifiable core earnings were sufficient to overcome the losses caused by the LBO interest expense.

On the contrary, in a situation somewhat similar to the above, an entity was incurring significant losses as a result of interest on LBO-related debt. However, the entity planned to undergo an IPO three or four years into the future. Due to the uncertainty regarding the entity’s ability to carry out an IPO, it was concluded that a full valuation allowance was appropriate for the NOL carryforward deferred tax asset.

PwC Observation: IPOs involve significant risks and uncertainties. Accordingly, we do not believe that the potential effects of an IPO should be considered until the IPO occurs.

2. During the past five years, a bank incurred substantial losses as a direct result of commercial real estate and lesser-developed-country (LDC) loans. The bank has fully reserved these problem loans and has not originated any new commercial real estate or LDC loans. The bank’s core earnings, which are primarily from consumer and non-real estate commercial lending, historically have been, and continue to be, very profitable.

Management forecasts that, based on historical trends, these core earnings will, over the next five years, be more than sufficient to recover the losses resulting from the old commercial real estate and LDC loans. Accordingly, it was concluded that a valuation allowance was not necessary for the bank’s deferred tax asset.

PwC Observation: In this fact pattern, the bank had demonstrated the ability to be profitable in what it considered to be its core businesses (consumer and non-real estate commercial lending). Once it concluded that it was going to cease originating commercial real estate and LDC loans (and the bank had fully reserved problem loans), the available evidence supported recognition of the deferred tax asset. However, exiting unprofitable businesses does not necessarily ensure that the ongoing entity will be profitable. In some cases, the losses in certain lines of business are indicative of flaws in the company’s broader business model. In other cases, costs associated with those unprofitable businesses may need to be absorbed by the remaining businesses, hindering the historically profitable businesses’ abilities to continue to be profitable. Careful analysis should be performed to determine whether exiting an unprofitable business is sufficient to overcome the losses incurred in recent years.

3. An entity had three separate and distinct lines of business. Historically, two of the lines have been, and continue to be, profitable. The third line incurred substantial losses that led to an NOL carryforward on the entity’s consolidated tax return. The entity recently discontinued its unprofitable line and sold the related assets.
The historical profit levels of the continuing operations were such that the entity could “utilize” the NOL in approximately eight years. Because this was well within the NOL carryforward period in the applicable tax jurisdiction, it was concluded that a valuation allowance was not necessary for the entity’s NOL carryforward deferred tax asset.

**PwC Observation:** Consistent with the bank example above, the mere exiting of a business often does not, in and of itself, ensure future profitable operations. In this case, the company had a clear track record of profitable results in the other lines of business. That factor, coupled with a lengthy carryforward period, was considered sufficient positive evidence. Furthermore, realization of a deductible temporary difference is contingent on the existence of sufficient taxable income of the appropriate character within the carryforward period. In situations where an entity may carryforward tax attributes indefinitely, demonstrating a return to sustainable profitability is generally sufficient.

### 4.

A company had significant losses in the first two years of operations due to substantial start-up costs and marketing expenses. During year 3, the company incurred losses in the first three quarters and income in the last quarter which resulted in a near breakeven year. In year 4, although the entity reported increasing levels of income in each quarter, it was still in a three-year cumulative loss position at the end of its fiscal year. Management’s projections show continued profitability with significant growth going forward. NOL carryforwards were expected to be utilized well in advance of their expiration dates, even without considering any further growth in future years.

Notwithstanding the cumulative loss evidence, as a result of the company’s demonstrated ability to recover the NOLs based on existing levels of taxable income, it was concluded that no valuation allowance is necessary.

**PwC Observation:** Depending on the facts and circumstances, other factors, such as what caused the losses and when the losses occurred in the three-year period may impact the assessment and conclusion.

### 5.1.4 Assessing Changes in the Valuation Allowance

The need for a valuation allowance is a subjective judgment made by management. Obviously, such judgments will change from period to period. However, there should be clear, explainable reasons for changes. In assessing changes in the valuation allowance, it is important to consider again the basis for amounts previously provided and how new information modifies previous judgments. For example, consideration should be given to whether the results for the current year provide additional insights as to the recoverability of deferred tax assets or as to management’s ability to forecast future results.

Said another way, the amount of deferred tax assets, net of the valuation allowance and the amount of change in the valuation allowance in the current year, should make sense considering the prior year’s assessment, current year’s earnings, and other available evidence. In general, if adjustments are made in the first quarter, the entity should be able to explain the change from the preceding year-end. Based on the short time period between issuance of an entity’s year-end financial statements and release of its first-quarter Form 10-Q, changes in judgment during this period would
be expected to be relatively uncommon and generally would result from a specific, significant event or change in facts and circumstances that could not have been foreseen.

5.2 SEC Staff Views on Disclosure and Valuation Allowance Assessments

Establishing a Valuation Allowance too Late

The SEC staff (the staff) continues to focus on the judgments and disclosures related to valuation allowances. The staff has required additional disclosures in certain circumstances in which net deferred tax assets are recorded. When valuation allowances are established, the staff may inquire whether the previous analysis was appropriate and, with the benefit of hindsight, may challenge prior years’ financial statements.

Reducing a Valuation Allowance too Late

The staff also has questioned the provision or retention of a valuation allowance when it appears to be overly conservative and when it may suggest earnings management (i.e., “selecting” the future period(s) in which to release the valuation allowance by modifying assumptions that are not easily susceptible of verification). In particular, the staff has questioned limiting the estimate of future income used in determining the valuation allowance to a relatively short time horizon. See Section TX 5.4.4.2.2.2 for further discussion.

The staff has emphasized that the estimates used in the ASC 740 valuation allowance assessment should be consistent with other estimates involving assumptions about the future used in the preparation of the financial statements and in other filing disclosures. When income projections for only limited future periods have been used in determining the valuation allowance, the staff has asked certain registrants, including those whose core business involves assets whose amortization is closely tied to revenue projections, to explain the longer periods used to amortize such assets.

The staff also has observed that the ASC 740 determination of the valuation allowance and the ASC 360, Property, Plant and Equipment, assessment of impairment of long-lived assets both rely on estimates of future results. Registrants should be prepared to explain and provide support for differences that exist in management’s estimates of future results when making these determinations. Even if the ASC 740 and ASC 360 assessments are consistent, but are both very conservative, there could be a staff challenge to excessive ASC 740 valuation allowances and to premature or excessive impairment write-downs, especially in periods preceding an IPO. See Section TX 5.4.4.2.2.4 for further discussion.

Disclosures

The adequacy and consistency of disclosures also have been challenged. As noted earlier, the staff will not allow assertions, whether stated or implied, in the forepart of the prospectus for a public offering or a periodic report that are inconsistent with the assumptions used in the preparation of the financial statements. The staff has objected specifically to certain optimistic assertions made by management in the forepart of periodic reports, while objective evidence disclosed in the financial statements led management to establish a full valuation allowance against deferred tax assets.
The following excerpt from an SEC comment illustrates a discrepancy between assertions made in management’s discussion and analysis and the establishment of a full valuation allowance against deferred tax assets in the financial statements:

The staff has reviewed the Company’s supplemental response to the previous comment regarding the 100 percent reserve against net deferred tax assets, and believes that management’s discussion and analysis in future filings should be expanded to disclose the general development risks, as described in your previous response to us, that lead to the conclusion that it was more-likely-than-not that the Company’s deferred tax benefits would not be realized. See the criteria specified in ASC 740-10-30-5 and the requirement in Item 303(a)(3) of Regulation S-K to disclose events and uncertainties that management reasonably expects will have a material impact on results of operations. If management concluded it was more-likely-than-not that the deferred tax assets would not be realized based upon all evidence including the general development risks, then it appears that management would also reasonably expect that such general development risks would have a material impact on results of operations (not just revenues) and should therefore be disclosed in the MD&A section. Please revise.

Furthermore, the staff has suggested that when a short time horizon is used in the income projections underlying the valuation allowance, the “risk factors” or other appropriate sections in a prospectus must include management’s conclusion that current evidence indicates that it is more-likely-than-not that there will be no income in later periods.

Additional disclosures regarding valuation allowances may be required by ASC 275, Risks and Uncertainties. When it is at least reasonably possible that a material adjustment of the valuation allowance will occur in the near term, the financial statements must disclose this possibility. This requirement is discussed in ASC 275-10-50-6 through 50-15, and an example relating to the valuation allowance is given in ASC 275-10-55-219 through 55-222. Refer to Section TX 15.7 for additional guidance.

In situations where the valuation allowance assessment is difficult, clients undoubtedly will be interested in the staff’s areas of focus. However, that focus should not be interpreted as a recommendation by the staff to release the valuation allowance. Rather, it emphasizes the importance—in determining the valuation allowance—of using a balanced, supportable approach that is consistent with other important assertions underlying the financial statements and with management’s non-financial statement disclosures throughout SEC filings. We expect that the staff will continue to focus on management’s judgment in its assessment of the need for a valuation allowance.

### 5.3 Other Considerations

#### 5.3.1 Evaluating the Effect of a Restructuring

When an entity is determining whether positive evidence outweighs negative evidence in forming a conclusion that a valuation allowance is not needed, it may be appropriate for the effect of a restructuring (i.e., an implemented plan to exit an activity) to be considered. In evaluating assumptions that decrease historical costs, it is appropriate to consider the effect of cost-cutting measures that have been successfully implemented to date. These measures are likely to impact the historical earnings trend in two ways. First, these measures usually require an earnings charge...
at the time they are implemented, which may not recur in the future. Second, they should result in a reduction of ongoing operating costs.

To the extent that the reduction in costs associated with the restructuring measures can be “objectively verified,” it is appropriate for an entity to consider those reductions as positive evidence when assessing the need for a valuation allowance. However, the effects that these cost-cutting measures may have on revenues and profitability also should be considered carefully (e.g., a significant reduction in sales force generally would correlate to a loss of sales volume). A strategy to implement an exit plan at some future date would be difficult to objectively verify because it is a future event.

An entity with significant negative evidence, such as a history of recent losses, normally will find it very difficult to demonstrate that even an implemented exit plan provides sufficient objective evidence that the entity will be restored to profitability, prior to the time that it actually becomes profitable. In these circumstances, it would be that much more difficult to demonstrate that an unimplemented exit plan provides sufficient objective evidence to overcome the negative evidence present.

5.3.2 Determining the Need for a Valuation Allowance in a Business Combination

When assessing the need for a valuation allowance against deferred tax assets at the date of business combination, all available evidence should be considered. Historical performance, as well as future projections, should be considered, with more weight assigned to information that is objectively verifiable.

In particular:

- It may be appropriate to consider certain pro forma adjustments to the historical operating results of the acquired entity to provide an indication of the future earnings capabilities of the acquired entity after acquisition. For example, in a case where a significant amount of debt is pushed down to the acquired entity in conjunction with the acquisition, it would be appropriate to consider the past results of the acquired entity adjusted to reflect the interest expense that will be incurred on the debt. Conversely, in a case where significant overhead or debt is eliminated from the target, it may be appropriate to adjust the historical operating results in order to provide a more accurate depiction of the business.

- In all cases, the greatest emphasis should be placed on information that is objectively verifiable. For example, anticipated “synergies” that are expected to result from the business combination may not be objectively verifiable until they can be demonstrated. On the other hand, it may be appropriate to reduce or exclude certain historical operating costs to the extent they relate to identified redundancies such as duplicate accounting systems that will be eliminated post combination.

An analysis of all available evidence may result in the recognition of a valuation allowance on the deferred tax assets of the acquired entity in conjunction with the acquisition or in some cases, no valuation allowance on the acquired deferred tax assets even though the target company may have previously recorded a valuation allowance in its historical financial statements. See Section TX 10.5.2 for additional discussions on evaluation the future combined results in a business combination.
5.3.3 Going-Concern Uncertainty

SAS 59 requires an explanatory paragraph when the auditor concludes that substantial doubt exists regarding an entity’s ability to continue as a going concern for a reasonable period of time, which is usually understood to be one year from the date of the balance sheet. In many circumstances, the factors that lead to the inclusion of such an explanatory paragraph also would constitute significant negative evidence under ASC 740. Because of the severity of the situations in which such an explanatory paragraph is required, we believe that a valuation allowance almost always would be required for all deferred tax assets that are not assured of realization by either (1) carryback to prior tax years or (2) reversals of existing taxable temporary differences. However, there may be circumstances, albeit relatively uncommon, where the immediate cause for the going-concern uncertainty is not directly related to the entity's operations, and, absent the matter that led to the uncertainty, the entity would expect to continue generating operating and taxable profits.

Conversely, the absence of a going-concern explanatory paragraph does not, by itself, constitute positive evidence about the realization of deferred tax assets. For example, if an auditor considered issuing a going-concern explanatory paragraph, but ultimately concluded that it was not needed (because the entity had sufficient sources of cash flow with which to meet its debt-service requirements and remain in existence for a reasonable period of time), this would not necessarily indicate that the entity would have future taxable income. Similarly, an assessment stating that a valuation allowance is required for all or a portion of an entity’s deferred tax assets is not necessarily indicative of the existence of a going-concern problem.

In addition to going-concern considerations, there are certain entities that, by their nature, ordinarily are required to record a valuation allowance for deferred tax assets that are not supported by either a carryback or a reversal of existing temporary differences. Examples include entities emerging from bankruptcy; development-stage entities, as defined by ASC 915, Development Stage Entities; and other start-up operations. An exception might be a subsidiary in the development stage whose parent has the ability, under the tax law, to cause the subsidiary to generate sufficient taxable income, and the intent to do so, if necessary.

When we have performed extended going concern procedures (regardless of whether a going concern opinion is ultimately rendered), and the company asserts that it can consider future taxable income to support realization of deferred tax assets, PwC engagement teams are required to consult with the Accounting Services Group within PwC’s National Professional Services Group.

5.4 Sources of Taxable Income

Future realization of deferred tax assets is dependent on taxable income of the appropriate character (e.g., ordinary or capital) within the carryback and carryforward periods available under the tax law. ASC 740-10-30-18 identifies four sources of such taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards. They are listed here in order of the most objective to the most subjective.

- Taxable income in prior carryback years if carryback is permitted under the relevant tax law.
- Future reversals of existing taxable temporary differences (including liabilities for unrecognized tax benefits).
• Tax-planning strategies.
• Future taxable income exclusive of reversing temporary differences and carryforwards.

**PwC Observation:** Pursuant to ASC 740-10-30-18, consideration of each source of income is required in order to determine the amount of the valuation allowance that should be recorded against deferred tax assets. We believe that companies should consider sources of taxable income beginning with the most objective, moving to the most subjective. If one or more sources are sufficient to realize the deferred tax asset, no further consideration is required of the remaining sources. If, for example, existing taxable temporary differences are greater than deductible temporary differences and loss carryforwards, and the reversal patterns are such that offset is expected under the tax law, there is no need to consider the remaining sources of taxable income, even if future losses are expected.

The first two sources are those for which it is unnecessary to look to future events other than reversals of the temporary differences: actual taxable income in the available carryback period and reversing taxable temporary differences that offset deductible temporary differences or carryforwards either in the reversal year or in the applicable carryback and carryforward periods. The third source is tax-planning strategies, which are actions that management ordinarily might not take but would take, if necessary, to realize a tax benefit for a carryforward before it expires. Finally, the fourth source, taxable income expected to be generated in the future (aside from reversing temporary differences), frequently requires the greatest attention in assessing whether a valuation allowance is necessary, since it requires estimates and judgments about future events, which are difficult to objectively verify. All four sources are discussed in more detail below.

It is important to reiterate that the underlying assumptions about the business and prospective outlook used to evaluate and determine future taxable income and the realizability of assets should be consistent with the assumptions used for other financial reporting projections.

### 5.4.1 Taxable Income in Prior Carryback Years if Carryback Is Permitted under the Tax Law

Taxable income that can be carried back to prior years is the most objectively verifiable source of income and should be considered first. To the extent that sufficient taxable income of the appropriate character (i.e., ordinary or capital) exists, and is not subject to limitations under current tax law in the carryback period, there is no need to consider other sources of taxable income in concluding that a valuation allowance is not necessary. However, if it is insufficient, an entity must consider one or more of the other sources of taxable income.
5.4.1.1 Special Considerations for Carrybacks

5.4.1.1.1 Liabilities for Unrecognized Tax Benefits as a Source of Taxable Income

A liability for unrecognized tax benefits should be considered a source of taxable income in the carryback period for purposes of determining the expected realization of a deferred tax asset. Because settlement with the taxing authority is presumed to be at the recorded amount of the liability, the position’s resolution effectively amounts to additional taxable income over the taxable income expected on the “as-filed” or expected-to-be-filed tax return. Therefore, unrecognized tax benefits should be viewed as an additional source of taxable income and be considered as part of the assessment of whether a deferred tax asset is realizable. Consistent with all sources of taxable income, and to the extent necessary under the relevant tax law, the character of the uncertain tax position should be considered. For example, in the United States, an uncertain tax position that avoided recognition of a capital gain may provide a source of income to realize capital losses that otherwise would not be realizable. In addition to character, an understanding of the period in which the taxing authority would assess the tax (to the extent the position was lost) also would need to be considered. For example, if the period in which the taxing authority adjusts taxable income is not within the carryback period for which the assessment of realizability of deferred tax assets is made, then the income is not available as a source.

5.4.1.1.2 Carrybacks That Free Up Credits

Since the applicable tax rate at which deferred taxes are recorded is the tax rate prior to consideration of credits, there is a special consideration when it is expected that net deductible temporary differences reversing in a single future year will be included in a tax loss that will be carried back to prior years and will, at least partially, free up tax credits (which were used originally to reduce the tax payable) rather than result in a refund. We believe that realization of deferred tax assets represents incremental cash tax savings. Merely replacing one deferred tax asset (deductible temporary difference) with another deferred tax asset (credit carryforward), when there is not a source of income to realize it, does not represent realization of the initial deferred tax asset, and a valuation allowance would be necessary. Refer to the following example:

Example 5-4: Loss Carryback

Company A generated a $2.0 billion net operating loss in Year X. The loss was carried back to the second and first preceding tax years to offset $95.0 million and $166.0 million of taxable income, respectively. As a result of carrying back the NOL, credits that previously were utilized in the carryback years were no longer needed. As a result, the $6.0 million and $10.0 million of research and experimentation (R&E) credits were “freed up” and would be available as a carryforward for use in future years.
### Reconciliation of Valuation Allowance (In '000)

<table>
<thead>
<tr>
<th>Reconciliation Item</th>
<th>1st Preceding Year</th>
<th>2nd Preceding Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL Generated in Year X</td>
<td>$2,000,000</td>
<td></td>
</tr>
<tr>
<td>Realization of Year X NOL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st Preceding Year</td>
<td>(166,000)</td>
<td></td>
</tr>
<tr>
<td>2nd Preceding Year</td>
<td>(95,000)</td>
<td></td>
</tr>
<tr>
<td>Total Year X NOL (Subject to VA)</td>
<td>1,739,000</td>
<td></td>
</tr>
<tr>
<td>Tax Rate</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Tax Effected NOL Balance</td>
<td>$608,650</td>
<td>(A)</td>
</tr>
<tr>
<td>PLUS:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Freed Up” R&amp;E Tax Credits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st Preceding Year</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>2nd Preceding Year</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Tax Credit Generated in Year X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st Preceding Year</td>
<td>3,320</td>
<td></td>
</tr>
<tr>
<td>2nd Preceding Year</td>
<td>1,900</td>
<td></td>
</tr>
<tr>
<td>Total Tax Credits (Subject to VA)</td>
<td>$21,220</td>
<td>(B)</td>
</tr>
<tr>
<td>Total Deferred Tax Asset (Subject to VA)</td>
<td>$629,870</td>
<td>= (A) + (B)</td>
</tr>
</tbody>
</table>

Note 1: The Alternative Tax Net Operating Loss Deduction (ATNOLD) is the sum of the alternative tax net operating loss (ATNOL) carrybacks and carryforwards to the tax year, subject to the following limitation: The ATNOLD is generally limited to 90% of alternative minimum taxable income (AMTI). The 90% limitation is increased to 100% for NOLs generated or taken as carryovers in tax years ending in 2001 or 2002. In situations when taxable income is fully offset by an NOL for regular tax purposes and fully offset (to the extent of the limitation of 90%) for AMT purposes, the computed AMT tax rate is 2% [= (100% – 90%) x 20%].

Corporations are allowed a $150,000 exemption; however, the exemption is phased-out if alternative minimum taxable income is $310,000 or more. In the example above, assuming no AMTI preferences and/or adjustments, Company A is phased-out of the $150,000 exemption and subject to the alternative minimum tax.

As Company A has no projected taxable income, a portion of the loss carried back was not realized (ASC 740-10-55-37), but rather resulted in the establishment of a new deferred tax asset in the form of a credit carryforward. Absent any other sources of future taxable income, Company A would need to establish a valuation allowance against the R&E and minimum tax credit carryforwards that were released and generated, respectively, through the loss carryback.
Therefore, of the $2.0 billion NOL (deferred tax asset) that Company A generated in Year X, $261.0 million will be realized as a benefit through the current-year provision vis-à-vis the loss carryback. The remaining NOL balance of $1.739 billion will result in a deferred tax asset of approximately $608.7 million (tax-effected at 35 percent) for which a valuation allowance should be established. Furthermore, a valuation allowance should be established against the $16.0 million of freed-up R&E credits as well as approximately $5.2 million of minimum tax credits for which Company A has determined realization to be not more-likely-than-not. Therefore, Company A’s total valuation allowance balance at the end of Year X is approximately $629.9 million.

5.4.1.1.3 Carryback Availability That May Not Be Used

As discussed above, ASC 740-10-30-18 states, “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.” This might be read to indicate that a computation considering only three sources—reversing temporary differences, carryback availability, and available strategies—would determine the maximum level of valuation allowance that would be required if no future taxable income was anticipated. However, with regard to carryback availability companies should carefully consider whether carryback availability truly provides an incremental source of taxable income to support realization of deferred tax assets.

Carryback availability will provide a source of income to realize a deferred tax asset only if carryback actually will occur. In general, we believe that the valuation allowance assessment should consider what the company actually expects to report on its tax return in the carryback window. Assume, for example, that management is projecting taxable income in the near term. That taxable income may preclude actual carryback. Accordingly, in that situation carryback availability would not provide an incremental source of taxable income to support the realization of a deferred tax asset.

If, however, a company is projecting taxable losses in the near term or is unable to rely on its projections of taxable income, it may be appropriate to consider carryback as an incremental source of taxable income to support realization of the deferred tax assets. For example, if a company has a three year cumulative loss and determines that it is unable to rely on its projections of future taxable income (e.g., because objectively verifiable evidence indicates the Company will have losses in the future), it may be appropriate to consider carryback availability as a source of income to realize deferred tax assets. Judgment must be applied in determining whether carryback availability provides an incremental source of taxable income.

5.4.2 Future Reversals of Existing Taxable Temporary Differences

To the extent that reversal of existing taxable temporary differences is used as a source of taxable income that provides assurance of realization, a scheduling process may be needed to establish whether appropriate offset to deductible temporary differences is provided. In some cases, scheduling can be an in-depth detailed analysis of reversal patterns, specifically tracking reversals of taxable temporary differences in order to ensure the realizability of existing deductible temporary differences. In other cases, obtaining a general understanding of reversal patterns is sufficient. Refer to Section TX 5.5 for further discussion.
**PwC Observation:** The mere existence of taxable temporary differences does not make them a source of taxable income for the recognition of deductible temporary differences. Scheduling generally will need to be performed at some level to determine whether the existing taxable temporary differences will reverse in a period that will allow them to be a source of income to realize deductible temporary differences.

This observation can be illustrated as follows:

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**Example 5-5: Should Deferred Tax Liabilities Related to an Outside Basis Difference Be Used as a Source of Future Taxable Income in Determining the Need for a Valuation Allowance?**

**Background/Facts:**
Parent X owns a foreign subsidiary and has established a deferred tax liability for the excess of book over tax basis in the investment. Although until the current period there was no definitive plan for repatriation, management could not assert indefinite reversal in accordance with ASC 740-30-25-17 due to uncertainty concerning its plans. Parent X is not profitable in its home jurisdiction and has significant net deferred tax assets (including NOL carryforwards) that carry a full valuation allowance.

**Question(s):**
Can Parent X use the deferred tax liability related to the outside basis difference in the foreign subsidiary as a source of taxable income in assessing the realizability of its deferred tax assets? If not, at what point would the deferred tax liability be considered a viable source of taxable income, thus supporting reversal of a portion of the valuation allowance?

**Analysis/Conclusion:**
When a taxable temporary difference related to the outside basis difference in a foreign subsidiary (e.g., related to undistributed foreign earnings) is viewed as a source of taxable income to support recovery of deferred tax assets, a company’s plans with respect to the timing of repatriation should be considered. Parent X would not be able to consider the taxable temporary difference on the outside basis difference as a source of taxable income for purposes of realization of its deferred tax assets if reversal is not expected to occur within the carryforward period (e.g., near-term repatriation of the cash might not be feasible). Alternatively, repatriation might be viewed similarly to a tax-planning strategy since presumably management might undertake a repatriation plan solely to prevent the loss carryforward from expiring unutilized, assuming such a strategy would be both prudent and feasible.

Conversely, a company asserting indefinite reinvestment under ASC 740-30-25-17 would be precluded from relying on repatriation as a tax-planning strategy (ASC 740-30-25-11 through 25-13).
Example 5-6: Whether Deferred Tax Credits Related to Leveraged Leases Can Be Considered in Determining the Amount of a Valuation Allowance for Deferred Tax Assets

Background/Facts:
Corporation X needs a valuation allowance for its deferred tax assets because it has cumulative losses in recent years. However, Corporation X has deferred tax liabilities that reduce the amount of valuation allowance required. Corporation X also has a portfolio of leveraged leases (as defined in ASC 840-10-25-43) that are accounted for under ASC 840, Leases. Corporation X has recorded deferred taxes from leveraged leases following the leveraged lease accounting model in ASC 840 and reflects the balance in a line item in the balance sheet titled "Deferred taxes from leveraged leases" in accordance with ASC 840-30-45-5.

Question:
Should the leveraged lease deferred taxes ("deferred tax credits") be considered as providing a source of taxable income under ASC 740-10-30-18, if the underlying taxable temporary differences will reverse during the periods that will allow them to be a source of income to realize some of Company X's deferred tax assets?

Analysis/Conclusion:
Yes. Leveraged lease deferred tax credits are not the same as deferred tax liabilities. Accounting for these credits is excluded from the scope of ASC 740 (see ASC 740-10-25-3c). Nevertheless, the underlying taxable temporary difference should be considered as a possible source of taxable income under ASC 740-10-30-18. However, because of differences in accounting for income taxes between the leveraged lease model and the ASC 740 asset-and-liability approach, the balance of the deferred credits may not provide a dollar-for-dollar offset to deferred tax assets. Accordingly, integration (see next paragraph below and ASC 840-30-45-6) of the results of accounting for income tax under the two standards is required when unrecognized deductible temporary differences or carryforwards unrelated to a leveraged lease could be offset by taxable amounts resulting from the reversal of the taxable temporary differences related to leveraged leases. A valuation allowance is not required for deferred tax assets if they will be realized by taxable income arising from the reversal of the taxable temporary differences related to the leveraged leases (subject to this integration process).

The concept of “integration” includes “converting” the balance of ASC 840 deferred tax credits to the equivalent deferred tax liability balance. The latter would be the deferred tax liability that would be recognized if the tax effects of leveraged leases were measured by applying the asset-and-liability approach of ASC 740, rather than leveraged lease model in ASC 840, to the pretax leveraged lease accounting. Potential differences between the leveraged lease model and the asset-and-liability approach would typically include differences in accounting for income tax rate changes and investment tax credits. See PwC ARM 4650.542 for further discussion.
Example 5-7: Consideration of limitations on the use of net operating loss carryforwards in assessing the need for a valuation allowance

Background/Facts:
Company A, a U.S. multinational, is assessing the need for a valuation allowance on deferred tax assets maintained by one of its foreign subsidiaries, Company B. As of the prior balance sheet date, Company A determined that, based on the weight of all available evidence, a valuation allowance for deferred tax assets was not required for Company B. This conclusion was based upon the scheduling of taxable and deductible temporary differences, along with tax loss carryforwards. The reversal patterns were such that the full benefit of the deferred tax asset was expected to be realized. Given this source of taxable income was sufficient to fully realize the deferred tax assets, no further consideration was required of any remaining sources.

Historically, Company B had the ability to carry forward tax losses on a fifteen-year basis with no limitation on the amount utilized. In the current period, the foreign government enacted tax law changes that impacted the utilization of existing losses in fiscal years commencing in 201X and thereafter. Under the new provisions, tax loss carryforwards can only be utilized to offset 70 percent of taxable income in any given year.

Question:
In determining the need for a valuation allowance, should Company A consider the loss limitations imposed by the tax law change enacted in Company B’s jurisdiction?

Analysis/Conclusion:
Yes. ASC 740-10-55-36 requires an entity to assess the recognition of a tax benefit for carryforwards as follows:

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.

The loss restrictions enacted by the foreign government pose new evidence that may shift loss utilization into later years or suggest that income in future periods will be insufficient to support realization of existing deferred tax assets. As a result, a partial valuation allowance could be required.

Assume that Company B has recorded deferred tax assets (“DTAs”) based on deductible temporary differences (“Other”) and net operating losses (“NOLs”) of $180 and $120, respectively. In addition, Company B has recorded deferred tax liabilities (“DTLs”) for taxable temporary differences of $300. Company B is unable to rely on a projection of taxable income (exclusive of reversing temporary differences) and the existing inventory of deductible and taxable temporary differences is expected to reverse ratably over the next three years. Assume there are no other sources of future taxable income, such as tax-planning strategies or actions.

Under local tax law enacted in 20X1, the NOLs expire in three years and are only available to offset 70 percent of taxable income in any given year. The following table summarizes the computed NOL utilization after application of the loss limitation:

(continued)
Accordingly, a partial valuation would be required for the remaining NOLs of $36 that are expected to expire prior to realization.

A similar scheduling exercise would be required if Company B previously maintained a full valuation allowance against its net DTAs. For example, assume a similar fact pattern with Company B instead having taxable temporary differences of $210 and a full valuation allowance recorded against its net DTAs. The following table summarizes the valuation allowance before and after application of the loss limitation:

<table>
<thead>
<tr>
<th>Account</th>
<th>BOY 20X1</th>
<th>Reversal 20X1</th>
<th>Reversal 20X2</th>
<th>Reversal 20X3</th>
<th>EOY 20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary Deductible Differences—Other</td>
<td>180</td>
<td>(60)</td>
<td>(60)</td>
<td>(60)</td>
<td>—</td>
</tr>
<tr>
<td>Temporary Taxable Differences</td>
<td>210</td>
<td>70</td>
<td>70</td>
<td>70</td>
<td>—</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>—</td>
</tr>
<tr>
<td>NOL Utilization (70% Limitation)</td>
<td>(7)</td>
<td>(7)</td>
<td>(7)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>NOL Remaining</td>
<td>120</td>
<td>113</td>
<td>106</td>
<td>99</td>
<td>99</td>
</tr>
<tr>
<td>Net DTA (30% Tax Rate)</td>
<td>27</td>
<td>30</td>
<td></td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>(27)</td>
<td>(30)</td>
<td></td>
<td></td>
<td>—</td>
</tr>
</tbody>
</table>

Accordingly, Company B would need to increase the existing valuation allowance from $27 to $30 to account for the NOLs that are expected to expire prior to realization. Similarly, in situations when an entity is in an overall net deferred tax liability position, a valuation allowance may be required if income in future periods is insufficient to support realization of NOLs prior to expiration.

When assessing the realizability of DTAs, companies need to evaluate all of the relevant tax laws and other evidence. As a reminder:

Because the NOL limitation (in this case) is determined by reference to future taxable income levels, some have observed that future losses would make the imposition of the limitation irrelevant. However, ASC 740-10-25-38 specifically precludes anticipating future tax losses. As a result, in situations where future taxable income cannot be relied upon, our view is that the benefit of any reversing taxable temporary differences (and the effect of any NOL limitation) be determined with an assumption of zero or break-even future income.

While detailed scheduling is not required by ASC 740 in all cases, it is necessary when it has an impact on the valuation allowance assessment.
5.4.2.1 Deferred Tax Liabilities on Indefinite-Lived Intangible Assets—“Naked Credits”

One example of a deferred tax liability that would not ordinarily serve as a source of income for the realization of deferred tax assets is a deferred tax liability that relates to an asset with an indefinite useful life (e.g., land, goodwill, indefinite-lived intangibles) that is located in a jurisdiction where there is a finite loss carryforward period. In this case, the deferred tax liability, commonly referred to as a “naked credit,” will not reverse until some indefinite future period when the asset is either sold or written down due to impairment.

Such taxable temporary differences generally cannot be used as a source of taxable income to support the realization of deferred tax assets relating to reversing deductible temporary differences, including loss carryforwards with expiration periods. In those situations where another source of taxable income is not available, a valuation allowance on deferred tax assets is necessary even though an entity may be in an overall net deferred tax liability position.

However, if the company can determine the expected timing of the reversal of the temporary difference, it may be appropriate to consider this deferred tax liability as a source of income for the realization of deferred tax assets. For example, if a Company enters into a sale agreement and as a result an indefinite-lived intangible asset was classified as held for sale pursuant to ASC 360-10-45-9, the timing of the reversal of the deferred tax liability is now predictable, and therefore can be considered as a source of income to support realization of deferred tax assets. Another example is an indefinite-lived intangible for in process R&D depending on when the reversal of the deferred tax liability is expected. See Section TX 10.4.5 for further discussion.

As a general rule, when an entity has more than one asset with an indefinite useful life and one or more of those assets is in a net deductible temporary difference position at the balance sheet date (e.g., due to an impairment charge recorded for book purposes), the taxable temporary differences related to other indefinite-lived assets should not be offset against such deductible amounts when assessing the need for a valuation allowance. Offsetting is not generally appropriate because the reversal of the deferred tax asset is not indefinite (i.e., reversal will occur as the tax basis is amortized).

However, in a situation where the deductible temporary difference is truly indefinite in nature it may be appropriate to use a deferred tax liability related to an indefinite-lived asset as a source of income to support realization of the deferred tax asset (assuming that they are within the same jurisdiction, of the appropriate character and that the deferred tax asset is realizable if the taxable income were to become available). A taxable temporary difference related to indefinite-lived assets would provide a source of taxable income to support realization of deferred tax assets in jurisdictions with an unlimited carryforward (e.g., Alternative Minimum Tax (AMT) credit carryforwards in the U.S.).

This is illustrated as follows:
Example 5-8: Determining the Amount of Valuation Allowance Necessary When There is a Deferred Tax Liability Related to an Indefinite-lived Asset in a Jurisdiction with an Unlimited Loss Carryforward Period

Background/Facts:
Company A is in a jurisdiction with an unlimited NOL carryforward period. Included in the net deferred tax asset is a deferred tax liability recorded for an indefinite-lived intangible asset. There have been significant historical losses and the taxable temporary difference related to the indefinite-lived intangible asset is the only source of income available to support realization of the deferred tax asset related to the NOL carryforward.

Question:
Should Company A consider the taxable temporary difference associated with the indefinite-lived asset as a source of taxable income to support realization of the NOL deductible temporary difference?

Analysis/Conclusion:
By definition, a naked credit tax effect arises when income tax attributes such as NOLs and credits have expiration periods. In such cases, it is generally not appropriate to offset deferred tax liabilities with indefinite/unknown reversal patterns against deferred tax assets that are scheduled to reverse or will expire over time.

However, if there is an unlimited loss carryforward period, the taxable temporary difference related to the indefinite-lived asset would constitute a source of taxable income to support the realization of the deferred tax assets related to attributes with an unlimited carryforward period since both have indefinite reversal or expiration periods. (This assumes that both are within the same tax jurisdiction, of the appropriate character and that the deferred tax asset is realizable if the taxable income were to become available.)

It should be noted that a similar analysis would apply if Company A were a U.S. corporation with accumulated AMT credits since such attributes have an unlimited carryforward period.

There may be cases, however, that an indefinite-lived deferred tax asset will not be realizable at the time the taxable temporary difference reverses. Therefore, it may not always be appropriate to characterize a taxable temporary difference related to an indefinite-lived asset as a source of taxable income to support the realization of an indefinite-lived deductible temporary difference. For example, if a deferred tax liability related to non-deductible goodwill was subsequently impaired (thus providing a source of taxable income at the time of impairment), a deferred tax asset related to land may not necessarily be realizable since the deduction is dependent on the sale or impairment of the land. By contrast, if the deferred tax asset was an NOL carryforward in an unlimited carryforward jurisdiction, the NOL deferred tax asset would be realizable at the time of the goodwill impairment.

5.4.3 Tax-Planning Strategies
In assessing the need for a valuation allowance, the consideration of tax-planning strategies is not elective; if there is an available tax-planning strategy that is prudent and feasible, it must be incorporated into the assessment.
As use of tax-planning strategies is not elective, the question arises as to the extent to which management must actively search for usable strategies.

A reasonable effort should be undertaken to find usable tax-planning strategies. Under ASC 740, these are actions that the entity is likely to implement if its projections of future taxable income otherwise would not be realized, so management should already be thinking about them as part of its regular tax planning. If a tax-planning strategy is discovered subsequently that appropriately could have been considered in a prior year, it will raise a question about whether the prior year’s financial statements should be restated. It could be asserted that the statements were issued originally in error because they failed to adequately recognize a potential tax-planning strategy existing at the balance sheet date. The FASB staff states, with respect to tax-planning strategies, in ASC 740-10-55-41:

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.

### 5.4.3.1 Tax-Planning Strategies Defined

ASC 740 identifies two functions of tax-planning strategies: (1) in assessing the valuation allowance for deferred tax assets, a tax-planning strategy may provide assurance of realization in a situation in which a valuation allowance otherwise might be necessary, and (2) a tax-planning strategy, whether or not used or needed to avoid a valuation allowance, may reduce the complexity of application of ASC 740.

For example, an entity could have a deferred tax liability in excess of the deferred tax assets recorded for a particular tax jurisdiction. However, it is not clear that the reversals of the taxable differences will offset, within the applicable carryback and carryforward periods, the reversals of the deductible differences and carryforwards represented by the tax assets. If future prospects are somewhat marginal, the entity may face a full-scale scheduling exercise to determine the extent to which reversing taxable differences will offset, both as to amount and timing, the deductible differences. But scheduling will be unnecessary if the entity has a valid tax-planning strategy that ensures that if any required future taxable income, other than reversals, is not generated, taxable income or deductions from reversals can be shifted among future years so that deductible differences and carryforwards will be offset by taxable differences.

As defined in ASC 740-10-30-19, a tax-planning strategy is a tax-planning action that meets certain criteria:

- It must be 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. If management would not implement a strategy because it would not be in the entity’s best interests, it would not be prudent. If management does not have the ability to carry out the strategy, it would not be feasible. The strategy need not be in the unilateral control of management, but it must be primarily within its control.
For example, restrictions in loan agreements would have to be considered in determining whether a strategy is feasible.

• It is a strategy that an entity ordinarily might not take, but would take to prevent an operating loss, including an operating loss expected to result from the future reversal of a deductible difference, or to prevent a tax credit from expiring unutilized, and that would result in realization of deferred tax assets. Thus, strategies that the entity takes ordinarily, or that are designed to shift taxable income and deductions to take advantage of different tax rates, are generally not tax-planning strategies as defined, but would be considered tax-planning actions that are reflected in projections/scheduling if management expects to employ such an action (refer to the discussion of tax-planning at Section TX 5.4.4.2.2.1).

**PwC Observation:** Two important distinctions between tax-planning actions and tax-planning strategies are: (1) tax-planning actions are reflected in estimates of future taxable income when scheduling or projecting income only if the entity is currently in a position to employ those actions; therefore, the timing of the recognition of the effects of tax-planning actions is different than for tax-planning strategies, which are anticipated based on management’s intent and ability, if necessary, and (2) the tax benefit recognized for a tax-planning strategy, as defined, is recorded net of any cost or expense incurred in implementing the strategy.

Some tax-planning strategies (e.g., triggering the LIFO reserve or shifting a tax-exempt portfolio to taxable) actually would create additional taxable income. Other tax-planning strategies may affect only the timing of specific taxable income or deductions. The latter would ensure realization of deferred tax assets if they provided appropriate offset of reversals of existing taxable differences against deductible differences. However, in some cases, they may only extend the period of future years to which the entity may look for additional taxable income to be generated other than from reversals. For example, a sale-leaseback typically would replace one deferred tax asset, that for an expiring loss carryforward, with another, that for the deferred gain for book purposes arising from the sale-leaseback. As mentioned in ASC 740-10-55-37, a reduction in taxable income or taxes payable as a result of NOLs and credit carryforwards does not constitute recognition of a tax benefit. The utilization of existing NOLs and credits is merely replaced by a temporary difference that will result in future deductible amounts.

Thus, absent future taxable income to realize the deferred tax asset related to the deferred gain, the sale-leaseback does not in itself realize the deferred tax asset. Realization would be achieved only if the entity was able to support the existence of a future source of taxable income that would be generated in the leaseback period.

A tax-planning strategy that triggers a gain on the appreciation of certain assets for tax purposes (including LIFO inventories) may require special consideration. ASC 740-10-30-22 cites appreciation in net assets as an example of positive evidence. For the strategy to create additional taxable income rather than merely affect the timing of taxable income and deductions, the appreciation would have to be unrecognized and unrealized. Recognized, but unrealized, appreciation (e.g., certain marketable securities carried at market under ASC 320, Investments—Debt and Equity Securities, but not subject to the mark-to-market tax rules) would already be considered a taxable temporary difference.
An available tax-planning strategy to create additional taxable income may not ensure realization of deferred tax assets if future operating losses are expected, which would offset the taxable income from the strategy. Refer to the following example:

**Example 5-9: Potential Tax-Planning Strategy That Only Reduces Future Loss**

**Background/Facts:**
XYZ Company has experienced a history of operating losses over the past five years that total $20.0 million and has a net deferred tax asset of $8.0 million (tax rate of 40 percent) arising primarily from NOL carryforwards from such losses. A full valuation allowance historically has been recorded against the net deferred tax asset.

Based on the introduction of a new product line, Company XYZ currently is projecting that, for the next three years, it will experience losses of approximately $5.0 million in the aggregate before it “turns the corner” and becomes profitable. Due to appreciation in the real estate market, Company XYZ’s investment in a shopping mall property is now valued at approximately $500,000 more than the carrying amount in its financial statements. The entity proposes to reverse $200,000 ($500,000 x 40%) of its valuation allowance based on a tax-planning strategy to sell the investment in the shopping mall. The shopping mall is not a “core” asset of the entity, and management asserts that it would sell the shopping mall property, if necessary, before it would permit the NOL carryforward to expire unused.

**Question:**
Should the valuation allowance be reduced for the tax-planning strategy?

**Analysis/Conclusion:**
We believe that a tax-planning strategy to sell appreciated assets constitutes a subset of the broader source of future taxable income from operations. Thus, it would not be appropriate to reduce a valuation allowance when it appears that the tax-planning strategy will only reduce an expected future loss. In the above case, based on (1) the entity’s history of losses, (2) an unproven new product line, and (3) the fact that the entity does not anticipate being profitable for at least three years, little weight can be assigned to the projection of profitability. Accordingly, there is no incremental tax benefit (at least for the foreseeable future), as the potential gain on the sale of the shopping mall property would only reduce what otherwise would be a larger operating loss.

**PwC Observation:** The consideration of future losses in this analysis differs from the principle established in ASC 740-10-25-38, which notes that “the anticipation of the tax consequences of future tax losses is prohibited.” ASC 740-10-25-38 considers the fact that, for example, if a company was anticipating losses for the foreseeable future, one conceptually might conclude that there was no need to record deferred tax liabilities because they might not represent an incremental increase to the company’s tax liability. However, the Board rejected this notion. In this context, future losses are considered as part of determining whether the implementation of the proposed tax-planning strategy will indeed provide a source of income for the realization of deferred tax assets.
Example 5-10: Determining When a Particular Tax-Planning Action Would Constitute a “Tax-Planning Strategy,” as Defined in ASC 740

Background/Facts:
Company X acquires certain entities in Europe that have net deferred tax assets. In completing an evaluation of the recoverability of the net deferred tax assets and assessing the need for a valuation allowance, Company X considers the following two actions:

1. Company X is contemplating a new business model to create an operating platform that is substantially different from the current platform. The new platform would involve the creation of a new European headquarters to centralize many of the risks and functions currently borne by various entities. Aside from the European headquarters operation, the other European territories would be established as contract manufacturers. As a result of the new platform, income would be shifted to certain entities, which would allow Company X to take advantage of more favorable tax rates and may in some cases shift income to certain jurisdictions that currently generate net operating losses and require full valuation allowances.

2. Company X is discussing combining two of its German entities for tax purposes, which would allow it to utilize all of its existing net operating losses (absent combining the two entities, Company X would need to provide a full valuation allowance).

Question:
Do either of the above considerations qualify as a “tax-planning strategy” as defined in ASC 740-10-30-19?

Analysis/Conclusion:
ASC 740-10-30-19 defines a tax-planning strategy as an action that an entity ordinarily might not take, but would take to prevent a tax attribute from expiring unused. It goes on to say that the action must be prudent and feasible and result in the realization of deferred tax assets.

The first scenario would not be considered a tax-planning strategy, but rather a tax-planning action, as the action is done in the ordinary course of business and is a planned operational change in the company’s underlying organization. In this case, it seems clear that the specific action is being undertaken for reasons that go well beyond realizing an existing tax attribute.

The second scenario might qualify as a tax-planning strategy as the action is one that management would take in order to realize a deferred tax asset.

The distinction between the two scenarios is important as it factors into any valuation allowance assessment and also dictates how the costs associated with each are handled. For purposes of determining the need for a valuation allowance, a tax-planning strategy can be anticipated and incorporated into future income projections. On the contrary, any potential future income from an anticipated tax-planning action ordinarily would not be included in projections until the company actually has effected the action because the impacts of the tax-planning action, as described in the fact pattern above, would not be objectively verifiable. However, in circumstances where the effects of the tax-planning action are objectively verifiable (i.e., no significant uncertainties or contingencies exist), the anticipated effects of such action would be included and incorporated into overall future income projections. Pursuant (continued)
to ASC 740-10-30-19, the costs of implementing a tax-planning strategy (net of any tax benefits associated with those expenses) would be netted when the company determined the amount of valuation allowance to be recorded. Conversely, the costs of implementing a tax-planning action are recognized when incurred.

Determining whether a particular tax-planning action can be considered a tax-planning strategy depends largely on the specific facts and circumstances and requires significant judgment.

5.4.3.1.1 Tax-Planning Strategies in Jurisdictions Where NOL Carryforwards Never Expire

By definition a tax-planning strategy is in part an action an entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused. The question then arises: if an NOL carryforward never expires, is it possible to consider tax-planning strategies as a source of taxable income to support realization of deferred tax assets.

The following example illustrates the general guidance in this situation:

Example 5-11: Consideration of Tax-planning Strategies in Jurisdictions where Net Operating Loss (NOL) Carryforwards Never Expire

Background/Facts:
As of December 31, 20X7, Company X has $40 million of NOL carryforwards for which it has recorded $10 million of deferred tax assets (i.e., a tax rate of 25 percent) and is evaluating the need for a valuation allowance. Company X has cumulative losses in recent years and cannot rely on projections of future taxable income. As a result, it is considering whether it can use tax-planning strategies as a source of taxable income.

The tax law in the jurisdiction in which Company X operates provides that NOL carryforwards do not expire, rather they can be used indefinitely. The Company has assets with an appreciated value of $50 million (i.e., fair value of $60 million and a book value of $10 million) that are not integral to the business. The Company does not have intentions to sell the appreciated assets, but it has asserted that it would do so, if necessary, to realize the tax benefit of the NOL carryforwards.

Question:
In assessing the need for a valuation allowance, can the Company consider a tax-planning strategy (for example, selling the appreciated assets) as a possible source of taxable income available to realize a tax benefit for the NOL carryforwards?

Analysis/Conclusion:
No. Although tax-planning strategies are one of the four sources of income that companies can typically consider when evaluating the need for a valuation allowance, ASC 740-10-30-19 defines a tax-planning strategy as an action that an entity “...ordinarily might not take, but would take to prevent a tax attribute from expiring unused.” ASC 740-10-55-39(b) clarifies this definition by indicating that strategies that are expected to be employed for business or tax purposes, other
than utilization of carryforwards that otherwise expire unused, are not tax-planning strategies as that term is used in ASC 740.

Accordingly, a company with operations in a jurisdiction in which NOLs do not expire cannot consider tax-planning strategies as a possible source of taxable income. However, Company X would not be precluded from considering the other possible sources of taxable income noted in ASC 740-10-30-18, including consideration of the impact of an objectively verifiable tax-planning action on future income projections (See Example 5-10 in Section TX 5.4.3.1).

For example, if Company X had committed to a definitive plan to sell the appreciated assets (rather than simply asserting that it would be willing to sell them, if needed), it would be able to consider the anticipated incremental income from the sale when assessing the need for a valuation allowance. However, if the Company also expects to have future operating losses, it would have to consider whether the anticipated incremental taxable income from the sale of the appreciated assets would enable it to realize the NOL carryforwards or if it would only reduce what otherwise would be a larger operating loss. This concept is illustrated in Example 5-9 in Section TX 5.4.3.1.

The above conclusion may appear counterintuitive as the Company has unrecognized appreciated assets that, if currently sold, would generate taxable income sufficient to realize the NOLs. However, ASC 740-10-30-23 requires any source of income to be weighted “commensurate with the extent to which it can be objectively verified.” As there is no expiration on the NOLs and no definitive plan to sell the appreciated assets, the ability to verify whether the taxable income associated with the appreciated assets is sufficient to realize the existing NOLs becomes challenging. For example, since the Company would have no separate tax motivation for selling the appreciated assets in the near term (i.e., no expiring attributes), it would be difficult to objectively verify the fact that the unrealized appreciation will be available at some point in the distant future when the Company eventually sells the asset. Further, the Company could continue to generate losses for an indefinite period of time and consequently, the sale of appreciated assets might only reduce what otherwise would be additional NOLs.

### 5.4.3.2 Examples of Common Tax-Planning Strategies

Some specific types of potential tax-planning strategies are discussed below.

#### 5.4.3.2.1 Sales of Appreciated Assets

The sale of appreciated assets, in order to trigger taxable income equal to the appreciation on the assets, is a potential tax-planning strategy. Because tax-planning strategies are considered in assessing the valuation allowance and because the valuation allowance is based on the weight of available evidence, we believe that, to be considered, the appreciation would have to exist at the balance sheet date. If the sale would not be required until some future date, then there must be a reasonable basis for concluding that the appreciation would still exist.

Generally, an outright sale would have to be of assets, such as securities, that individually are not integral to the business. Any outright sale of fixed assets used in operations entails economic considerations that go well beyond those typically involved in tax-planning strategies. Similarly, unrealized appreciation in intangibles generally cannot be severed from the business itself. Sales of these assets involve questions of whether the entity wants to remain in certain business lines, products, or
marketing areas. In most cases, it would be difficult to make a realistic assessment about whether the outright sale of such assets would be prudent and feasible.

A sale of appreciated assets can be expected to have an effect on taxable income after the sale date. For example if appreciated debt securities are sold, interest income in future years will be reduced. Further, an outright sale of appreciated real estate generally will result in increased occupancy expense subsequent to the sale date. If appreciated real estate is sold and leased back, occupancy expense for book purposes may be largely unchanged because of amortization of the gain on the sale over the lease term, but occupancy expense for tax purposes is likely to be higher, offsetting the appreciation recognized for tax purposes. Such impacts on future taxable income, other than reversals, should be considered.

5.4.3.2.1.1 Appreciated Securities

The sale of appreciated securities classified as available-for-sale or trading could be considered an available tax-planning strategy. However, as discussed in ASC 320-10-25-5, appreciated securities that are classified as held-to-maturity do not qualify as tax-planning actions or strategies because considering them available-for-sale would be inconsistent with the held-to-maturity designation. Tax-planning strategies involving available-for-sale or trading securities may impact both the timing and/or character of income.

With respect to timing of income recognition, entities that have expiring attributes often will assert their ability and intent to sell appreciated securities, if necessary, to avoid the expiration of certain attributes, such as net operating or capital loss carryforwards. Entities also might assert their ability and intent to sell securities carried at an unrealized loss to take advantage of capital gain income that exists in the carryback period. Selling appreciated securities ensures that the deferred tax liability on the unrealized gains will serve as a source of income, in the proper period, to avoid the loss of the related attributes. Selling securities carried at an unrealized loss ensures that the deferred tax asset, which likely would be considered capital in nature, will be realized through income in the carryback period. In either case, it is important that management perform a detailed enough analysis to be able to conclude that sufficient income of the appropriate character will be generated (or exists in the carryback period) and that it would consider the sale of the securities to be prudent and feasible within the timeframe necessary to avoid the expiration of the attributes or the close of the carryback window.

U.S. taxpayers and taxpayers in other jurisdictions with relatively short carryback provisions most likely will need to be ready to implement any strategy in the relative near term. Furthermore, because of the potential for volatility of market values of securities, expectations of invoking the strategy at a distant future date may not be appropriate. As a result, management should document and support its readiness and intent to sell securities. The assertion of selling securities with unrealized losses as a tax-planning strategy would represent a trigger for the recognition of an other-than-temporary impairment on the securities, if it has not already been recognized.

PwC Observation: The sale of appreciated securities classified as available-for-sale or trading should only be considered an available tax-planning strategy to the extent that a company is prepared to sell the debt securities in order to realize the gains and utilize related loss carryforwards before they expire. If a company is not willing or able to sell the debt securities and trigger the realized gains, it would not be appropriate to consider the potential sale as a tax-planning strategy. However, due to the presumed tax advantages of utilizing carryforward attributes before they expire, it is essential to understand and document the business reasons for believing it would not be prudent or feasible to trigger the gains in such a case.
Available-For-Sale Debt Securities with Unrealized Losses

ASC 740-10-25-20 states that, “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 decline in fair value of a debt security below its tax basis is presumed to result in a future tax deduction, even though a loss has not yet been realized for book or tax purposes. Along with any other deferred tax assets, the company must evaluate the available evidence to determine whether realization is more-likely-than-not. An initial step in this assessment process is to determine whether a deferred tax asset related to an unrealized loss on a debt security will reverse through (1) holding the security until it recovers in fair value or (2) through sale at a loss.

Hold to Recovery—Preferable View

A company’s assertion that it has the intent and ability to hold an available-for-sale debt security until it recovers in value (e.g., at maturity, if necessary) results in recovery of the book basis of the security through collection of the contractual cash flows. While the recovery in book basis provides a source of future taxable income to be considered in the overall assessment of the need for a valuation allowance against the company’s deferred tax assets, this source of taxable income should not be viewed in isolation. In other words, to the extent that the expected recovery in book value of the available-for-sale debt security, in conjunction with other projected sources of income, is expected to result in positive future income for the company as a whole, such income may be used to support realization of deferred tax assets.

However, if there is significant negative evidence, such as cumulative losses in recent years or an expectation of additional near-term losses, taxable income implicit in the expected recovery of the book basis of the available-for-sale security may only serve to reduce future losses of the company. In such circumstances, the expected appreciation would not provide support for the realization of deferred tax assets because there would be no incremental future tax benefit to the company. This would be the case even though the deductible temporary difference related to the available-for-sale debt security is expected to reverse as the respective book and tax bases of the investment converge upon maturity of the security.

A valuation allowance cannot be avoided unless there is evidence that the benefit of the deferred tax asset will be realized as a result of future taxable income (or one of the other potential sources identified in ASC 740-10-30-18). It is not sufficient to merely project that the deductible temporary difference will reverse.

Hold to Recovery—Alternative View

In November 2008, in connection with registrant submissions on this topic, the SEC staff advised that it would not object to an alternative view for deferred tax assets related to unrealized losses on AFS debt securities when a company asserts the ability and intent to hold the security to recovery (maturity, if necessary) and provided that the company prominently discloses this accounting policy and its impact. Under this view, these deferred tax assets would be evaluated separately from a company’s other deferred tax assets and, because the future taxable income implicit in the recovery of the book basis of the AFS debt securities will offset the deductions underlying the deferred tax assets, a valuation allowance would not be necessary (even in cases where a valuation allowance might be necessary for all other deferred
We understand that the basis for the alternative view is the conflict some see in the objectives of ASC 320 and ASC 740 in this narrow fact pattern. With that in mind, the SEC staff encouraged the registrants to request clarification from the FASB.

The FASB has been addressing the matter in connection with its reconsideration of the pretax accounting for these and other financial instruments. As described in its most recent exposure draft on Recognition and Measurement of Financial Assets and Liabilities, the Board has reversed course from a prior exposure draft and has now proposed that deferred tax assets on debt instruments measured at fair value with changes in fair value recognized in other comprehensive income be evaluated separately from other deferred tax assets of an entity. These deferred tax assets would essentially be viewed as “placeholders” for the tax effects of the unrealized losses recognized in other comprehensive income. Such deferred tax assets would then reverse over time as the unrealized losses on the debt investments reverse over the period to maturity. An expectation of future taxable income would not be necessary in order to support realization, and a valuation allowance would not be necessary even when significant negative evidence, such as recent cumulative losses, results in a valuation allowance for all other deferred tax assets. An entity, however, would need to assert that it has the ability and intent to hold the investments to recovery to support not recording a valuation allowance. It is unclear how narrowly the FASB intends to apply this proposed approach, for example, whether it will apply by extension to other items that are recorded in other comprehensive income that could be expected to reverse over time.

The final outcome of this matter will depend on the Board’s redeliberations. Therefore, companies that are potentially affected by this issue should stay abreast of the Board’s redeliberations of this matter.

Sale at a Loss

A sale of a depreciated debt security would result in a tax loss. Avoiding a valuation allowance in that case may depend on having sufficient taxable income of the appropriate character (e.g., capital gains instead of ordinary income). Holding the security until maturity (or until the unrealized loss is eliminated) would effectively obviate the need to consider whether there are sources of capital gains to offset the potential capital loss implicit in the temporary difference. Therefore, the positive assertion of the intent and ability to hold the available-for-sale debt security until it recovers in value would alleviate the “character of income” concern for such a company. If such an assertion cannot be made, however, the company must look to available sources of capital gains for recovery of the deferred tax asset.

Although asserting the ability to hold a security until it recovers in value (e.g., at maturity, if necessary) may appear, on the surface, to be contrary to the available-for-sale classification under ASC 320, we do not believe that the two positions are incompatible. Classifying a security as held-to-maturity under ASC 320 requires a positive assertion of intent and ability to hold the security to maturity. However, an entity must only be able to assert that it has the intent and ability to hold a debt security to maturity, if necessary to recover its value, to consider the expected recovery in book value as a source of future taxable income.

When a debt security is classified as available-for-sale but management asserts that it will hold the asset until it recovers in value, we believe that the reversal pattern of
the temporary difference would be determined as if the security would be carried at amortized cost in the future for book purposes using the balance-sheet-date market value as amortized cost at that date. The reversal in each future year would be determined as the difference between the recovery of book basis and the recovery of tax basis assigned to that year under the method—loan amortization or present value—that has been elected for the category of temporary differences (see Section TX 5.5.1.2.2.1) in which the security is included.

PwC Observation: In April 2009 the FASB issued guidance which changed the threshold for determining whether an other-than-temporary impairment (“OTTI”) on debt securities is required. As a result, companies are no longer required to assert the intent and ability to hold debt securities to recovery to avoid recording an OTTI loss. Instead, a company is only required to demonstrate that it does not have the intent to sell the debt security and that it more-likely-than-not will not be required to sell the debt security before its anticipated recovery. However, this change in threshold for recognition of OTTI losses does not change the need for a company to assert the intent and ability to hold its debt securities to recovery (maturity, if necessary) to support realization of its deferred tax assets. A company would still need to assert (and demonstrate) the intent and ability to hold the securities to recovery (maturity, if necessary) to avoid a valuation allowance if:

- a capital loss, if triggered, would otherwise attract a valuation allowance absent a source of capital gains,
- a company is placing reliance on recovery of the contractual cash flows of debt securities as an incremental objective source of future taxable income, or
- a company is following the alternative view described above in Section TX 5.4.3.2.1.2.

As the value of available-for-sale debt securities begins to recover, unrealized losses for some available-for-sale securities would be reduced; in some cases, available-for-sale securities that were previously in a net unrealized loss position may now be in an unrealized gain position. Because of the recovery in value, an entity may decide to sell certain of its available-for-sale securities. If securities are sold, the question arises as to how the sale impacts an entity’s hold-to-maturity assertions. If an entity sells securities while they are still in an unrealized loss position, these actions would potentially be inconsistent with an assertion to hold to recovery. However, because management’s assertion is to hold the security until it recovers in value, sale of an available-for-sale security that is in an unrealized gain position would not necessarily be inconsistent with this assertion.

5.4.3.2.2 Sale-Leaseback

Another potential tax-planning strategy is the sale-leaseback of fixed assets that, because of accelerated tax depreciation, have a higher book than tax basis. For tax purposes, the sale would accelerate the reversal of the taxable temporary difference (the excess-book-over-tax basis at the date of the sale-leaseback) into taxable income in the year of the sale. Ideally, use of this strategy should be confined to an asset for which there is a reasonable basis to conclude that its fair value will at least equal its remaining book value at the time of the sale. If the sale would be at a loss, the taxable income that would be generated would be correspondingly reduced. And, if the loss reflects actual market depreciation, then the loss would be considered a cost of the strategy. On the other hand, a sale-leaseback of an appreciated asset
could generate taxable income from appreciation in excess of the book basis which in the U.S. could be considered a capital gain. For sale-leaseback transactions to work as tax-planning strategies, the existence of future taxable income is imperative. Without future taxable income, a sale-leaseback merely changes the timing of temporary difference reversal patterns; therefore, scheduling is required.

The following example illustrates the use of a sale-leaseback, tax-planning strategy:

**Example 5-12: Use of a Sale-Leaseback, Tax-Planning Strategy**

In 2007, XYZ Company incurred a $20,000 loss, which it must carryforward. The carryforward expires in 20 years. XYZ also has deductible temporary differences totaling $4,000, which will reverse over the next four years, and a building used in operations with a taxable temporary difference of $25,000, which reverses over 25 years. Management has concluded that no future taxable income, other than reversals, can be assumed in assessing the realizability of deferred tax assets. The pattern of temporary difference reversals and loss-carryforward utilizations, before consideration of tax-planning strategies, is shown below:

<table>
<thead>
<tr>
<th>Tax Attributes at Dec. 31, 2007</th>
<th>2008</th>
<th>2009</th>
<th>2010-2027</th>
<th>2028 and Beyond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future taxable income other than reversals</td>
<td>$—</td>
<td>$—</td>
<td>$—</td>
<td>$—</td>
</tr>
<tr>
<td>Taxable temporary difference for building</td>
<td>25,000</td>
<td>1,000</td>
<td>1,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Net deductible temporary differences</td>
<td>(4,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Subtotal</td>
<td>21,000</td>
<td>—</td>
<td>—</td>
<td>16,000</td>
</tr>
<tr>
<td>Loss carryforward</td>
<td>(20,000)</td>
<td>—</td>
<td>—</td>
<td>(16,000)</td>
</tr>
<tr>
<td>Net taxable temporary difference</td>
<td>$1,000</td>
<td>$—</td>
<td>$—</td>
<td>$—</td>
</tr>
</tbody>
</table>

This projection indicates that $4,000 of the loss carryforward would expire unused. A valuation allowance may be required, therefore, because $5,000 of the $25,000 taxable temporary difference for the building will reverse beyond the carryforward period. However, if, prior to 2028, XYZ sold the building for an amount at least equal to the then existing book basis and leased the facilities back, this would accelerate the reversal of the remaining $5,000 of taxable temporary differences into the carryforward period. If the sale-leaseback was prudent and feasible, it would eliminate the need for a valuation allowance.

**5.4.3.2.3 LIFO Reserves**

An entity may have a taxable temporary difference for LIFO inventories (i.e., the book LIFO carrying amount exceeds the LIFO tax basis). The most significant such differences arise in nontaxable business combinations. The resulting deferred tax liability typically would be expected to be paid only in the indefinite distant future. When there is no temporary difference because book LIFO and tax LIFO are the same, the LIFO reserve is typically a measure of unrealized appreciation. In either case, triggering the tax LIFO reserve could be a valid tax-planning strategy.
The use of LIFO generally is considered to be an almost permanent deferral of tax, and, from an economic prudence perspective, any entity would be reluctant to forgo this economic benefit. However, the question under ASC 740 is whether an entity would trigger all or part of its LIFO reserve in order to keep a loss or credit carryforward from expiring unused.

There are two ways that a LIFO reserve can be triggered for tax purposes. The first is simply to change to a different method of accounting for inventories for tax purposes. Electing to change to a different accounting method requires IRS permission, but approval should be perfunctory in most cases. An entity can also be required to change to a different method of accounting if it fails to meet the IRS requirements to be on LIFO.

Conformity for financial reporting purposes is required when LIFO is utilized for tax purposes, however, it is not required when LIFO is not used for tax purposes. It should be noted that if a change to a non-LIFO method is also made for financial-reporting purposes, the non-LIFO method would have to be justified as preferable in the circumstances, and an SEC registrant would need to obtain a preferability letter from its auditors.

For tax purposes, the difference between LIFO and the new method, essentially the LIFO reserve, is a tax-method change that is spread ratably over four years. Presumably, an entity would wait as long as possible before terminating its LIFO election, but, in order to maximize the benefit of the termination, it would have to be made in time to be effective no later than the beginning of the fourth year prior to the expiration of the carryforward.

Would termination of the LIFO election be prudent? If an entity on LIFO operates in a generally inflationary environment and expects the level of its inventories to remain stable or increase, there is generally no benefit in having a higher tax basis in its inventories. Further, terminating the LIFO election means that, if the entity is able to return to profitable operations, taxes in the future will be computed on a non-LIFO basis and will be higher. Under the relevant tax law, a reversion to LIFO will not be available for at least five years and, even then, only if the entity uses the LIFO method for financial reporting purposes.

On the other hand, an entity that actually is considering terminating LIFO in order to keep a carryforward from expiring may well be in dire straits. And it may, in fact, want to terminate tax LIFO to avoid having to use LIFO for book purposes. Use of a non-LIFO method would increase the carrying amount of inventories and could improve balance sheet ratios. The entity's projected circumstances will have to be considered carefully in determining whether termination of the LIFO election would be prudent.

The second way a LIFO reserve can be triggered, which is a less drastic tax-planning strategy, and one that would release only a portion of the LIFO reserve, would involve a deliberate reduction of LIFO inventories to liquidate layers. Whether such an action would be prudent and feasible is heavily dependent on an entity's structure and operations. Deliberate reductions are generally difficult to achieve because they involve undesirable and perhaps costly changes in operations or corporate structure, and their benefits may be minimal. Frequently, the bulk of the LIFO reserve relates to the oldest layers of inventory, so substantial liquidations would be required in order to release much of the reserve.
A tax LIFO reserve may provide for a possible tax-planning strategy, which must be considered if an entity is providing a valuation allowance. However, it may be difficult to establish that such a tax-planning strategy would be prudent.

5.4.3.2.4 Shifting Tax-Exempt Portfolios

If an entity has a substantial portfolio of available-for-sale debt securities whose interest is tax-exempt, or corporate stock whose dividends allow for a dividends-received deduction, it may consider a tax-planning strategy to shift the portfolio to higher yielding securities with fully taxable interest or dividends. This would increase taxable income in future years and could be important in ensuring a source of future taxable income that will utilize regular tax loss carryforwards. It also might be considered by an entity that is an AMT taxpayer and that must consider whether deferred tax assets for AMT credit carryforwards and for regular deductible differences computed at the regular tax rate will be realized. Because tax-exempt interest and certain dividends-received deductions are added back in arriving at accumulated current earnings (ACE), the portfolio’s shift could operate to increase the income base for regular tax without substantially changing the income base for tentative minimum tax.

If tax-exempt debt securities are classified as held-to-maturity, the assessment of the valuation allowance under ASC 740 cannot contemplate the sale of these securities in order to purchase securities that would generate taxable income, per ASC 320-10-25-5(c). Such a classification under ASC 320 requires that an entity demonstrate the positive intent and ability to hold securities to maturity, and a tax-planning strategy that might require the sale of such securities prior to their maturity would be inconsistent with that assertion. A company could, however, have a tax-planning action or strategy to invest collections of interest and principal from the existing tax-exempt portfolio, or “new money” from sources previously invested in tax-exempt securities, in taxable securities.

An expected reduction in reported after-tax returns would not have to be accrued as a cost of the strategy. However, if there is currently market depreciation in the tax-exempt portfolio so that a loss would be realized on its sale, an intent to sell those assets, even in the context of a tax-planning strategy, likely would require the recognition of an other-than-temporary impairment loss on the securities.

5.4.3.2.5 Noneconomic Tax-Planning Strategies

Certain tax-planning strategies may provide a source of income for the apparent recognition of deferred tax assets in one jurisdiction, but not provide incremental tax savings to the consolidated entity. In order to avoid a valuation allowance in reliance on a tax-planning strategy, we believe that the tax-planning strategy generally must provide cash savings to the consolidated entity. To the extent that the only benefit a proposed tax-planning strategy provides is a financial reporting one (i.e., the avoidance of the need to record a valuation allowance), we do not believe it constitutes “realization” of the deferred tax asset. Consider the following examples:
Example 5-13: Noneconomic Tax-Planning Strategies

Background/Facts:
Company A operates in the United States and in Switzerland. Due to poor U.S. sales, Company A has incurred losses resulting in significant NOL carryforwards. Its Swiss operations historically have been profitable, but due to the specifics of the local tax law, no tax is due on that income.

For financial reporting purposes, Company A has a deferred tax asset for the NOL sustained in the United States. In order to realize the deferred tax asset, Company A has proposed to move income from Switzerland to the United States in order to avoid the need for a valuation allowance on the U.S. NOL carryforward.

Question:
Does this represent a valid tax-planning strategy?

Analysis/Conclusion:
The proposed tax-planning strategy does not provide any incremental tax benefit to Company A, as the same amount of tax would be due to taxing authorities (on a consolidated basis) before and after consideration of the tax-planning strategy (i.e., zero tax rate in Switzerland versus no taxable income in the United States after consideration of the NOL carryforward). The only “benefit” achieved is a potential financial reporting benefit for the recording of an asset that in actuality would ultimately provide no incremental benefit to Company A. In fact, without a valid business purpose, one that would persist after Company A utilized all of its U.S. NOL carryforwards, for moving the income it would be difficult to imagine how such a strategy would be “prudent.”

However, if Company A has a valid business purpose for moving income from Switzerland to the United States and intends to do so, and, would continue to subject that income to U.S. tax after the losses are fully utilized, it may be appropriate to treat the movement of income from Switzerland to the United States as a tax-planning action and incorporate the effects in the projection of future taxable income.

Example 5-14: Assessing a Tax-Planning Strategy to Combine a Profitable and an Unprofitable Company

Background/Facts:
Company X, a U.S. company, has a wholly owned holding company that, in turn, wholly owns an operating company. The holding company and the operating company are in the same foreign jurisdiction but file separate returns. Historically, the holding company has generated losses (primarily due to interest expense from intercompany loans) and has significant NOL carryforwards. The operating company has generated profits in the past, which are expected to continue for the foreseeable future. In addition, the operating company has been benefiting from a tax holiday (i.e., a period of not paying taxes) for the past 15 years and expects the tax holiday to continue for the foreseeable future.

In assessing the need for a valuation allowance on the deferred tax asset arising from the NOLs, Company X considers a tax-planning strategy that would merge the two companies. It is projected that the combined company would be profitable and
therefore would utilize the holding company’s NOLs. However, the merger would violate the conditions of the tax holiday, and the combined entity would become subject to the normal income tax rate.

**Question:**
Would the combination of the two companies be considered a prudent and feasible tax-planning strategy under ASC 740-10-30-19?

**Analysis/Conclusion:**
No. The implementation of the strategy might be feasible, but neither the holding company nor the operating company currently pays cash taxes. If the two companies were to merge, the tax holiday would be forfeited, and the combined company would be in a tax-paying position after using the NOLs. Since the tax-planning strategy is economically detrimental to Company X, it would not satisfy the requirement to be both prudent and feasible in order to qualify as a tax-planning strategy.

### 5.4.3.3 Costs to Implement a Tax-Planning Strategy

Determining whether a particular tax-planning action is a tax-planning strategy, or just a part of projecting future taxable income, often will not be clear. The distinction is important, as illustrated in Example 5-10. As previously mentioned, the tax benefit recognized for a tax-planning strategy, as defined, would be net of any expense or loss to be incurred in implementing the strategy. In effect, the expense, net of any recognizable tax benefits that it would generate, will be accrued as part of the valuation allowance. ASC 740-10-55-159 through 55-162, provides an example of such an accrual. However, it should be noted that if and when the tax-planning strategy actually is triggered and any related professional fees or other expenses are incurred, they should not be presented as components of income tax expense. This is the case even though such expenses would have been estimated for purposes of reducing the amount of tax benefit realizable as a result of the potential tax-planning strategy.

We believe that guidance related to costs of implementing a tax-planning strategy also applies in the case of an acquired temporary difference. If a tax-planning strategy is used to support acquired temporary differences and NOL carryforwards as of the opening balance sheet date, then only the “net” benefit should be recognized as a deferred tax asset in acquisition accounting.

Certain tax-planning strategies involve an intra-entity asset transfer from a higher tax-rate jurisdiction where the entity currently does not pay taxes as a result of losses to a lower tax-rate jurisdiction where the entity does pay taxes. In such circumstances, as illustrated in the following example, the tax benefit of the tax-planning strategy is measured at the lower tax rate. The tax rates differential effectively is a cost associated with implementing the strategy.

**Example 5-15: Measuring the Benefit of a Cross–Jurisdiction Tax-Planning Strategy**

**Background/Facts:**
Company A currently has a full valuation allowance recorded against its net deferred tax asset which is comprised primarily of expiring NOL carryforwards. Company A currently owns intellectual property (IP) in the United States that is used by its foreign
subsidiary and that is expected to generate taxable income. Company A has incurred operating losses for several years and has significant negative evidence; however, its foreign subsidiary has been generating profits and paying foreign income taxes, albeit at a lower tax rate.

As a tax-planning strategy, Company A could sell the rights to this IP to the subsidiary. In this fact pattern, the value of the IP approximates the amount of Company A's NOLs. Therefore, the utilization of the NOL carryforwards would offset Company A's tax gain on the sale. In effect, the deferred tax asset related to the NOLs will be realized through increased tax amortization on the transferred IP asset that reduces tax payments in the foreign jurisdiction. In this regard, it must be more-likely-than-not that the foreign subsidiary will be profitable in future years at a level sufficient to utilize the amortization as tax deductions to reduce taxable income.

Absent objective and verifiable evidence of future taxable income in the subsidiary’s jurisdiction, this tax strategy would not result in the realization of deferred tax assets, and the valuation allowance should not be released. Simply transferring the IP and utilizing NOLs that have a full valuation allowance does not result in a realizable benefit if the IP is transferred to another jurisdiction and its new tax basis does not result in an incremental tax benefit to Company A.

In this case, the tax-planning strategy appears to meet the prudent and feasible criteria stipulated by ASC 740-10-30-19 since the subsidiary is paying taxes and could benefit from the tax amortization on the stepped-up IP tax basis.

**Question:**
To the extent that the above represents a valid tax-planning strategy, how should the effects of the strategy be measured? What should the accounting be if the strategy is actually implemented in a subsequent period?

**Analysis/Conclusion:**
In our view, the amount of the valuation allowance that should be reversed is equal to the amount of benefit that ultimately would be received in the subsidiary’s jurisdiction, which should be measured at the subsidiary’s tax rate.

For example, assume that the tax rate in the United States is 40 percent, and the tax rate in the subsidiary’s jurisdiction is 30 percent. As the tax benefit in the IP sale strategy ultimately will be realized at a 30 percent tax rate, the amount of U.S. deferred tax asset that does not require a valuation allowance as a result of the tax-planning strategy equals the gain multiplied by the 30 percent tax rate in the buyer’s jurisdiction. If the U.S. deferred tax asset was based on $100 of NOLs, which corresponds to a resulting deferred tax asset of $40 at 40 percent, the portion of the deferred tax asset that is expected to be realized under the strategy would be measured at a 30 percent tax rate. Therefore, $30 of the $40 valuation allowance should be reversed and a $10 valuation allowance should remain, absent any other source of future taxable income.

If in a subsequent period Company A actually implements the tax-planning strategy, the tax effect of the transaction is required to be deferred in the balance sheet consistent with the requirement in ASC 740-10-25-3(e) related to intra-entity asset transfers.

For example, if the IP is transferred for a $100 taxable gain, the entire NOL carryforward is utilized. In this case, both the deferred tax asset ($40) and the related valuation allowance ($10) are reversed, resulting in a net tax consequence of $30 on the sale. Consistent with the requirement in ASC 740-10-25-3(e), the net tax effect (continued)
of $30 is required to be deferred on the balance sheet and amortized to income tax expense over the IP's remaining useful life.

The subsidiary's initial tax basis in the IP would likely be $100 in this case. However, a deferred tax asset for the tax-over-book basis is prohibited from being recognized in accordance with the requirements in ASC 740-10-25-10(3)(e). Rather, the tax benefit from amortization of the IP in the subsidiary's jurisdiction is recognized as it is realized each year through deductions on the tax return and offsets (in the consolidated accounts) the additional tax expense from amortizing the $30 deferred charge over the IP's remaining useful life.

To the extent that the valuation allowance release and IP transfer occurred in the same period, the accounting treatment would be the same as illustrated above based on the guidance in TX 2.3.4.2.1.2.

Section TX 2.3.4 provides additional guidance on intra-entity transactions.

**PwC Observation:** ASC 740-10-30-18 requires that all sources of taxable income be considered before a valuation allowance is established. While many use tax-planning strategies as a means to avoid detailed scheduling, in many instances that goal is not accomplished, specifically when there are significant implementation costs, which may result in a partial valuation allowance. Scheduling is almost always required in instances when a company asserts only a partial valuation allowance. In addition, if the strategy entails significant expenses or losses, detailed scheduling or forecasts might be necessary to determine whether those sources provide sufficient taxable income.

### 5.4.3.4 Examples of Actions That Do Not Qualify as Tax-Planning Strategies

#### 5.4.3.4.1 Excluding a Loss Subsidiary from Tax Consolidation

Questions have arisen regarding whether excluding a loss subsidiary from the consolidated tax return constitutes a tax-planning strategy. For example, assume a U.S. entity has three subsidiaries, two of which are profitable. The third has large losses, giving the consolidated group NOL carryforwards. The current profit and loss trends of each subsidiary are expected to continue into the near future. The entity is contemplating a tax-planning strategy to sell more than 20 percent, but less than 50 percent, of the loss subsidiary. As a result, the operating results of the loss subsidiary would no longer be included in the consolidated tax return, but would continue to be consolidated for financial reporting purposes. Those entities that remain in the consolidated tax return will be able to utilize the NOL carryforwards generated during the years when the loss subsidiary was included in the consolidated tax return. Is selling a minority interest in a subsidiary, such as that described above, an acceptable tax-planning strategy under the provisions of ASC 740?

No. This strategy does not result in an incremental cash tax savings and thus does not constitute realization of the deferred tax asset. The strategy lacks substance and is merely a recharacterization of an existing consolidated-return NOL as a future separate-return NOL, both of which would be incorporated within the same consolidated financial statements.
5.4.3.4.2 Acquiring a Profitable Entity

Acquiring a profitable business may provide a source of income that would result in realization of a deferred tax asset. However, we do not believe that a proposed business combination can be anticipated. As discussed at Section TX 5.1.1, transactions that are inherently outside the company’s control and fundamental to its organizational structure are not considered in the valuation allowance assessment, as in many other areas of GAAP, until they have been completed. Although this issue is not specifically addressed in ASC 740, we understand that the FASB discussed a similar fact pattern during the deliberations leading to ASC 740 and indicated that it did not intend for tax-planning strategies to be taken this far. Consequently, the tax effects of such events (e.g., the acquisition of an entity) should not be recognized before the events have occurred. See Section TX 10.5 for further discussion.

5.4.3.5 In Summary

Actions That May Qualify as Tax-Planning Strategies:

- Selling operating assets and simultaneously leasing them back for a long period of time.
- Accelerating the repatriation of foreign earnings for which deferred taxes previously were provided.
- Funding a liability, where the funding is deductible on the tax return, before the expected payment date in order to generate a tax loss which would be available for carryback.
- Filing a consolidated or combined tax return.
- Electing to deduct foreign taxes paid or accrued rather than treating them as creditable foreign taxes.
- Disposing of obsolete inventory that is reported at net realizable value in the financial statements.
- Selling loans at their reported amount (i.e., net of an allowance for bad debts).
- Shifting an investment portfolio classified as available-for-sale under ASC 320, from tax-exempt to taxable debt securities.
- Changing from LIFO to some other method of accounting for inventories for tax purposes or deliberately reducing LIFO inventories to liquidate layers.
- Electing out of the installment sales provisions for tax purposes.
- Electing to capitalize and amortize research and development costs for tax purposes rather than deducting them currently if returned to profitability and running out of time to use other attributes based on carryforward periods.
- Merging or liquidating subsidiaries into the parent in a tax-free transaction.

Actions That Generally Would Not Qualify as Tax-Planning Strategies:

- Selling certain operating assets that are important to future operations, such as trademarks or patents.
- Funding executive deferred compensation before the expected payment date, since it will trigger taxable income for the executives.
- Disposing of a subsidiary that is not profitable (could be an action).
• Initiatives that reduce costs in order to increase the entity’s profitability (could be an action).
• Changing an entity’s tax status (the effect of a change in tax status is reflected on the approval date, or on the filing date if approval is not necessary, and is considered a discrete event).
• Moving income from a nontax jurisdiction to a taxable one solely to realize net operating loss carryforwards.

5.4.3.6 Issues in Evaluating Tax-Planning Strategies

5.4.3.6.1 Time Value of Money

Although ASC 740 precludes discounting deferred taxes, the time value of money may need to be considered in assessing whether a tax-planning strategy is prudent. For instance, as discussed earlier in this chapter, the scheduling should not reflect forgoing a carryback, which would maximize a deferred tax asset (and thus delay the receipt of cash), if it is not reasonable to expect that the entity actually would take such an action given the time value of money. ASC 740-10-55-43 through 55-44 gives an example of a tax-planning strategy to sell installment sales receivables to accelerate the reversal of the related taxable temporary differences. If a higher rate of interest would be earned on the installment sales receivables than could be earned on an alternative investment, the interest rate differential—the reduction in future interest income—must be considered in determining whether the strategy would be prudent. If, after considering the time value of money, a tax-planning strategy is deemed to be prudent, the loss of future interest income is not considered a “cost” of the tax-planning strategy (refer to Section TX 5.4.3.3).

5.4.3.6.2 Unrecognized Tax Benefits

As previously mentioned, ASC 740-10-30-18 states that a tax-planning strategy may be a possible source of taxable income for the realization of deferred tax assets. ASC 740-10-30-20 makes clear that the unit of account, recognition, and measurement principles for unrecognized tax benefits should be applied when determining whether a tax-planning strategy provides a source of future taxable income for the realization of deferred tax assets. In effect, a proposed tax-planning strategy would need to meet the ASC 740 more-likely-than-not recognition threshold from a tax law perspective before the company considered whether it was also prudent and feasible. Assuming recognition is met (and the tax-planning strategy was determined to be prudent, feasible, and primarily within the company’s control), the amount of taxable income that would be provided by the tax-planning strategy should be measured as the largest amount of benefit that is more-likely-than-not to be realized.

5.4.3.6.3 Separate Statements of Subsidiary

It is important to evaluate tax-planning strategies for a subsidiary in the context of the consolidated group’s tax-planning objectives. Management of the subsidiary may not be in a position to be able to assess whether the strategy is prudent and feasible. A strategy that may seem prudent and feasible to management of the subsidiary may not be prudent and feasible in the context of the worldwide objectives. The parent company may have business plans for the subsidiary (e.g., discontinuances of certain product lines, relocation of certain functions to other countries or other U.S. subsidiaries, acquisition or other commencement of new operations which will be placed in the subsidiary) to which management of the subsidiary is not privy. It also
may be necessary to obtain documentation from the parent company to support tax-
planning strategies that have effects on other entities within the consolidated group
to ascertain feasibility and prudence.

5.4.3.7 Consistent Use in Different Jurisdictions

Tax-planning strategies, which assume transactions affecting the timing of
deductions and taxable income, must be reflected consistently across the entities
(e.g., parent entity and its subsidiaries) and jurisdictions (e.g., federal and state)
affected by the strategies. It is possible that actions or strategies that reduce taxes
in one jurisdiction will increase taxes in another. Of course, when inconsistent tax
elections are allowed in different tax jurisdictions (e.g., whether to file consolidated or
separate returns), it may be appropriate to use different elections.

5.4.4 Future Taxable Income Exclusive of Reversing Temporary Differences
and Carryforwards

5.4.4.1 General

To the extent that realization is not ensured by carryback, reversals of taxable
temporary differences, or tax-planning strategies, and is therefore dependent on
the existence of future taxable income, projections of future taxable income will be
necessary. The question arises whether the focus should be on future taxable income
or future pretax book income. Although, the realization of tax benefits ultimately
depends on the availability of taxable income, in general forecasts of future pretax
book income (adjusted for permanent differences) should be used when assessing
the realizability of deferred tax assets. Over the remaining lifespan of the entity, future
taxable income will, in the aggregate, equal future pretax book income adjusted for
permanent differences. In projecting future income, all available information should
be considered. This includes operating results and trends in recent years, internal
budgets and forecasts, analysts’ forecasts, industry trends, and anticipated changes
in the business. Generally, the most recent results should be considered indicative of
future results, absent evidence to the contrary.

However, to the extent such recent results include aberrational items, either favorable
or unfavorable, those items should be excluded from the results when determining
a “core” level of earnings. Also, in cyclical industries, recent results may not be at all
indicative of near-term future results; rather, the phase of the cycle currently being
experienced may indicate that improvement or deterioration should be expected.

PwC Observation: Great care should be taken when evaluating whether items
are truly aberrational and should therefore be excluded from a company’s analysis
of “core earnings.” In general, it is often difficult to obtain objectively verifiable
evidence that such items are, in fact, aberrational. Management’s expectation—
without sufficient corroborating evidence—is not sufficient to assert that items
are aberrational. Also, it is often difficult to justify the exclusion of so called
nonrecurring, unusual or infrequent items because items of a similar nature may
have occurred in the past or may occur in the future.

For an entity that has demonstrated core earnings, we believe prospects for the near
term are important, as they are likely to represent more objective positive evidence
when compared with potential negative evidence based on business or macro-
environmental risk factors that are not objectively verifiable. In addition to a baseline
of current operating results, the projections should take into account factors such as any demonstrated cyclical aspects of the entity’s industry and the entity’s stage of development. Judgment is necessary in determining how detailed or formalized projections should be to assess the objective verifiability of the end result. The weight given to the forecast will be dependent on the extent to which the major assumptions can be objectively or independently supported, as well as the entity’s previously demonstrated ability to accurately budget and project future results.

The following example demonstrates the notion of core earnings:

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**Example 5-16: Core Earnings**

Company A has a gross deferred tax asset balance of $2.6 million and a gross deferred tax liability balance of $0.4 million at the end of the current year. In the prior year, Company A's pretax income was $1.7 million. In the current year, Company A reported pretax income of $1.0 million, inclusive of the impact of a settlement related to employment discrimination of $0.6 million. The allegation of discrimination was believed to be isolated and represented the first allegation of employment discrimination ever encountered by Company A. No further allegations were expected. In determining Company A's core earnings, it would be reasonable to conclude that core earnings of approximately $1.6 million exist as the settlement was isolated and was not indicative of Company A's future profits (i.e., this event generated an isolated one-time charge, resulting in a distortion of income for the period that would not be representative of Company A's ability to generate profits in the future).

Therefore, in its assessment of valuation allowance needs against its net deferred tax asset balance of $2.2 million at the end of the current year, Company A would consider its current-year core earnings of $1.6 million, which is the reported pretax income adjusted for the one-time settlement charge. Based on the facts presented, it is more-likely-than-not that Company A will realize the future benefits of its deferred tax assets and not have to record a valuation allowance against its net deferred tax asset balance at the end of the current year.

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**5.4.4.2 Considerations When Projecting and Scheduling Future Taxable Income Other Than Reversals of Existing Temporary Differences**

**5.4.4.2.1 Originating Temporary Differences in Future Projections**

Future taxable income, other than reversals, includes, in concept, the effect of future originating temporary differences for assets in place, as well as their reversals. It also includes the origination and reversals for depreciable or amortizable assets to be acquired in the future. Thus, future taxable income embraces not only future book income and future permanent differences, but also temporary differences, other than reversals of those existing at the balance sheet date. Estimating future originations and their reversals on a year-by-year basis generally would be quite an exhaustive exercise, and one that could not be very precise.

But shortcuts may be employed. For example, the net amount of recurring temporary differences may be expected to remain at approximately the same level at each future balance sheet date (i.e., new originations may be assumed to replace reversals each year). The year-by-year effect of future originating differences could be approximated at an amount equal to reversals of existing temporary differences;
of course, the net originations would be deductible if the net reversals were taxable, and vice versa.

However, shortcut approaches, and the consideration of future originations in general, must be used with care. Originating deductible differences may provide the taxable income that “uses” reversing deductible differences, but at the same time they will create new deductible differences, which will reverse in later future periods. For example, an originating deductible difference for accrued vacation increases taxable income in the year of accrual but when the vacation is taken or paid, the temporary difference will reverse and will decrease taxable income in a future period. Consistent with ASC 740-10-55-37, we do not believe that a tax benefit is realized from the reversals of existing deductible differences if they are only replaced by new deductible differences that will not be realized. Thus, inclusion of taxable income from originating differences in the scheduling, or other analysis, may require, in turn, consideration of whether the deductible differences they create will be realized. This could extend the analysis further and further into the future. Ultimately, there must be future pretax income, after considering permanent differences, to realize the benefit of the existing deductible differences.

**PwC Observation:** Because of the imprecise nature of the estimates of future taxable income, other than reversals, we believe that specific consideration of future originations of temporary differences is generally not warranted. Rather, estimates of future pretax book income, adjusted for future permanent differences that are expected to be significant, usually will suffice as a surrogate for future taxable income. However, the actual timing of deductions and taxable income is relevant under the tax law and must be considered in applying ASC 740. Thus, care should be taken to ensure that large net originations that might alter the analysis are not likely to occur before using such an assumption for purposes of assessing the need for a valuation allowance.

### 5.4.4.2.2 Projecting Future Pretax Book Income

In general, once the results of scheduling reflect the temporary difference reversals in the years they are expected to take place, future taxable income amounts for each year should be scheduled to determine the net taxable result for each future year.

The following are guidelines for projecting future earnings for purposes of the valuation allowance assessment:

- It is generally presumed that an entity with cumulative profits in recent years (or that is in a cumulative loss situation, but has demonstrated a return to sustainable profitability) will remain profitable unless there is objectively verifiable evidence to the contrary.
- The starting point should be the amount and trend of book income (i.e., pretax income adjusted for permanent items) during the past year because this evidence is typically the most objective indicator available.
- While projections of future income should be consistent with historical results, it is sometimes necessary, in determining the existence of core earnings that have been demonstrated in the past and that would be reasonable to assume for the future, to “adjust” the historical earnings for unusual items (both positive and negative), the effects of purchase accounting, or changes in capital structure. For example, if the proceeds of a recent public offering were used to pay down debt, the interest expense in periods prior to the offering should be adjusted to arrive
at historical core earnings, which forms the starting point for projections of future periods.

- Favorable improvements in profitability based on items such as built-in growth rates and “synergistic” effects of recently completed acquisitions should be approached with a high degree of skepticism. Since growth rates and the effects of acquisitions are inherently difficult to objectively verify, generally very little weight can be given to their effects until demonstrated.

- Projections of future taxable income must consider all years that may provide a source of taxable income for the realization of deferred tax assets.

- In certain cases, a probability-weighted model for projecting future taxable income should be used, following a process consistent with the one for determining “expected cash flows” described in Statement of Financial Accounting Concepts No. 7, Using Cash Flow Information and Present Value in Accounting Measurements (CON 7), and ASC 360-10-55-23 through 55-32. The results of a CON 7 analysis are most useful when the various inputs into the analysis can be objectively verified. In applying this approach, each scenario (with its own annual projection of taxable income) should be weighted based on the company’s assessment of the expected outcome, which in turn contributes to the overall probability-weighted projected income for the year. The result of such an analysis should be compared with the level of core earnings to assess the reasonableness of the result.

5.4.4.2.2.1 Tax-Planning

After detailed scheduling of future taxable income has been performed and after all the carryback and carryforward rules have been applied, there may still be years in which there is net taxable income, and also years with net deductions. There also may be loss carryforwards that will not be fully used against taxable income scheduled during the carryforward years, and years with net taxable income beyond the carryforward period. In addition, there may be an opportunity to shift income to years with lower tax rates, or deductions to years with higher tax rates.

There may also be an opportunity to change the manner of recovery of an asset or settlement of a liability, thereby changing the nature of taxable income between capital and ordinary. This could be advantageous when there is a difference between enacted capital gain and ordinary income tax rates or when there are capital losses—either incurred and carried forward or expected—which can be used only against capital gains.

Faced with a specific pattern of taxable income and loss, an entity can attempt to minimize its net tax liability through tax planning. The objective of tax planning is to minimize the overall tax cost. Often, tax planning can be used to accelerate or delay the recognition of income or deductions to take advantage of otherwise unused deductions and carryforwards. While the deferred tax computation usually focuses on the regular tax liability, an entity evaluating tax-planning items also would consider any significant effect that it would have on AMT.

Tax-planning effects reflected in the scheduling or other estimates of future taxable income should be actions that an entity expects to undertake unless changed circumstances or estimates in future years eliminate the need. The final scheduling or other estimate of future taxable income should reflect what is likely to occur. See Section TX 5.4.3 for further guidance.
5.4.4.2.2 Short-Term Outlook Approach

While it is difficult to generalize, once an entity concludes that positive evidence outweighs negative evidence so that some or all of a valuation allowance can be released, we would not normally expect that release to occur over a number of successive years. A particular concern arises when an entity that has returned to profitability reflects no tax provision or benefit, net of valuation allowance release, for a length of time.

In this regard, the SEC has questioned the retention of a valuation allowance when it appears to be overly conservative and when it may suggest earnings management (i.e., “selecting” the future period(s) in which to release the valuation allowance by modifying assumptions that are not easily susceptible to verification).

We have observed an approach in practice of limiting the estimate of future income used in determining the valuation allowance to a relatively short time horizon, such as projecting out the same number of years as the entity has been profitable or projecting out for the same period (e.g., three years) that the company uses for internal budgetary purposes. Except in certain rare situations, based on the individual facts and circumstances, we generally do not believe that such an approach is appropriate. Mere uncertainty about the sustainability of taxable income due to general business and macro-economic risk factors is not a valid reason to use a short-term outlook. This view is supported in ASC 740-10-30-17, which states, “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.” The use of projections based on a relatively short timeframe fails to consider all available evidence.

As a general rule, the appropriate place to consider the inherent risk of future operations is in the quantification of the core earnings or in the development of projections, not through excluding consideration of potential positive evidence that may be present in later years. Because of the inherently arbitrary nature of truncating projections of future taxable income after a specific short-term period, the use of this approach may be challenged and would need to be appropriately supported with specific facts and circumstances. Assuming such a short-term outlook approach was deemed appropriate, it would generally be acceptable only for a short timeframe. If the entity continued to meet or exceed projections, this myopic outlook would no longer be appropriate.

5.4.4.2.3 Unlimited Carryforward Period

As noted above, projections of future taxable income must consider all years that may provide a source of taxable income for the realization of deferred tax assets. In jurisdictions where an unlimited carryforward period exists and an entity has demonstrated, or returned to, a sustainable level of profitability, it is often difficult to identify and objectively verify any negative evidence that would outweigh that positive evidence.

As a result, even though realization of deferred tax assets in a jurisdiction that has an unlimited carryforward period for net operating losses may be expected to occur in the far distant future based on current projections, absent specific negative evidence of sufficient weight, the full deferred tax asset should be recognized. If an entity’s operations turn for the worse in future years, the change associated with a change in assessment about the realizability of deferred tax assets would be properly reflected.
in the period in which the operations deteriorated and the weight of existing negative evidence overcame the existing positive evidence.

5.4.4.2.4 Consistency of Projections with Other Accounting Estimates

As a starting point, the projections used for valuation allowance assessments should generally be consistent with other projections or estimates used in the preparation of the financial statements and in other filing disclosures (e.g., impairment tests under ASC 360, Property, Plant and Equipment or ASC 350, Intangibles—Goodwill and Other). This is particularly true when a company does not have cumulative losses in recent years or has returned to sustained profitability. In such cases, the SEC has challenged registrants that have used a short-term outlook when assessing the realizability of their deferred tax assets, but have used longer-term forecasts to support the carrying value or amortization periods of long-lived assets.

On the other hand, if a company has cumulative losses in recent years, it is generally appropriate to adjust the projections used in the valuation allowance analysis to a level that is objectively verifiable. Most recent historic results are generally considered to be the most objectively verifiable; although under circumstances in which sufficient evidence exists, it may be appropriate to consider “core earnings.” This is because the impairment models for long-lived assets generally consider management’s best estimates of future results, while ASC 740-10-30-23 requires the evidence considered in a valuation allowance assessment to be “weighted” based on the extent it can be objectively verified. Therefore, projections of taxable income (which are inherently subjective) generally will not carry sufficient weight to overcome the objective negative evidence of cumulative losses unless they are adjusted to a level that is objectively verifiable.

In either case, if a company uses assumptions in its valuation allowance assessment that are not consistent with other projections or estimates used in the preparation of its financial statements (or other disclosures), it should be prepared to explain and provide support for any such differences.

5.4.4.2.5 Special Considerations When There Are Cumulative Losses

Because a projection of future taxable income is inherently subjective, it generally will not carry sufficient weight to overcome the evidence of cumulative losses in recent years. As a result, the source of positive evidence needed to overcome the significant negative evidence of cumulative losses often must come from what has already been demonstrated (or is otherwise objectively verifiable). Accordingly, the foundation of the projection process is the amount and trend of book income (i.e., pretax income/loss adjusted for permanent items) during the past year because this evidence is typically the most objective indicator available.

If an entity has cumulative losses in recent years, but recently has returned to profitability, one must consider whether the evidence of recent earnings carries sufficient weight to overcome the weight of existing significant negative evidence, and whether the level of uncertainty about future operations allows a conclusion that the entity has indeed returned to sustainable profitability. See Section TX 5.1.3.1 for further guidance.

5.4.4.2.6 Special Considerations for Certain Deferred Tax Assets

The issue of future taxable income, other than reversals, can be particularly critical with respect to four specific types of deferred tax assets—net operating loss
carryforwards, accruals for postretirement benefits other than pensions (discussed in Chapter TX 18), AMT credit carryforwards, and foreign tax credit (FTC) carryforwards.

**Loss Carryforwards**

Under ASC 740, tax loss carryforwards are treated just like deductible temporary differences. An asset is recorded for a loss carryforward and is reduced by a valuation allowance only if it is more-likely-than-not that the benefit will not be realized. This does not mean, however, that valuation allowances for loss carryforwards necessarily are uncommon. Tax loss carryforwards may be indicative of recent book losses, which, as discussed above, constitute objective negative evidence that is not easy to overcome.

Further, in a jurisdiction where there is a limit on the period during which a carryforward can be used, the fact that that period has started to run for a carryforward may result in more concern about its realizability than for deductible differences, which have not yet been claimed on the tax return. On the other hand, an unlimited carryforward period does not necessarily ensure realization, which is ultimately dependent on future income.

**Other Postretirement Benefits (OPEBs)**

Assessing the realization of deferred tax assets associated with OPEBs is problematic because the tax deductions typically will occur over a period of 40 or 50 years or even longer. It is unlikely that the reversal of significant taxable temporary differences for which deferred tax liabilities have been provided would extend into such distant future years.

We believe that the focus should be first on other deferred tax assets, which are expected to reverse in the foreseeable future and whose realization is dependent on future taxable income, other than offsetting taxable differences or carrybacks. If those tax assets are significant and if no valuation allowance is required for them, generally no valuation allowance should be required for the deferred tax asset associated with OPEB accruals.

OPEBs are payable over a period extending into the distant future, and in the United States, there are presently only limited ways to obtain tax deductions for OPEBs prior to actual benefit payments. As a result, there is very little advance funding of OPEB benefits.

Underlying the recorded OPEB obligation is a calculation that estimates future benefit payments attributable to service to date and discounts them to present value. This calculation measures the accumulated postretirement benefit obligation (APBO). ASC 715, *Compensation—Retirement Benefits*, requires the recognition of the entire APBO at each balance sheet date.

Thus, the accrued obligation at each balance sheet date is the present value of the estimated future benefit payments, which will generate tax deductions in the years paid. The reversal pattern can be determined by application of either the loan amortization or the present value method. See Section TX 5.5.1.2.2 for further discussion.
AMT Credit Carryforwards

Projections of taxable income are important in order to determine whether tax attributes that require special consideration, such as AMT credit carryforwards, will be realized. To utilize its AMT credits, a company must generate sufficient regular tax in excess of tentative minimum tax (the amount of tax computed under the AMT system).

As described in Section TX 4.2.5.1, an entity generates AMT credit carryforwards for every dollar of AMT paid. AMT credit carryforwards can be used in any future year to reduce the regular tax to the amount of tentative minimum tax (TMT) calculated for that year. A deferred tax asset is established for AMT credit carryforwards as for other tax credits. Assessing the realizability of AMT credit carryforwards, which is described in ASC 740-10-55-32 through 55-33, can be difficult.

In circumstances where, before consideration of AMT carryforwards, the deferred tax liability exceeds deferred tax assets for deductible differences and loss and FTC carryforwards, it is possible that reversals of the temporary differences at the balance sheet date will ensure future realization of some or all of the AMT credits. First, there is a 15 percent differential in rates between regular tax and TMT computations. Further, depreciation deductions for regular tax generally run ahead of those for AMT, and the amount of the regular-tax taxable temporary differences generally will exceed the amount of AMT taxable temporary differences. Ordinarily, we would expect the AMT reversals to occur with the regular tax reversals. For taxable depreciation differences, both would occur over the remaining book life of the underlying asset. Thus, an aggregate calculation may be sufficient. In these instances, to the extent that a net deferred tax liability provided for regular-tax temporary differences and carryforwards (other than AMT credits) exceeds the TMT deferred tax liability generated by AMT temporary differences and carryforwards, it may be appropriate to consider that the AMT credit carryforwards are assured of realization.

There is another circumstance, undoubtedly rare, in which reversals of temporary differences could ensure realization of AMT credits, but by carryback rather than carryforward. This circumstance would require that (1) AMT net deductible differences in excess of regular net deductible differences were expected to reverse in years in which they could be carried back to recover AMT paid and (2) such carryback was anticipated to actually occur (i.e., the reversing deductible differences were not expected to be offset by taxable income other than from reversals).

To realize AMT credit carryforwards in excess of the amount that is assured by existing temporary differences or carryback, an entity must become a regular taxpayer. Judging that likelihood requires taking a close look at what has caused the entity to be subject to AMT in the past and then assessing the prospects for the future. If the AMT position has resulted from timing differences (i.e., deductions entering into regular taxable income faster than into alternative minimum taxable income [AMTI]), it may be possible to predict that, ultimately, there will be a net reversal, which will cause regular tax to exceed TMT. However, the AMT position may have resulted from permanent differences between regular taxable income and AMTI—for example, statutory depletion in the extractive industries—or from limits on use of loss carryforwards, FTCs, or FTC carryforwards in computing TMT, which will result in their expiration. In these circumstances, the entity, to avoid a valuation allowance, may have to be able to predict, supported by objective positive evidence, that its future tax posture will be significantly different from the current one. Absent the ability to project income, tax-planning strategies would need to be considered.
**FTC Carryforwards under U.S. Federal Tax Law**

When foreign source earnings are included in the U.S. tax return, a credit can be taken, with certain limitations, for the taxes paid or accrued on those earnings in the foreign country or countries. Credits also are generated by foreign taxes actually paid by (or on behalf of) the U.S. entity directly to a foreign taxing authority (e.g., withholding taxes on dividends or income taxes on branch income) and deemed paid (income tax paid by a foreign subsidiary or a 10 percent-or-more-owned investee included in earnings and profits for U.S. tax purposes, when the underlying income is remitted as dividends). If a credit for taxes deemed paid is to be claimed, the dividends included in U.S. taxable income must be grossed up by the amount of the deemed-paid taxes.

Foreign tax credits cannot be used to reduce a U.S. tax liability on domestic-source income. In general, if foreign taxes were paid on foreign-source income in the aggregate at a rate in excess of the U.S. statutory rate, the use of the credits is limited to the tax that would have been paid if the U.S. statutory rate had been used. Foreign-source income includes grossed-up dividends and is reduced by allocations of certain domestic deductions (e.g., administrative costs, interest, etc.). Also, the FTC limitation must be calculated separately for certain categories of foreign-source income. Use of the credits also may be limited if there is a taxable loss from domestic sources since such a loss would offset the foreign-source income before the credits were applied.

FTCs can be carried back one year and forward ten years. To realize the deferred tax asset recorded for FTC carryforwards under ASC 740, an entity must be able to generate sufficient future foreign-source taxable income, and that income must, in the aggregate, have been taxed in foreign jurisdictions at less than 35 percent. The FTC carryforwards can be used only if, and to the extent that, a 35 percent rate exceeds the future credits generated by the future foreign-source income itself. In addition, the entity must not anticipate a taxable loss from domestic sources in the years in which the carryforwards must be used.

In many cases, therefore, it will be difficult to avoid a valuation allowance for FTC carryforwards. Unless the circumstances that generated the carryforwards were aberrational, it is likely that future foreign-source income also will generate excess FTCs, which will become additional carryforwards, rather than utilize existing FTC carryforwards.

As discussed in Chapter TX 11, because ASC 740 continues the indefinite reinvestment exemption for unremitted earnings of foreign subsidiaries, it also prohibits, in assessing the need for a valuation allowance, considering the future taxable income that would result from remitting unremitted earnings for which no tax has been provided based on the indefinite reinvestment exemption. But what about future earnings of those subsidiaries?

Under ASC 740-30-25-13, those earnings cannot be considered in assessing the realizability of FTC carryforwards, or any other item that gives rise to a deferred tax asset, “except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.” Thus, if there has been a past policy or practice of remitting a certain percentage of the earnings from a particular subsidiary, that percentage of the subsidiary's projected future earnings can be considered in assessing the valuation allowance. The idea is that if an entity invokes the indefinite reinvestment exception and does not recognize deferred tax liabilities for some or all of its unremitted foreign earnings, then it is
precluded from having a net deferred tax asset for related FTC carryforwards, unless the realizability of those carryforwards is supported by an established pattern of dividends that does not contradict its assertions under ASC 740-30-25-17. Whether an “established pattern” of dividends exists is a matter of judgment to be assessed on a case-by-case basis. However, if there have been no dividends, or if there has been no pattern of dividend payments to date, or if a change in pattern is required to support realization of the deferred tax asset, then a valuation allowance is required for as long as it takes to reasonably conclude that a pattern has been established.

Other future foreign-source income can and should be considered. This would include earnings from foreign entities where the indefinite reinvestment exception is not used and foreign branch income. Consideration also should be given to royalties from subsidiaries or others and to rental income and interest that are treated as foreign-source income under the tax law. These latter sources may be particularly important in assessing realization because, assuming an efficient worldwide tax footprint, those “earnings” typically will not have been taxed at high rates in the foreign jurisdictions.

5.5 Scheduling Future Taxable Income

Scheduling future taxable income, if carried to its full extent, involves extensive number-crunching. At the extreme, it would be tantamount to estimating what the tax return would look like for each future year in which temporary differences reverse.

5.5.1 When Is It Necessary?

The simple answer is: When it matters. That is, when the assessment of the appropriate valuation allowance or the applicable tax rate could vary materially depending on relatively minor shifts in the timing of taxable income. For example, scheduling will have to be considered in the following situations:

- The realization of the deferred tax asset is dependent upon future reversals of existing taxable temporary differences. In other words there is a deferred tax asset, but the likelihood of future taxable income from sources other than reversing taxable differences does not provide sufficient assurance of realization to avoid a valuation allowance. ASC 740 requires that projections of future taxable income must consider all years that may provide a source of taxable income for the realization of deferred tax assets. The entity must determine to what extent reversals of taxable differences ensure realization through offsetting. This situation could occur not only where future prospects are marginal or worse, but also in jurisdictions where carryback and carryforward periods are relatively limited, future results are expected to be erratic, or there is a limitation on the use of certain tax attributes. For example, certain states limit the amount of NOL available in any one period.

- A change in the tax rate is enacted but will not take effect until a future year or years. The entity must determine the amount of temporary differences for which the current tax rates are applicable and the amount of temporary differences for which the rates enacted for the future will be applicable.

While a detailed deferred tax computation is illustrated later in this chapter, we believe it will be the exception rather than the rule that detailed computations will have to be carried to this extreme. The specific facts and circumstances will determine the extent to which scheduling and detailed tax computations are necessary.
5.5.1.1 General Approach to Scheduling

There are two basic approaches to the scheduling exercise. In one approach, only reversals of temporary differences, actual carryback availability, and available strategies are considered. This approach would be used when prospects for other future taxable income are bleak, and the net deferred tax liability or asset might approximate the result of a detailed tax computation based on the scheduling of reversing differences only. However, consideration should be given to the extent to which carryback availability provides assurance of realization. An abbreviation of this approach, a scheduling of reversals of temporary differences only, also could be used to determine the amount of reversals that will occur before, and the amount that will occur after, an enacted future rate change when taxable income is expected in each future year. The other approach includes estimated future taxable income other than reversals. This scheduling approach does not result in a computation of the net deferred tax liability or asset. However, when it is not clear whether all deductible differences and carryforwards will be used, this second approach can be used to estimate the amount that will expire unused. This approach also may be employed to determine the applicable rate when enacted future rate changes and carrybacks from future years exist.

While the following discussion is in the context of full-scale scheduling and detailed deferred tax computations, reasonable approaches to aggregate temporary differences may be sufficient in many cases. For example, when there is a loss carryforward that expires in 10 years, the question may be the amount of reversals that will occur during the remainder of the carryforward period, and year-by-year scheduling will be unnecessary.

5.5.1.2 Patterns of Temporary Difference Reversals

Scheduling temporary differences can be extremely technical. For each class of temporary differences, the pattern of reversal must be determined. ASC 740-10-55-15 through 55-22 acknowledges that in many cases there is more than one logical approach. It further notes that the consideration of reversal patterns is relevant primarily in assessing the need for a valuation allowance. Judgment is critical in that assessment, and attempts at precision in predicting future taxable income, other than reversals, would be pointless. The guiding concepts in determining reversal patterns are stated in ASC 740-10-55-12 through 55-14.

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. The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years.

In addition, ASC 740-10-55-15 through 55-22 provides some ground rules:

- The methods used for determining reversal patterns should be systematic and logical.
- Minimizing complexity is an appropriate consideration in selecting a method.
- The same method should be used for all temporary differences within a particular category of temporary differences for a particular tax jurisdiction.
- The same method for a particular category in a particular tax jurisdiction should be used consistently from year to year.
“Category” is not defined in the guidance but two examples are cited: (1) liabilities for deferred compensation and (2) investments in direct financing and sales-type leases. Different methods may be used for different categories of temporary differences. If the same temporary difference exists in two tax jurisdictions (e.g., U.S. federal and a state tax jurisdiction), the same method should be used for that temporary difference in both tax jurisdictions.

A change in method is a change in accounting principle subject to the guidance in ASC 250, Accounting Changes and Error Corrections. Such a change, if material in its effects, would have to be justified as a change to a preferable method, and an SEC registrant would be required to obtain a preferable letter from its independent auditors.

5.5.1.2.1 Depreciable and Amortizable Assets

Only reversals of temporary differences at the balance sheet date would be scheduled. As indicated in ASC 740-10-55-14, the future originations and their reversals would be part of future taxable income, other than from reversing differences, which is one of the sources of future taxable income to be considered in assessing the need for a valuation allowance.

### Example 5-17: Depreciable Assets

To illustrate, assume that a $12,000 taxable temporary difference relates to a depreciable asset with a future pattern of depreciation expense at December 31, 2000, as follows:

<table>
<thead>
<tr>
<th>Basis Difference at Jan. 1</th>
<th>Book Depreciation</th>
<th>Tax Depreciation</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001 (12,000)</td>
<td>2,400</td>
<td>5,000</td>
<td>(2,600)</td>
</tr>
<tr>
<td>2002 (14,600)</td>
<td>2,400</td>
<td>5,000</td>
<td>(2,600)</td>
</tr>
<tr>
<td>2003 (17,200)</td>
<td>2,400</td>
<td>2,000</td>
<td>400</td>
</tr>
<tr>
<td>2004–2010 ($2,400 book depreciation each year)</td>
<td>(16,800)</td>
<td>16,800</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$24,000</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

Under ASC 740, the $12,000 temporary difference would be deemed to reverse on a FIFO basis as follows:

<table>
<thead>
<tr>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004–2007 ($2,400 each year)</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciable asset</td>
<td>—</td>
<td>—</td>
<td>$400</td>
<td>$9,600</td>
</tr>
</tbody>
</table>

The origination of the additional $5,200 temporary difference in 2001 and 2002 and its reversal in 2008 through 2010 are not considered part of the reversal of the temporary difference existing at the balance sheet date. They are, instead, considered part of the future taxable income other than reversals.
We believe that the following methods of categorizing temporary differences for determining reversal patterns may be used:

- Asset-by-asset approach.
- Asset category (e.g., buildings).
- Total property, plant, and equipment category.

However, to the extent that certain assets within a particular category are indefinite-lived assets for financial reporting purposes (e.g., land, goodwill, indefinite-lived intangibles), we believe that, as a general rule when assessing the need for a valuation allowance, those assets should be isolated and the reversal of taxable temporary differences associated with them not scheduled. For example, in assessing the need for a valuation allowance, a taxable temporary difference associated with land that there is no present plan to dispose of, should not be offset against deductible temporary differences associated with depreciable plant and equipment.

5.5.1.2.1.1 Tax Lives Longer than Book Lives

There will be certain assets for which tax lives are longer than book lives. For these assets, book depreciation generally will run ahead of tax depreciation. In preparing the financial statements, it is assumed that the asset will be abandoned or taken out of service and disposed of at the end of its book depreciable life. Accordingly, the remaining tax basis at the end of the book life would be expected to be available as a tax deduction at that time. Thus, the excess-tax-over-book basis at the balance sheet date generally would be expected to reverse in the last year of the book life.

5.5.1.2.1.2 Construction in Progress

There may be a difference between the book basis and tax basis of construction in progress. The timing of reversal will depend on when book and tax depreciation commence. If there is an excess tax basis, it will reverse in the first years in which tax depreciation exceeds book depreciation. An excess book basis will reverse in the first years in which book depreciation exceeds that taken for tax.

5.5.1.2.1.3 Nonamortizable Tax Intangibles (Other than Goodwill)

In business combinations in which the tax basis of the acquired entity’s assets and liabilities is stepped up, tax basis may have been assigned to identifiable intangible assets other than goodwill. In some taxing jurisdictions the intangibles (e.g., tradenames) may not be amortizable for tax purposes, even though they may be for book purposes. In these circumstances, the laws of the particular taxing jurisdiction(s) would need to be considered to assess whether the recovery of the tax basis of the intangibles is allowed other than through a disposition or liquidation of the entire business. For example, whether the tax basis can be recovered by disposition or abandonment of the intangible asset. (In the U.S., since the 1993 Tax Act, losses generated upon disposition of intangibles are generally disallowed for US tax purposes.) If the basis can be recovered, consideration should also be given to the appropriate tax rate(s) to apply to gains and losses resulting from the relevant disposal options.

While these assets may seem similar to goodwill, they are different in their nature and do not represent a residual. In future periods, book amortization will give rise to a temporary difference for the excess tax basis, and a deferred tax asset will be
recognized for the deductible temporary difference. While there may be no plans for sale or disposition of the intangibles, and it would not be expected to occur (if at all) before some distant future year, under the ASC 740 comprehensive allocation system, reversal of the temporary difference would be assumed. The question is whether a valuation allowance must be established.

To the extent that a loss on the sale of the intangible asset is expected, the company needs to consider whether there will be sufficient future taxable income of appropriate character available to realize the loss.

5.5.1.2.2 Assets and Liabilities Measured at Present Value

This broad grouping includes many financial instruments (e.g., loans receivable and long-term debt), leases that are capitalized by the lessee or recorded as receivables by the lessor, most accruals for individual deferred compensation contracts, and OPEB obligations. The FASB staff specified two basic approaches for scheduling the reversal of temporary differences related to assets and liabilities that are measured at present value. The same basic approaches are presumably available for determining patterns of reversal under ASC 740 as well. With respect to an asset or liability measured at present value, the aggregate future cash payments will exceed the “principal” balance (i.e., book basis or tax basis, as the case may be) at the balance sheet date, and the difference between the two scheduling methods involves the portion of future cash payments expected in each future year that is deemed to recover or settle the “principal” balance at the balance sheet date.

The two approaches are termed the loan amortization method and the present value method. Under the loan amortization method, future payments are considered to apply first to accrued interest, with the balance applied to principal. The application to principal would be the reversal. Under this method, when payments are level, annual reversals will increase each year. This model mirrors the model used generally in financial statements in accounting for assets and liabilities measured at present value (i.e., the reversal amount for each future year will be the amount by which the recorded asset or liability is expected to be reduced in that year). The recorded asset (liability) may be expected to increase in a future year if the payment(s) receivable (payable) in that year will be less than the interest income (expense) expected to accrue. Therefore, no reversal would be deemed to occur in that year.

The present value method assigns to each reversal year the present value at the balance sheet date of the payment to be made in that year. When payments are level, annual reversals will decrease each year. The present value method can be viewed as considering each required future payment as a separate zero-coupon asset or liability, with all interest accruing unpaid from the balance sheet date to the payment date. In contrast, the loan amortization method (and the financial statement model) emphasizes that the series of payments constitutes a single contract.

The results of the two different methods in a very simple application can be illustrated as follows:

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2 Question 10 of the Special Report on FAS 96.
**Example 5-18: Assets and Liabilities Measured at Present Value and under the Loan Amortization Methods**

Assume that on December 31, 20X1, an asset or liability is recorded in the amount of $614,457. This amount represents the present value, using a 10 percent interest rate, of 10 payments due on December 31 of each of the next 10 years. The reversal patterns under the two methods would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan Amortization</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$ 38,554</td>
<td>$ 90,909</td>
</tr>
<tr>
<td>20X3</td>
<td>42,410</td>
<td>82,645</td>
</tr>
<tr>
<td>20X4</td>
<td>46,651</td>
<td>75,131</td>
</tr>
<tr>
<td>20X5</td>
<td>51,316</td>
<td>68,302</td>
</tr>
<tr>
<td>20X6</td>
<td>56,447</td>
<td>62,092</td>
</tr>
<tr>
<td>20X7</td>
<td>62,092</td>
<td>56,447</td>
</tr>
<tr>
<td>20X8</td>
<td>68,302</td>
<td>51,316</td>
</tr>
<tr>
<td>20X9</td>
<td>75,131</td>
<td>46,651</td>
</tr>
<tr>
<td>20Y0</td>
<td>82,645</td>
<td>42,410</td>
</tr>
<tr>
<td>20Y1</td>
<td>90,909</td>
<td>38,554</td>
</tr>
<tr>
<td>Total</td>
<td>$614,457</td>
<td>$614,457</td>
</tr>
</tbody>
</table>

The reversal for 20X2 under the loan amortization method is based on the allocation of the 20X2 payment ($100,000) first to interest ($61,446) and the remainder to principal ($38,554). Under the present value method, the reversal assigned to 20X2 is the present value at December 31, 20X1, of the lease payment to be made on December 31, 20X2, and is calculated to be $90,909.

Note that when the asset or liability requires a series of level payments from the balance sheet date until liquidation, the reversal pattern derived under the loan amortization method is the exact reverse of that derived under the present value method.

It generally will be easier to apply the loan amortization method because the reversal amounts are usually consistent with the financial statement amounts. Accordingly, they may be readily available, and the reversals deemed to occur in future years for a particular asset or liability may not change from year to year. Application of the present value method, by contrast, may require computations to be made solely to determine the reversals. Further, the reversal deemed to occur in any specific future year for any particular asset or liability will change from year to year. This occurs because, as the period between the balance sheet date and the future year decreases, the discount to present value also decreases, and the reversal deemed to occur in that future year increases.

While both may be acceptable, we believe the loan amortization method is preferable because it is consistent with the “interest method” required by ASC 835, Interest. Whichever method is selected, it must be used consistently.
Financial Instruments

Carried at Amortized Cost for both Book and Tax

The selected method, loan amortization or present value, is applied separately to the book basis and to the tax basis of the financial instrument. Application to book basis would use the interest rate embedded in the book accounting, and application to tax basis would use the interest rate implicit in the tax accounting. In effect, the reversal of the temporary difference at the balance sheet date that is deemed to occur in each future year is the difference between the recovery in that year under the selected method of the book basis and of the tax basis.

In general, the reversal pattern under the loan amortization method would track the change in the temporary difference, assuming neither the book nor the tax balance increases during any year. However, assume a loan receivable with a tax basis equal to the principal amount, a lower book basis, and the entire principal due at maturity (similar considerations would arise for long-term debt with all principal due at maturity, a tax basis equal to the principal amount, and a lower book basis), the amortization method would schedule the reversal of the entire temporary difference in the year of maturity, since it is only in that year that recovery of (reduction in) the tax basis occurs. The amount of the temporary difference would change each year and, accordingly, the amount of the reversal deemed to occur in the year of maturity also would change in each year's deferred tax calculations.

However, we believe that it also would be an acceptable application of the loan amortization method under ASC 740 to consider the reversals of the temporary difference at the balance sheet date to occur as the book basis is accreted to the principal amount and the temporary difference is correspondingly reduced. Under this approach, the expected future book interest income in excess of taxable interest income in each future year would be deemed to result in a tax deduction in that year. Even though actual tax deductions are not expected to occur in this pattern, the pattern would reflect the book income expected to be recognized without being reported as taxable income.

There are situations (e.g., marketable bonds) where discount or premium for tax purposes is amortized on a straight line basis or is not amortized at all. We believe that it would be reasonable in such cases to consider the temporary difference to reverse in the pattern in which it is expected to reduce.

ASC 310 requires amortization of certain net fees or costs (i.e., those related to revolving credits) on a straight-line basis. Assuming that the net fees or costs were taxable (deductible) on loan origination, we believe it would be appropriate to schedule deductions (taxable income) based on expected book amortization.

Carried at Fair Value for Both Book and Tax

When a security is carried at market for both book and tax purposes, there typically should be no significant temporary differences.

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3 As defined by Question 10 in the FASB Special Report on FAS 96.
Carried at Amortized Cost for Book and Fair Value for Tax

When a debt security is carried at amortized cost under ASC 320 (i.e., a held-to-maturity security), but marked to market for tax, the reversal pattern of the temporary difference may be problematic. Because the security is classified as held-to-maturity, the premium or discount for tax purposes will be presumed to disappear over the remaining life of the instrument, but it will not amortize in any systematic pattern. Rather, the market value, and tax basis, will change as a result of the shortening of the period to maturity and of changes in market interest rates and in the issuer's credit standing. In such circumstances, it appears reasonable to assume, for purposes of determining the reversal pattern, that market interest rates and issuer's credit standing will remain unchanged to maturity. The reversal pattern would be determined in the same way as if tax reporting in the future were to be based on amortized cost using the balance-sheet-date tax basis as amortized cost at that date. The reversal in each future year would be determined as the difference between the recovery of book basis and the recovery of tax basis assigned to that year under the method, either loan amortization or present value, elected for the category of temporary differences in which the security is included, as discussed in this chapter.

Carried at Fair Value for Book and Amortized Cost for Tax

When a security is carried at market under ASC 320, but at cost or amortized cost for tax purposes, the reversal pattern will depend on management's intentions and expectations. For example, we believe that it would not be prudent to anticipate changes in market prices in determining reversal patterns. Accordingly, the timing of the reversal of the balance-sheet-date unrealized appreciation or depreciation of an equity security should correspond to the period in which management intends to sell and should be consistent with the operating plans of the entity.

On the other hand, when a debt security is classified as available-for-sale, but management has no particular expectation that it will be sold prior to maturity, the best approach may be to assume that the security will be held to maturity and that market interest rates and the issuer's credit standing will remain unchanged. The reversal pattern then would be determined as if the security were to be carried at amortized cost in the future for book purposes using the balance-sheet-date market value as amortized cost at that date. The reversal in each future year would be determined as the difference between the recovery of book basis and the recovery of tax basis assigned to that year under the method, either loan amortization or present value, elected for the category of temporary differences in which the security is included.

For a debt security expected to be sold within the next few years but considerably in advance of its scheduled maturity, it may be appropriate to consider reversals to occur in the years prior to expected sale in the pattern suggested for a debt security for which there is no particular expectation for sale, with the balance of the temporary difference reversal assigned to the year in which sale is expected.

5.5.1.2.2 Leases

When a lessor records its investment in leased property as a sales-type or direct-financing lease, the book asset is measured at present value, and the accounting is similar to that for a loan receivable. The lessor accrues interest on its investment and applies lease payments to reduce it. However, for tax purposes, if the lease is a “true lease,” the lessor owns a depreciable asset and depreciates the tax basis as permitted by the tax law.
A lessee that capitalizes a lease obligation that is a “true lease” for tax purposes will amortize the asset over the lease term (or shorter useful life) in its financial statements. The liability is measured at present value, and the lessee accrues interest on the recorded obligation and applies lease payments to reduce it. However, the lessee is entitled to tax deductions for the full amount of its lease payments.

Both of these situations involve a single transaction, a lease. However, the FASB took the position that both the lessor in a direct-financing or sales-type lease and the lessee in a capital lease have two temporary differences. Under this view, a lessee with a capitalized lease has both a book asset and a book liability, each with a tax basis of zero. A similar situation would exist for a seller-lessee in a sale-leaseback of real estate that failed to qualify for sale-leaseback accounting in accordance with ASC 840, Leases. The effect of the capital gains tax on the sale-leaseback is discussed later in Section TX 5.5.1.2.6. In addition, a lessor in a direct-financing or sales-type lease has an investment in the lease (an asset measured at present value) for book purposes with no tax basis, and property for tax purposes with no book basis.

We believe that it is acceptable but not required under ASC 740 to consider two temporary differences to exist in these situations. One effect would be in disclosure. Since, as discussed in Section TX 15.2, gross deferred tax assets and gross deferred tax liabilities must be disclosed, the lessor, using the two-difference approach, would include in its deferred tax assets the amount related to the tax basis of its depreciable property, and in its deferred tax liabilities, the amount related to taxable income to be reported on collection of its lease payments, which are deemed to be the recovery of its investment in the leased property. The lessee would include, in deferred tax assets, the amount for the future deductions for lease payments, which are deemed to reduce the capital lease obligation, and, in deferred tax liabilities, the amount for future taxable income equal to amortization of its leasehold asset. If, on the other hand, the lease is considered to generate a single temporary difference, a single net asset or liability would be included in the disclosure, generally a deferred tax liability for the lessor and a deferred tax asset for the lessee.

The one-difference approach may be simpler to conceptualize and to apply. It would simply net book/tax differences for each year. For example, the lessee in a capital lease generally would recognize book expense (amortization of the leasehold asset and interest on the capital lease obligation) faster than it could claim tax deductions for lease payments. In early years, when the deductible temporary difference was being accumulated, the reversal would be deemed to occur only after the “turnaround” (i.e., in the years when the tax deduction exceeded book expense).

But the two-difference approach would consider full reversal of both the asset and the liability. The two-difference method would recognize, in the reversal pattern, the excess book expense over tax deductions (i.e., future taxable income) that would occur in the years before the turnaround.

Regardless of whether the one-difference or two-difference approach is elected, it will be necessary, in determining the reversal pattern, to recognize that two reversals must be considered. There will be, in addition to the reversal of the asset (the lessor’s investment) or the liability (the lessee’s obligation) measured at present value, the reversal of the depreciable or amortizable asset (for tax purposes for the lessor, for book purposes for the lessee).

4 FASB Special Report on FAS 96.
Also, the ASC 740 methodology always recognizes a deferred tax liability for taxable differences but may provide a valuation allowance against deferred tax assets. It is conceivable that, as a result, the net of the deferred tax balances (assets, liabilities, valuation allowance) under the two-difference approach could be a greater liability or smaller asset than under the one-difference approach. Of course, when scheduling or other detailed analysis is required, the impact of the different reversal patterns may depend on the pattern of the net reversals of other temporary differences.

5.5.1.2.2.3 Deferred Compensation

For deferred compensation contracts with individual employees, other than pensions and OPEBs, the accrued liability may represent the present value at the balance sheet date of stipulated payments scheduled to commence upon an employee’s retirement. Under the present value method, reversals are deemed to occur equal to the present value of payments to be made in each future year.

The loan amortization method assumes that any benefit payment applies first to interest accrued after the balance sheet date, including the interest from the balance sheet date to the retirement date, as well as the interest accruing between the retirement and payment dates. Under this approach, only a portion of payments due in the later payment years relates to the liability accrued at the balance sheet date.

In some cases, the present value at retirement of expected deferred compensation payments is accrued by straight-line charges over the period to retirement. Under ASC 715, Compensation—Retirement Benefits, the present value of the deferred compensation payments must be fully accrued at the “full eligibility date,” which may precede the retirement date. For simplicity, this discussion assumes those dates are the same.

Even when the accrual of the liability prior to the retirement date is not interest-adjusted, in concept, the liability is measured at present value. Thus, an appropriate approach is to apply the selected method, loan amortization or present value, to expected actual future payments to determine the reversal pattern of the liability that will be accrued at the retirement date. Then, those reversals would be deemed to relate to the accrued liability at the balance sheet date based on the ratio of the accrued liability to the expected liability at the retirement date.

When payments will be made for the remaining life of the employee rather than for a stipulated period, the actuarial assumption used in providing the accrual also should be used in estimating the timing of the payments. The method of payment (lump sum versus annuity), as well as early or late retirement options, may be at the employee’s election. Absent any data on likely employee options that are expected to be selected, management judgment will be required.

Pensions

Accounting for pensions under ASC 715 can give rise to a number of temporary differences. In general, there will be no pension asset or liability for tax purposes. Deductions are generally available for qualified arrangements when cash contributions are made. The pension asset or liability for financial reporting thus will constitute a temporary difference.

Because the accounting model for pensions estimates future benefit payments and discounts them to present values, at first it might seem appropriate to consider any pension an asset or liability to be measured at present value for purposes of
determining reversal patterns. Further, the ASC 715 model for OPEBs is based on the model for pensions, and we consider the recorded OPEB obligation to be a liability measured at present value. However, because pension obligations typically are funded in advance to some extent, the U.S. federal tax code provides for a tax deduction of the funding, not the future benefit payment.

We believe that it is appropriate to base the reversal of a pension asset or liability on estimates of how and when the recorded asset or liability actually will be reduced. If it is expected that there will be increases in the recorded asset or liability before reductions occur, those would be ignored. The first reductions anticipated would be deemed to apply to the asset or liability existing at the balance sheet date. This approach is similar to that for depreciable assets, where increases in the temporary difference are ignored and reversals are applied on a FIFO basis. The approach we suggest may require consultation with the entity’s actuaries, but we do not believe that significant cost should be involved. Predictions of future events will be very important in estimating the pension reversal pattern.

**PwC Observation:** It is not appropriate to consider any new taxable temporary differences arising from changes in actuarial assumptions (e.g., future return on plan assets, changes in discount rates, etc.) when scheduling future taxable income.

There may be circumstances in which there is simply no way to make a reasonable estimate of when reduction of the pension temporary difference will occur. In that case, a pragmatic approach will be necessary. The FASB provided a pragmatic approach, which might be reasonable depending on the entity’s circumstances. Under this approach, the temporary difference, whether for an asset or a liability, is deemed to reverse pro rata over the average remaining service life of employees expected to receive benefits under the plan or, when all or almost all participants are inactive, over their average remaining life expectancy.\(^5\)

However, we do not believe that use of the loan amortization or present value methods is appropriate under ASC 740 for pension-related deferred tax balances. We believe that these methods were acceptable because the previous standard prohibited entities from considering future events. Under ASC 740 however, that prohibition has been removed.

5.5.1.2.3 **Deferred Foreign Taxes**

A foreign branch and/or a foreign subsidiary of a U.S. corporation may generate non-U.S.-source income that is required to be included in the U.S. corporation’s income tax return currently, that is, when the income is earned by the foreign branch or foreign subsidiary. The income and loss of a foreign branch are effectively considered the income or loss of the U.S. corporation branch owner and hence are currently includible in the U.S. corporation income tax return as though the foreign branch were a division of a U.S. corporation. The income of a foreign subsidiary of a U.S. corporation (commonly referred to as a “controlled foreign corporation” or a CFC) is currently includible in the U.S. corporation’s income tax return when the CFC either generates a certain type of foreign-source income considered under U.S. tax law as “subpart F income” or when it pays dividends from foreign-source earnings not previously taxed in the United States. Subpart F income includes certain types of

\(^5\) FASB Special Report on FAS 96.
foreign-source income (e.g., certain passive income, certain active business income generated from related parties) that under U.S. income tax law is currently includible in the U.S. corporation's income tax return. U.S. taxation of subpart F income cannot be deferred—that is, U.S. tax is assessed on subpart F income when earned.

As the same item of income or loss of a foreign branch or a CFC might be taxable both in the foreign country (under the foreign country’s tax laws) and in the United States (under U.S. income tax laws), the U.S. corporation may have to keep two sets of temporary differences: one set of temporary differences for purposes of the U.S. return (those temporary differences would be included in the deferred tax computation for the U.S. consolidated tax group) and another set for foreign tax purposes. The deferred foreign tax asset or liability resulting from application of ASC 740 will be a temporary difference in the deferred U.S. tax computation because it has book basis but no tax basis (for U.S. tax purposes, foreign deferred taxes of the branch do not enter the computation of U.S. taxable income until the foreign temporary differences become current taxes).

For U.S. deferred tax computations, a deferred foreign tax asset of a branch is a taxable difference, and a deferred foreign tax liability is a deductible difference. A future benefit (deductible temporary difference) on the books of the foreign branch or subsidiary will result in less income tax paid for local country tax purposes. Accordingly, the U.S. parent will be entitled to a lesser foreign tax credit or deduction, as a result of the future benefit, than if the foreign branch or subsidiary had a future tax liability (taxable temporary difference). When a deferred foreign tax asset is recovered, it reduces foreign taxes paid, and when a deferred foreign tax liability is settled, it increases foreign taxes paid.

The U.S. tax temporary differences for deferred foreign taxes generally will reverse as the underlying foreign tax temporary differences reverse, but how the reversals will enter into the deferred tax computation will require special consideration. When projecting and scheduling future taxable income, the company needs to consider not only the temporary differences of its foreign operations, but also the sources of income; whether there is sufficient income of the appropriate source (i.e., foreign or U.S.) to utilize foreign tax credits; as well as how the credit or deduction will be incorporated into the projection of taxable income and/or the U.S. deferred tax computation (i.e., at 100 percent for a credit or an amount that is the U.S. federal tax effect from a deduction). The applicable rate in the U.S. deferred tax computation may be 100 percent if foreign taxes are expected to be credited rather than deducted when reversal occurs. U.S. taxpayers have an annual election to deduct foreign taxes paid or to take them as a credit against the tax liability. The use of foreign taxes paid as deductions generally will be of less benefit than their use as credits; however, there are limitations on the use of foreign tax credits, thereby making a deduction, which will reduce taxes paid, of greater benefit than a credit, which might expire.

In deciding whether to deduct or credit foreign taxes paid, the taxpayer also will have to consider any dividends received from foreign subsidiaries. If the taxpayer elects to credit foreign taxes actually paid, then it also must gross up the dividends included in its taxable income, claiming a foreign tax credit of an equal amount for taxes deemed-paid (i.e., the foreign income taxes paid by the foreign subsidiaries in earning the income remitted).

5.5.1.2.4 Tax Return Accounting Method Changes

The effect of a U.S. tax return accounting method change—the cumulative difference at the date of change between the old and new tax methods—generally is reflected in
taxable income on a straight-line basis over a period of years, subject to acceleration in certain circumstances. The reversal pattern of the effect of the change, that is, the “spread,” is the pattern expected for actual tax return purposes. There will be another, separate, temporary difference if, after the tax return accounting method change, there is a difference between the book and tax bases of the asset or liability for which the change was made. Generally, this difference reverses when the asset or liability is reduced or disposed of. See Section TX 7.7 for a discussion relating to the accounting for various types of accounting method changes.

5.5.1.2.5 Deferred Revenue or Income

For many types of revenue that enter into taxable income currently but are deferred to some future period for financial reporting (e.g., rent received in advance), it may be difficult to discern just how the temporary difference reverses (i.e., what the future tax consequence will be of earning the income). Under ASC 740, the deferred revenue indicates that a future sacrifice will be required in order to earn the revenue and that sacrifice is measured by the amount of the deferred revenue. The deferred revenue frequently will include future gross profit (i.e., it will exceed the amount of tax deductions expected to be generated in earning the revenue). Nevertheless, the entire amount of deferred revenue must be considered a deductible difference. For purposes of considering its reversal pattern, it is probably easiest to think of the deferred revenue as a liability that will be settled by a deductible cash payment in the period recognized.

5.5.1.2.6 Sale-Leasebacks

One type of deferred income is the gain on a sale-leaseback. It is not uncommon for capital gains tax to be incurred on sales of real estate. Any benefit of a lower capital gains rate would be reflected in the current tax provision, and the deferred gain would be a deductible temporary difference. The deferred gain is deemed to reverse as ordinary deductions (i.e., the excess of future ordinary deductions for lease payments over future book expense, whether rent in an operating lease or depreciation in a capital lease).

5.5.1.2.7 Reserves for Bad Debts and Loan Losses

For specific reserves for bad debts, reversal will occur in the future year when the receivable is expected to be charged off. Generally, reversals would be expected to occur within three years. The same was true for specific reserves for loan losses prior to ASC 310, which permits those practices to be continued.

However, when an allowance for loss on a loan is based on present value measurements under ASC 310, the increase in the present value may be recognized with the passage of time. If so, this would indicate that the pattern of reversal of deductible temporary differences would be determined as discussed for financial instruments (i.e., using the loan amortization or present value method).

Unallocated reserves cannot be associated with an individual loan or trade receivable. Estimates of reversals should be based on management’s best estimate of when receivables or loans outstanding at the balance sheet date will result in actual charge-offs for tax purposes. For financial institutions to assume the sale or exchange of loans (to generate deductions), the loans would have to be carried at the lower of cost or market value. The carrying amount would consider the loan-loss reserves to the extent that they have been provided to cover losses on sales or swaps.
5.5.1.2.8 **Inventory Reserves**

Reversal occurs as the related inventory turns on a flow-of-goods basis. Obsolete inventory may be anticipated to be sold over, say, a three-year period, while damaged inventory may be expected to be sold for scrap in the next period.

5.5.1.2.9 **Reserves for Litigation**

The reversal pattern for accruals for litigation should be consistent with management’s intentions and the basis of the accrual. For example, if management intends to “vigorously contest” a claim, the reversal should take into account the sometimes ponderous pace of the legal process. If, on the other hand, management intends to settle and expects to have the ability to do so, reversal in the near term may be expected.

5.5.1.2.10 **Warranty Reserves**

The reversal pattern should be based on the period in which the claims are expected to be paid. Historical trends generally would be used to estimate the pattern of the reversals. The reversal period should not exceed the warranty period, except for processing delays.

5.5.1.2.11 **Stock Appreciation Rights**

The compensation expense recognized for book purposes will be deductible when employees exercise the related rights. The accrued compensation expense may in fact be reversed by market price declines. We believe, however, that reversal should be deemed to occur in the year(s) when exercise is anticipated.

5.5.1.2.12 **Other**

5.5.1.2.12.1 **Contract Accounting**

The percentage-of-completion method typically will be used for both book and tax purposes in accounting for contracts. However, the tax law measures completion of a contract on the basis of a cost-to-cost analysis and incorporates a number of accounting conventions, which may result in significant differences from the method employed for financial reporting. This temporary difference may originate over several periods and reverse over several periods. Reversals would be determined by estimating all future book and tax amounts. The accumulated differences at the balance sheet date would reverse in the first years in which the differences run in the opposite direction.

5.5.1.2.12.2 **Future Taxable Income Other Than Reversals**

When scheduling future taxable income for purposes of assessing the need for a valuation allowance, estimating and scheduling future taxable income, other than reversals, by year might be the least technical component of the scheduling process. However, it is generally the most difficult and often the most important. Estimating how much future taxable income the entity will generate involves a great deal of judgment. The extent to which deferred tax assets do not require a valuation allowance often will be dependent on this judgment. Refer to the guidance earlier in this chapter on developing a projection of future taxable income other than reversals.
5.5.1.2.12.3 Carriers and Carryforwards

In the United States, carryback and carryforward periods for corporations are generally 2 years and 20 years, respectively, with respect to newly generated NOLs. However, in certain countries, there is no carryback, but there is an indefinite carryforward period. There may be different rules for carrybacks and carryforwards in each city, state, and applicable foreign taxing jurisdiction.

Forgoing a Carryback

The Internal Revenue Code provides an election to forgo the carryback of a loss when there is available taxable income in the carryback years. For example, rates in the carryforward period may be higher than rates in the carryback period. An entity also might make this election if it has used foreign tax credits to reduce or even eliminate the actual taxes payable in the preceding three years. To that extent, the loss carryback will not result in a refund but will only free up the foreign tax credits. However, given the short carryforward period of ten years for foreign tax credits and other restrictive limitations on their use, any freed-up foreign tax credits might expire unused. What the entity can do instead is file an election in the year of the loss to carry it forward.

There may be other circumstances in which credits that would be freed up by carryback of a loss could, in turn, be used by further carryback to claim a refund of taxes paid in years preceding the loss carryback period. In such cases, a carryback benefit at or approaching the full statutory rate may be available.

The election to forgo a carryback should be reflected in the deferred tax computation only when that election actually is expected to be made. In certain circumstances, what actually is expected to take place will not minimize the deferred tax liability. One reason this might occur is that, while the time value of money impacts the actual tax-planning actions an entity expects to take, discounting deferred taxes is not permitted. For example, an entity might carry a loss back because of the time value of money (the benefit from having the cash from the refund immediately), even though the gross benefit—the nominal, undiscounted amount—would be expected to be greater with a carryforward. Depending on the tax rates in the carryback period and valuation allowance requirements, the carryback might have an unfavorable impact on deferred taxes.
5.5.2 Examples of Scheduling

5.5.2.1 Example of Scheduling Future Taxable Income

Example 5-19: Example of Scheduling Future Taxable Income

At the end of 2000, the company identified its temporary differences. The deductible differences exceed the taxable differences by $2,100. In assessing the realization of the deferred tax asset attributable to the $2,100 net deductible difference, the company considered all four sources of possible taxable income, in accordance with ASC 740-10-30-18. Before scheduling future taxable income—including a determination that it did not have any available prudent and feasible tax-planning strategies—the company scheduled the reversals of the temporary differences below. The “net temporary differences” line indicates the year-by-year taxable income or loss that would be generated solely by reversals of temporary differences existing at December 31, 2000.

The company then layered into the analysis its estimated future taxable income other than reversals. At this point, the “net future taxable income before carryback/carryforward” line indicates tax losses in two future years.

The company then applied the tax law for loss carrybacks and carryforwards to the expected future tax losses. Both years with tax losses can be carried back to prior years in the carryback period. At this point, the analysis indicates that all deductions will be used.

It might seem unnecessary in this particular case for the company to estimate and schedule future taxable income, other than reversals, in order to determine that there is sufficient taxable income to use all the deductions. If the carryback and carryforward rules of the tax law had been applied immediately after scheduling the reversals of the temporary differences, all the annual losses indicated on the “net temporary differences” line would have been used by carryback or carryforward. However, as discussed at Section TX 5.4.1.1.3, carryback availability may not support future realization of a deferred tax asset if, in fact, no actual carryback is expected.

In this example, the company has included in its scheduling its estimated future taxable income other than reversals. Those estimates may have been conservative because of the emphasis on objective evidence in the more-likely-than-not assessment, and thus the “future taxable income before carryback/carryforward” line may not be the company's best estimate of whether there will be actual carrybacks. Nonetheless, the company has sufficient estimated future taxable income so that it is not relying solely on actual carryback to justify its deferred tax asset as more-likely-than-not of realization.

(continued)
Example of scheduling future taxable income:

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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net future taxable income/(loss) before carryback/carryforward</td>
<td>2,700</td>
<td>2,800</td>
<td>2,900</td>
<td>3,000</td>
<td>3,100</td>
<td>35,500</td>
<td></td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td>(4,100)</td>
<td>2,225</td>
<td>2,825</td>
<td>(750)</td>
<td>5,400</td>
<td>42,300</td>
<td></td>
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<td></td>
</tr>
<tr>
<td><strong>Carryback/Carryforward</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior-year availability</td>
<td>$2,500</td>
<td>$2,600</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryback 2001 to 1999</td>
<td>(2,500)</td>
<td>2,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Carryback 2001 to 2000</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Carryback 2004 to 2002</td>
<td>(1,600)</td>
<td>1,600</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>(4,100)</td>
<td>2,225</td>
<td>2,825</td>
<td>(750)</td>
<td>5,400</td>
<td>42,300</td>
<td></td>
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</tbody>
</table>

If the company had tax credit carryforwards or expected to generate tax credits in the future, the analysis would have to be expanded to incorporate the applicable tax rate and the credits. This would be necessary to assess the realization of the deferred tax assets recorded for the tax credits.
5.5.2.2 Example of Unused Deduction

Example 5-20: Example of Unused Deduction

At the end of 2000, the company has taxable temporary differences related to fixed assets of $10,000, which reverse at a rate $500 per year over the next 20 years. The company also has deductible temporary differences related to OPEB of $10,000, which reverse at the rate of $250 per year over the next 40 years. Expected taxable income, excluding the reversals of temporary differences, is $100 per year. As shown below, after considering the 2-year carryback and 20-year carryforward periods, $700 of the OPEB deductions would not offset any taxable income. Absent a tax-planning strategy, a valuation allowance for $700 of the deductible temporary differences that reverse in years 2027 through 2040 would be recorded.

<table>
<thead>
<tr>
<th>Each Year 2001–2020</th>
<th>Each Year 2021–2040</th>
<th>Each Year 2041–2060</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductible temporary difference reversals</td>
<td>$ (250)</td>
<td>$ (250)</td>
</tr>
<tr>
<td>Taxable temporary difference reversals</td>
<td>500</td>
<td>–</td>
</tr>
<tr>
<td>Expected future taxable income other than reversals</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Expected taxable income/(loss) per year</td>
<td>350</td>
<td>(150)</td>
</tr>
<tr>
<td>x 20 yrs.</td>
<td>x 20 yrs.</td>
<td>x 20 yrs.</td>
</tr>
<tr>
<td>7,000</td>
<td>(3,000)</td>
<td>2,000</td>
</tr>
<tr>
<td>Carryback from 2021–2022 to 2019–2020</td>
<td>(300)</td>
<td>300</td>
</tr>
<tr>
<td>Carryforward from 2023–2040 to 2041–2060</td>
<td>–</td>
<td>2,000</td>
</tr>
<tr>
<td>$ 6,700</td>
<td>$(700)</td>
<td>$ –</td>
</tr>
</tbody>
</table>

The $700 of unused deductions consists of $50 in each year 2027–2040.

This example suggests a level of precision in estimates of future taxable income on a year-by-year basis. Even if estimates are made for distant future years on a year-by-year basis, such forecasts are inherently imprecise. However, when it is necessary to estimate the deductible differences or carryforwards that will not be used, an overall estimate would follow the approach illustrated.

PwC Observation: When scheduling, it is important to consider the effects of ASC 740 and the manner in which taxing jurisdictions make adjustments upon audit. In the U.S., audit adjustments are generally recorded back to the year in which the audit adjustment is related. As a result, depending upon the timing of the reversal of deductible temporary differences and the year in which the uncertain tax position relates to, an entity’s liability for unrecognized tax benefits for a particular jurisdiction may (or may not) be a source of income for the realization of deferred tax assets.
Chapter 6:
A Change in Valuation Allowance
Chapter Summary

ASC 740-10-45-20 provides the primary guidance for recording the effects of a change in valuation allowance that occurs during the year. This guidance requires that a change in valuation allowance be sourced to financial statement categories based on several factors, including whether a deferred tax asset was benefited in the year during which it was established and whether the taxable income used to support realization of the deferred tax asset results from the current year or future years. Because the language used in ASC 740-10-45-20 and ASC 740-20-45-1 through 45-14 can sometimes lead to counterintuitive results, this guidance should only be viewed in conjunction with ASC 740’s model for intraperiod allocation, which is discussed more fully in Chapter TX 12.
Excerpts from ASC 740 and ASC 805

**ASC 740-10-45-20:**
The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily shall be included in income from continuing operations. The only exceptions are changes to valuation allowances of certain tax benefits that are adjusted within the measurement period as required by paragraph 805-740-45-2 related to business combinations and the initial recognition (that is, by elimination of the valuation allowances) of tax benefits related to the items specified in paragraph 740-20-45-11(c) through (f). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraphs 740-20-45-2 and 740-20-45-8.

**ASC 805-740-45-2:**
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).

### 6.1 Recording the Effects of Changes in Valuation—in General

ASC 740-10-45-20 provides general guidance for recording the effects of changes in valuation allowance recorded during the year. ASC 740-10-45-20 essentially groups valuation allowances into the following four categories:

- Effects 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 should be recorded to continuing operations (see Section TX 12.2.2.2.3).

- Effects of a change to valuation allowances of certain tax benefits that are adjusted within the measurement period as required by paragraph 805-740-45-2 related to business combinations (see Section TX 10.5.5).

- Effects resulting from the initial recognition (that is, by elimination of the valuation allowance) of tax benefits related to the items specified in ASC 740-20-45-11(c)–(f). These items are allocated to the related component of shareholder's equity.
that gave rise to the underlying benefit that is being initially recognized. We refer to these items as “source of loss” items (see Section TX 12.2.2.2.3.2 for a more detailed discussion of “source of loss” items).

• All other changes should be allocated based on ASC 740’s general rules for intraperiod allocation (see Section TX 12.2 for the general rules surrounding ASC 740’s incremental approach to allocating tax expense or benefit for the year).

**PwC Observation:** ASC 740’s incremental approach gives priority to continuing operations over other financial statement components when determining whether there are available future sources of taxable income to realize losses or deferred tax assets. As a result, nearly all changes in valuation allowance are recorded to continuing operations. Exceptions to this basic rule include (1) the initial recognition of “source of loss” items, as discussed below and in Section TX 12.2.2.2.3.2, (2) increases or decreases in a valuation allowance due solely to income or loss recognized in the current year from financial statement components other than continuing operations, and (3) certain adjustments occurring during the measurement period after a business combination.

### 6.2 Changes in Valuation Allowance in Specific Areas

#### 6.2.1 Changes in Valuation Allowance—Business Combinations

##### 6.2.1.1 Establishment of a Valuation Allowance Against an Acquired Company’s Deferred Tax Assets at the Time of Acquisition

ASC 805-740-25-3 requires an acquirer to assess the need for a valuation allowance as of the acquisition date for an acquired entity’s deferred tax asset in accordance with ASC 740-10. If a valuation allowance is required to be recorded against deferred tax assets acquired in a business combination, it would be recorded as part of acquisition accounting. See Section TX 10.5.2.

##### 6.2.1.2 Changes to the Acquired Deferred Tax Assets in a Period Subsequent to a Business Combination

Under ASC 805-740-45-2, a change in valuation allowance that does not qualify as a measurement period adjustment is reflected in income tax expense (or as a direct adjustment to contributed capital as required by ASC 740-10-45-20 through 45-21). A change in valuation allowance within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected as an 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.

The acquirer must consider whether changes in the acquired deferred tax balances are due to new information about facts and circumstances that existed at the acquisition date or are due to events arising in the post-combination period. Discrete events or circumstances that arise within the measurement period and did not exist at the acquisition date generally would not be recorded in acquisition accounting. See Section TX 10.5.5.

Unlike the general transition provisions of ASC 805, whereby the guidance is applied only to business combinations consummated after the effective date of ASC 805, the guidance related to the release of a valuation allowance subsequent to the date of an
6.2.1.3 Changes in the Acquirer's Valuation Allowance at the Time of a Business Combination

Pursuant to ASC 805, the impact on the acquiring company’s deferred tax assets and liabilities caused by an acquisition is recorded in the acquiring company’s financial statements outside of acquisition accounting (i.e., not as a component of acquisition accounting). This applies to a change in tax rate expected to be applicable when the deferred tax assets and liabilities reverse as well as a release or recognition of all or part of a valuation allowance against the acquirer’s deferred tax assets as a result of the business combination. Such impact is not a part of the fair value of the assets acquired and liabilities assumed; therefore, the decrease in valuation allowance must be recorded in the income tax provision (subject to intraperiod allocation) of the acquirer. Similarly, if a valuation allowance is required on the acquirer’s deferred tax assets as a result of the acquisition, the impact should be reflected in the acquirer’s income tax provision at the date of the acquisition and not as a component of acquisition accounting. See Section TX 10.5.6.

6.2.1.4 Effects of Tax Law Changes on a Valuation Allowance Recorded Against Acquired Tax Benefits in a Business Combination

The tax effects of a change in tax law or regulation that result in a change in valuation allowance that was initially recorded in acquisition accounting is recorded in continuing operations in the period of enactment. See Section TX 7.5.1 for further guidance.

6.2.1.5 Ordering of Recognition of Tax Benefits

Since the treatment of the initial recognition of tax benefits from “source of loss” items are treated differently from other tax benefits that are recognized within a year, when benefits from both “source of loss” and non-“source of loss” are recognized during the year, there is a need to determine which tax benefit was recognized. See Section TX 12.2.2.2.3.3 for a discussion of the ordering rules that should be followed in making this determination.

6.2.2 Changes in Valuation Allowance Related to Items of Other Comprehensive Income

See Section TX 12.2.3.2.2.2 for a discussion of common intraperiod allocation issues, including changes in valuation allowances relating to unrealized appreciation and depreciation on available-for-sale (AFS) securities accounted for under ASC 320, Investments, and other items of other comprehensive income.

6.2.3 Changes in Valuation Allowance Resulting from Transactions Among or with Shareholders

ASC 740-10-45-21 states that “changes in valuation allowances due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders should be included in the income statement.” In addition, the guidance indicates that a write-off of a pre-existing deferred tax asset that an entity can no longer realize as a result of a transaction among or with its shareholders should similarly be charged to the income statement, since the same
net effect results from eliminating a deferred tax asset and increasing a valuation allowance to 100 percent of the amount of the related deferred tax asset.

See Section TX 10.8 for a discussion of the effects of release of a valuation allowance as a result of a transaction with a noncontrolling shareholder.

6.2.3.1 NOL Carryforward Limitation Following an Initial Public Offering

Assume that an entity, after completing an initial public offering, is required to reduce its deferred tax assets or increase its valuation allowance related to NOL carryforward amounts for which future utilization is limited as a result of the tax change in ownership rules. Should the tax consequences of this change be charged to contributed capital or recognized in the income statement?

The effects of writing off a deferred tax asset (or recording a valuation allowance) in these circumstances should be recognized in the income statement. ASC 740-10-45-21 concluded that changes in valuation allowances due to changed expectations about the realization of deferred tax assets caused by transactions among or with shareholders should be included in the income statement. The guidance further concluded that the write-off of a preexisting deferred tax asset in these circumstances should be charged to income, because the same net effect results from eliminating a deferred tax asset or increasing a valuation allowance to 100 percent of the amount of the related deferred tax asset. This guidance may differ from the guidance for changes in tax bases of assets and liabilities that are caused by transactions with or among shareholders for which ASC 740-20-45-11(g) concluded the related tax effects should be included in equity. See Section TX 12.2.3.3.2 for further discussion.

6.2.4 Transactions between Entities under Common Control

See Section TX 10.9.1 for a complete discussion of the accounting for a change in the valuation allowance as a result of a common control transaction.

6.2.5 Changes in Valuation Allowance in Spin-Off Transactions

6.2.5.1 Recording an Increase to a Parent's Valuation Allowance When a Subsidiary Is Spun Off in a Nontaxable Transaction

In the United States, if a parent spins off more than 20 percent of a subsidiary in a nontaxable transaction that is recorded as a distribution to shareholders, the subsidiary would be excluded from the consolidated tax return. As a result, the parent may conclude that a valuation allowance against its deferred tax asset is necessary now that the subsidiary’s taxable temporary differences are no longer available as a source of future taxable income to the parent. In this case, the charge for the establishment of the valuation allowance should be to continuing operations. Although the realizability assessment of the parent’s deferred tax assets may have changed due to the decision to spin off the subsidiary, it is accounted for separate and apart from the spin transaction.

6.2.5.2 Recording a Valuation Allowance on a Subsidiary’s Assets When a Spin-Off Creates the Need for a Valuation Allowance

In certain cases, deferred tax assets exist related to the subsidiary that are supportable in consolidation, but will, upon spin-off, require a valuation allowance. An issue arises as to whether this impairment should be recognized in the
consolidated financial statements prior to the spin-off. In such cases, we understand that the FASB staff has concluded that the consolidated financial statements of the parent should reflect a charge to continuing operations at the time of the spin-off, even though such a charge would not have been required if the spin-off had not occurred. The staff’s view appears to be based on a conceptual argument that the parent is not transferring the deferred tax assets at the value at which those assets were recorded in consolidation. Rather, the deferred tax assets have been impaired by the decision to spin off the business into a separate entity that, more-likely-than-not, will be unable to realize the value of those deferred tax assets. This charge should also be reflected in the standalone financial statements of the subsidiary (or will have already been reflected in earlier periods, if the subsidiary was accounting for deferred taxes in accordance with the separate return method described in Section TX 14.1.1).

6.2.6 Changes in Valuation Allowance When Restating Prior-Period Presentation for Discontinued Operations

See Section TX 12.2.3.2.4.1 for a discussion on restating prior-period presentation for discontinued operations when there is a change in the beginning-of-the-year valuation allowance that results from a change in assessment about future realizability of deferred tax assets.
Chapter 7: 
Change in Tax Laws or Rates
Chapter Summary

ASC 740 requires that the tax effects of changes in tax laws or rates be recognized in the period in which the law is enacted. Those effects, both current and deferred, are reported as part of the tax provision attributable to continuing operations, regardless of the category of income in which the underlying pretax income/expense or asset/liability was or will be reported. This chapter contains illustrative examples of the concepts surrounding changes in tax laws or rates and expands the discussion to include the accounting for automatic, nonautomatic, and nondiscretionary changes in tax return accounting methods.
Excerpts from ASC 740

ASC 740-10-35-4:
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.

ASC 740-10-45-15:
When deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.

7.1 Determining the Enactment Date

ASC 740-10-45-15 requires that the effects of a change in tax law or rates be recognized in the period that includes the enactment date. While the date of enactment is not explicitly defined, we believe that “enactment” occurs when the law has been subjected to the full legislative process.

For U.S. federal tax purposes, the enactment date is most often the date the President signs the bill into law. Enactment can occur in other ways, such as when the second house of Congress affirmatively overrides a presidential veto. The key concept is that the full legislative process is complete. Most states follow the same or similar processes.

Many foreign countries have requirements similar to those in the United States in that an official, such as the President, must sign legislation into law. For others, enactment occurs only after the law is published in an official publication, similar to a federal register.

The SEC, as well as the FASB and the AICPA International Practices Task Force, has long held the view that legislation should not be considered “enacted” until the foreign country’s official ultimately signs it into law and the full legislative process is complete (i.e., the law cannot be overturned without additional legislation). Thus, future (i.e., not fully enacted) rate changes cannot be anticipated and should not be recognized.

7.2 Distinguishing Between Interpretive and Legislative Regulations

Once tax legislation has been enacted, most jurisdictions employ a governmental department or agency (e.g., the U.S. Department of Treasury) to promulgate regulations necessary to implement and interpret the tax laws. In determining the proper accounting for changes in tax regulations, it is important to understand whether the regulation in question is interpretive or legislative in nature. (In some circumstances, judgment will be required to determine whether a regulation is interpretive or legislative in nature.)

- Interpretive: In the U.S. federal context, the majority of Treasury regulations are interpretive in nature. Interpretive regulations are meant to interpret or clarify existing tax laws. In deliberating the guidance on accounting for unrecognized tax benefits, the FASB concluded that a change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position should be recognized as a discrete item in the period in which the
change occurs (i.e., as a nonrecognized subsequent event). Thus, the effects of interpretive regulations issued or changed after the balance sheet date but before the issuance of the financial statements should not be reflected in the prior period financial statements. Only a footnote disclosure of the event (if material) would be required. See Section 16.5.5 for more information.

- Legislative: In the U.S. federal context, legislative regulations are issued pursuant to a specific delegation by Congress and, thus, generally have the full force and effect of law. Issuances of or changes to legislative regulations should be accounted for as changes in tax law in the period of enactment in accordance with the provisions of ASC 740-10-45-15.

Although the timing for recording the effects of newly issued or changes to existing interpretive and legislative regulations, which occur after the balance sheet date but before the issuance of the financial statements, are the same, the tax effects of the two types of regulations are subject to different intraperiod allocation rules. This may affect the component to which the related tax effects are allocated. See Section TX 16.9.1 and Section TX 12.2.2.2.1 for more information.

7.3 Accounting for Rate Changes

The total effect of tax rate changes on deferred tax balances is recorded as a component of the income tax provision related to continuing operations for the period in which the law is enacted, even if the assets and liabilities relate to other components of the financial statements, such as discontinued operations, a prior business combination, or items of accumulated other comprehensive income.

As discussed in ASC 740-10-55-23 and 740-10-55-129 through 55-135, an enacted change in future tax rates often requires detailed analysis. Depending on when the rate change becomes effective, some knowledge of when temporary differences will reverse will be necessary in order to estimate the amount of reversals that will occur before and after the rate change.

As discussed in Chapter TX 4, beginning at Section TX 4.2.3, the timing of reversals of temporary differences may not be the only consideration in the determination of the applicable rate to apply to those temporary differences. The applicable rate is determined by reference to the rate expected to be in effect in the year in which the reversal affects the amount of taxes payable or refundable. For example, assume that reversals are expected to occur in a future year after a change in enacted tax rates takes effect. Also assume an expectation that taxable results for that year will be a loss that will be carried back to a year before the rate change takes effect, and that the reversals will increase or decrease only the amount of the loss carryback. In those circumstances, the rate in effect for the carryback period is the applicable rate. Similarly, if rates changed in a prior year and carryback of a future tax loss to pre-change years is expected, then the pre-change tax rate will be the applicable rate for reversals whose effect will be to increase or decrease the loss carryback.

The calculation is even more complicated if the reversing temporary differences both reduce current-year taxable income and generate losses that are expected to be carried back to a pre-change year. Assuming graduated rates are not a significant factor, the tax effects of the reversals ordinarily should be determined on an incremental basis. Specifically, if the net reversing difference—the excess of deductible over taxable differences included in the expected tax loss—was less than or equal to the projected amount of the tax loss, the applicable rate would be the pre-change rate; the post-change rate would be applied to the amount of the net reversal that exceeded the projected tax loss.
Example 7-1: Determining the Applicable Rate When Temporary Differences Both Reduce Taxable Income and Generate Losses Expected to Be Carried Back

Assume that as a result of new tax legislation, the statutory tax rate drops from 35 percent to 30 percent and that an entity estimates $900 of pretax book income and $1,000 of net reversals of deductible temporary differences that will result in a taxable loss of $100 in the post-change period. Also assume that the entity expects to carry back this loss to a pre-change period.

Because $900 of the temporary differences is expected to reduce taxable income and the resulting taxes payable in the post-change period, the lower post-change rate of 30 percent should be applied to those deductible temporary differences. Conversely, because the remaining $100 of deductible temporary differences is expected to be carried back to a pre-change 35 percent rate period, the 35 percent rate should be applied to that portion of the reversing deductible temporary differences.

A similar, but opposite, approach may be appropriate when taxable income is expected for a post-change year but its amount is less than the amount of a net reversing taxable difference—that is, there is an excess of taxable over deductible reversals. If a tax loss in that year could be carried back to a pre-change year, the applicable rate would be the future rate only to the extent of the estimated taxable income for the year of reversal, and the current rate would be applied to the balance of the reversals. If a tax loss in the reversal year would be carried forward, the rate expected to be in effect in the carryforward years would be the applicable rate for all the reversals.

Example 7-2: Determining the Applicable Rate When There Are Pretax Losses and Net Reversing Taxable Temporary Differences That Create Taxable Income

Assume that as a result of new tax legislation, the statutory tax rate drops from 35 percent to 30 percent and that an entity estimates $900 of pretax book loss and $1,000 of net reversals of taxable temporary differences that result in taxable income of $100 in the post-change period. Also assume that the entity has sufficient taxable income in the relevant carryback period to absorb losses.

Applying the incremental concept to deferred taxes, $900 of the $1,000 net reversing taxable temporary differences would be reflected using the pre-change rate (since it serves to offset what would have been carried back and benefited at the pre-change rate), with the balance, $100, reflected at the post-change rate.

In some cases, enacted tax legislation may involve a phase-in of several different rates over a period of time. The key questions in the analysis will be (1) when will the temporary differences reverse, and (2) will the reversals reduce taxes payable in the years of reversal or will they result in a carryback or carryforward that will generate a tax refund from an earlier year or reduce a tax payable in a future year, each of which has a different tax rate? ASC 740-10-55-129 through 55-130 provides an example (see Chapter TX 4, Example 4-3). Additionally, enacted tax legislation may also include a provision that changes the tax rate in a particular year if specified conditions occur. Example 7-3 illustrates how a company should consider contingent income tax rates when measuring its deferred taxes.
Example 7-3: Treatment of Contingent State Income Tax Rates

**Background/Facts:**
State X has a corporate income tax rate of 5 percent. In the current year, State X enacts a revision to the tax law providing that, in the event specified budgetary goals are not met for a particular year, the 5 percent rate will be increased to 8 percent, retroactive to the beginning of that year. Company Y conducts business in State X and in accordance with ASC 740 must measure its deferred taxes based on the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred taxes are expected to be realized or settled.

**Question:**
Should Company Y measure its deferred taxes, at the 5 percent corporate tax rate or at the enacted, but contingently applicable, 8 percent rate?

**Analysis/Conclusion:**
Company Y should use judgment as to whether State X will meet the specified criteria to maintain the 5 percent corporate income tax rate in assessing the rate(s) to use in its accounting for income taxes. The measurement of State X deferred taxes should be recorded using Company Y's best judgment as to the rate expected to be applicable upon realization or settlement, consistent with the guidance in ASC 740-10-30-9, which discusses graduated tax rates and other provisions of enacted tax laws to be considered in determining the tax rate to be applied. Because the outcome of the uncertainty in this case depends on factors that are external to any particular company, it may be important for Company Y to obtain relevant input and evidence as to the likelihood of State X meeting its budgetary goals.

This guidance is specific to enacted income tax rates that are contingent upon specified criteria to be measured at a future date rather than those that are contingent upon future legislative action (i.e., that would not be considered enacted).

The applicable rate would require ongoing monitoring and consideration should be given to disclosure of the uncertainty, the rate applied and the potential impact of a change in expectations. The effects of any changes in expectations should be accounted for as a change in estimate in the period in which the change in expectation occurs.

7.4 Interim-Period Considerations

As discussed above, the effect of a change in tax laws or rates on a deferred tax liability or asset must be reflected in the period of enactment.

When determining the effect of a tax law change, entities must consider the law change's effect on the deferred tax balances existing at the enactment date and, to the extent the law change is retroactive, its effect on taxable income through the enactment date. For entities that prepare quarterly financial statements, estimating the effect of the law using the most recent quarter end, adjusted for known material transactions between the enactment date and the quarter end, usually is sufficient. For other entities, calculating the effect of the law change may require additional work. For such entities, the effect of reversals of beginning deferred tax balances for the period through the enactment date has to be considered, as well as the deferred tax effects of originating temporary differences.
Computing this effect, however, requires measuring temporary differences and the related deferred taxes at an interim date, that is, the date of enactment. For determining the effect of a tax rate change, the deferred taxes actually accrued through the enactment date (by application of the effective rate to year-to-date “ordinary” income and by discrete recognition of other tax effects) should be used (see more about computing deferred taxes for interim periods in Section TX 7.4.1).

In the interim period in which a rate change is enacted, the tax used in computing the new annual effective rate combines:

• Tax currently payable or refundable on estimated “ordinary” income for the current year, reflecting the effect of the rate change to the extent that it is effective for the current year.

• The deferred tax expense (the difference between the beginning-of-year and the estimated end-of-year balances in the balance sheet deferred tax accounts) attributable to estimated “ordinary” income for the year (including changes in the valuation allowance that are reflected in the effective rate computation). This computation would be based on the newly enacted rate, and thus the beginning-of-year deferred tax balance used in computing deferred tax expense would be after adjustment for the rate change.

Application of this new effective rate to year-to-date “ordinary” income would automatically include in the interim period of the enactment the adjustment of deferred taxes provided by application of the effective rate in prior interim periods. The adjustment of the beginning-of-year deferred tax balances for the rate change would be reflected as a discrete item in the interim period of the enactment. When items other than “ordinary” income have been reported in prior interim periods, both their current and deferred tax effects would be adjusted in the interim period of the enactment. While this approach may be acceptable for simple rate changes, more detailed analysis often may need to be performed.

All adjustments to reflect a rate change are measured as of the enactment date and reflected in income from continuing operations (See Example 7-4).

### 7.4.1 Computing Deferred Taxes in an Interim Period

When a change in tax law is enacted on a date that is not close to an enterprise’s year-end, the question arises as to how temporary differences should be computed as of an interim date. Three possibilities present themselves:

• Assume that the entity files a short-period tax return as of the date of the law’s enactment. The tax laws govern how annual deductions such as depreciation are allowed in a short-period return. The existing book bases of the assets and liabilities would be compared with these “pro forma” tax bases to determine the temporary differences.

• Assume that net temporary differences arise and reverse evenly throughout the year. For example, if the beginning net temporary difference is $100 and the projected ending net temporary difference is $220, the temporary difference increases by $10 a month as the year progresses.

• Assume that net temporary differences arise in the same pattern that pretax accounting income is earned. That is, if pretax income is earned 10 percent, 20 percent, 30 percent, and 40 percent in the first through fourth quarters, respectively, then temporary differences would increase or decrease on that basis as well.
In terms of the asset-and-liability approach underlying ASC 740, the first alternative might be viewed as the most intuitive, but it is inconsistent with the principles of interim reporting that treat an interim period as a component of the full year and not a stand-alone period. The second alternative would be practical; however, like the first alternative, it is inconsistent with how an entity estimates its quarterly tax provision and, thus, its deferred tax accounts. The third alternative avoids the inconsistency and would be relatively easy to compute, at least for entities accustomed to computing an effective tax rate for quarterly reporting. Whichever method is chosen, it should be applied consistently.

### 7.4.2 Retroactive Tax Rate Change

In 1993, when the U.S. federal tax rate was increased from 34 percent to 35 percent retroactively to January 1, 1993, the EITF considered the issue of how to determine the tax effect of a retroactive change in enacted tax rates that is included in income from continuing operations for the period that includes the enactment date of the retroactive change. As set forth in ASC 740-10-25-48 and ASC 740-10-45-16, “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...the cumulative tax effect is included in income from continuing operations.”

As set forth in ASC 740-10-30-26 and ASC 740-10-45-17, “the reported tax effect of items not included in income from continuing operations (for example, discontinued operations, extraordinary items, cumulative effects of changes in accounting principles, and items charged or credited directly to shareholders’ equity) that arose during the current fiscal year and before the date of enactment of tax legislation shall be measured based on the enacted rate at the time the transaction was recognized for financial reporting purposes...the tax effect of a retroactive change in enacted tax rates on current or deferred tax assets and liabilities related to those items is included in income from continuing operations in the period of enactment.”

### 7.4.3 Retroactive Changes in Tax Laws or Rates Following Adoption of an Accounting Standard

Sometimes, tax law or rate changes occur in the same year that new accounting standards are adopted and the effect of the law or rate change dates back to the accounting standard adoption date. As set forth in ASC 740-10-45-18, if an entity adopted a new accounting standard as of a date prior to the enactment date, the effect of the change in tax laws or rates would not be recognized in the cumulative effect of adopting the standard, but would be recognized in income from continuing operations for the period that included the enactment date. This would be true regardless of whether the change in tax laws or rates was retroactive to the earlier date.

---

**Example 7-4: Computation of Income Tax Expense with an Enacted Change in Tax Rates in an Interim Period**

**Background/Facts:**

Company A recognized a net deferred tax liability of $160 at December 31, 20X5 related to the temporary differences shown below. (Assume that no valuation allowance was necessary for the deferred tax asset.)

(continued)
Fixed Assets | Inventory
---|---
Book basis [A] | $2,000 | $900
Tax basis [B] | 1,500 | 1,000
Temporary difference: TTD or (DTD) [A – B = C] | 500 | (100)
Federal tax rate for all future years [D] | 40% | 40%
Deferred tax liability or (asset) [C x D = E] | 200 | (40)
Net deferred tax liability at December 31, 20X5 | $160

Company A projected that, at December 31, 20X6, the net deferred tax liability would be $280, based on a $300 increase in its taxable temporary difference. Therefore, for 20X6, the projected deferred tax expense will be $120 ($280–$160).

Company A's income tax expense for the first quarter of 20X6 was calculated as follows:

**Step 1: Estimated taxable income:**

- Estimated annual pretax income $100,000
- Less
  - State income tax $(5,000)
  - Dividend received deduction (1,000) (6,000)
- Increase in excess accumulated tax over book depreciation $(800 – $500) (300)
- Estimated taxable income $93,700

**Step 2: Annual effective tax rate:**

- Estimated taxable income $93,700
- Statutory federal income tax rate 40%
- Estimated current income taxes payable 37,480
- Estimated federal deferred tax expense [$300 increase in TTD x 40%] 120
- Less research and experimentation tax credit (2,000)
- Add state income tax (including deferred state income taxes of $400) 5,400
- Estimated full-year income tax provision $41,000
- Estimated annual effective tax rate [$41,000/$100,000] 41%

**Step 3: Income tax provision:**

- First-quarter pretax income $20,000
- Estimated full-year effective income tax rate 41%
- Income tax provision—first-quarter 20X6 $8,200

**Question:**

If an increase from 40 percent to 45 percent in the federal income tax rate was enacted on June 15, 20X6, retroactive to the beginning of the year, how would the effect of the change be reflected in income tax expense for the three and six months ended June 30, 20X6?

(continued)
**Analysis/Conclusion:**

**Step 1: Estimated taxable income:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated annual pretax income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>State income tax</td>
<td>$(5,000)</td>
</tr>
<tr>
<td>Dividend received deduction</td>
<td>$(1,000)</td>
</tr>
<tr>
<td>Increase in excess accumulated tax over book depreciation</td>
<td>$(300)</td>
</tr>
<tr>
<td>Estimated taxable income</td>
<td>$ 93,700</td>
</tr>
</tbody>
</table>

**Step 2: Annual effective tax rate:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated taxable income</td>
<td>$ 93,700</td>
</tr>
<tr>
<td>Statutory federal income tax rate</td>
<td>45%</td>
</tr>
<tr>
<td>Estimated current income taxes payable</td>
<td></td>
</tr>
<tr>
<td>Estimated federal deferred tax expense [$300 increase in TTD x 45%]</td>
<td>135</td>
</tr>
<tr>
<td>Less research and experimentation tax credit</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Add state income tax (including deferred state income taxes of $400)</td>
<td>5,400</td>
</tr>
<tr>
<td>Estimated full-year income tax provision</td>
<td>$ 45,700</td>
</tr>
<tr>
<td>Estimated annual effective tax rate [$45,700/$100,000]</td>
<td>45.7%</td>
</tr>
</tbody>
</table>

**Step 3: Income tax provision:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revised estimated income tax provision</td>
<td>$ 13,710</td>
</tr>
<tr>
<td>Year-to-date income tax provision</td>
<td>$ 13,710</td>
</tr>
<tr>
<td>Less first-quarter income tax provision</td>
<td>(8,200)</td>
</tr>
<tr>
<td>Second-quarter income tax provision</td>
<td>$ 5,510</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted deferred tax liability ($500 x [45% – 40%])</td>
<td>$  25</td>
</tr>
<tr>
<td>Adjusted deferred tax asset ($100 x [45% – 40%])</td>
<td>(5)</td>
</tr>
<tr>
<td>Net increase in income tax expense</td>
<td>$ 20</td>
</tr>
<tr>
<td>Plus second-quarter tax expense</td>
<td>5,510</td>
</tr>
<tr>
<td>Total second-quarter tax expense</td>
<td>$ 5,530</td>
</tr>
<tr>
<td>Total six months tax expense ($13,710 + $20)</td>
<td>$ 13,730</td>
</tr>
</tbody>
</table>

1 Assume no net changes in the temporary differences and the related deferred tax balances between December 31, 20X5 and immediately prior to the change in the enactment date of the new tax rate (i.e., June 15, 20X6).

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### 7.4.4 Leveraged Leases

ASC 840-30-S99-2 discusses SEC Staff views on the effect of a change in tax law or rate on leveraged leases. When a change in income tax rates is enacted, all components of a leveraged lease should be recalculated from inception through the end of the life of the lease based on the revised after-tax cash flows. The difference
between the amount originally recorded and the recalculated amount would be included in income in the current year.

7.5 **Valuation Allowances**

An enacted tax law or tax rate change entails reconsideration of the realizability of existing deferred tax assets. Consistent with ASC 740-10-45-15, any adjustment to an existing deferred tax asset through the creation or adjustment of an existing valuation allowance should be included in income from continuing operations for the period that includes the enactment date.

In some instances, tax rate changes may be enacted after year-end but before the financial statements are issued. In those situations, also in accordance with ASC 740-10-45-15, the enacted change would not be recognized until the period that includes the enactment date. Some might argue that any valuation allowance for deferred tax assets should take into consideration the impact of a decrease in tax rates. However, the Board’s intent is that the impact of all tax rate or tax law changes be reflected in the period of enactment, regardless of the effect on deferred assets and liabilities in financial statements for earlier periods. Accordingly, the impact on the valuation allowance of a decrease in tax rates enacted after year-end but before the financial statements are issued, would not be recorded at year-end. However, when changes in tax laws or rates are enacted subsequent to year-end but before the financial statements are released, the effect on existing deferred tax assets or liabilities should be disclosed.

7.5.1 **Valuation Allowances Relating to Assets Acquired in a Prior Business Combination**

The effect of a change in tax law or rate that results in a change in valuation allowance that was initially recorded in acquisition accounting should be included in income from continuing operations pursuant to ASC 740-10-45-15. This applies to any reduction in the valuation allowance that otherwise would not have been recognized, regardless of whether the valuation allowance is reduced in the period of the tax law or rate change or in a subsequent period.

7.6 **Disclosure Requirements**

An entity’s financial statements should disclose all adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates. When rate changes occur, the reconciliation of the effective tax rate should include an item for the effect of rate changes enacted in the current year.

We believe that it generally would be adequate to disclose the effect of the rate change on (1) beginning-of-year deferred tax balances and (2) taxes, both current and deferred, provided prior to the enactment date in categories other than continuing operations. Both of these would be items in the rate reconciliation. Other disclosures also might be satisfactory. In any case, the amount(s) disclosed should be clearly described. For further discussion on the disclosure requirements related to enacted changes in tax laws or rates, see Section TX 15.3.4.

7.7 **Changes in Tax Methods of Accounting**

For U.S. federal tax purposes, the two most important characteristics of a tax method of accounting (hereinafter “accounting method”) are (1) timing and (2) consistency. If the method does not affect the timing for including items of income
or claiming deductions, it is not an accounting method and generally IRS approval is not needed to change it. In order to affect timing, it must determine the year in which an income or expense item is to be reported. Said differently, if the issue is whether income is taxable or whether an expense is deductible, then an accounting method is not involved.

In general, to establish an accounting method, the method must be consistently applied. In this regard, the consistency requirement varies depending upon whether an accounting method is proper or improper:

- The use of a *proper* accounting method in a single U.S. federal return constitutes consistency and, therefore, the adoption of an accounting method.
- An *improper* accounting method is adopted after it has been used consistently in at least two consecutive returns.

Once an accounting method has been adopted for federal tax purposes, any change must be requested by the taxpayer and approved by the IRS. Changes in accounting methods cannot be made by amending returns. Rather, there are two procedures for requesting changes from the IRS: (1) automatic and (2) non-automatic. In the case of an automatic change, IRS consent is deemed to have been received once all the requirements of the IRS guidance are met. With a non-automatic change, IRS consent is received only upon written consent from the IRS. In either case, the request for change is filed by the taxpayer on federal Form 3115, *Application for Change in Accounting Method*.

### 7.7.1 Transition to New Accounting Method

In general, whenever a taxpayer changes its accounting method, the tax law provides mechanisms to transition from the old to the new accounting method. The “cut-off” approach results in a prospective change starting in the year of change for new transactions. *Old* transactions continue to be accounted for using the old accounting method.

The other, more common, method of transition is a “cumulative catch-up” approach which triggers an Internal Revenue Code §481(a) adjustment. Under this method, a taxpayer must begin using the new accounting method on the first day of the year of change as if it were always used (i.e., for both old and new transactions). Generally, a negative §481(a) adjustment (i.e., reduction of taxable income) is taken into taxable income in one tax year (the year of change) while a positive adjustment (i.e., increase to taxable income) is spread over four years.

#### 7.7.1.1 Positive §481(a) Adjustments

Accounting method changes that result in a positive adjustment and do not conform to the book treatment for the related item will generally result in two temporary differences. The first temporary difference is the basis difference between book and tax because the methods are not conformed (there may or may not have already been a temporary difference depending on whether the book and tax treatments were previously the same). The second relates to the §481(a) adjustment. The issue of what temporary differences exist when a taxpayer changes its accounting method is addressed in ASC 740-10-55-59 through 55-61. In the example provided, a change in tax law required a change in accounting method for tax purposes related to inventory. The guidance concludes that the change gives rise to two temporary differences. The first relates to the temporary difference already in existence on the
inventory. The second relates to the deferral of the catch-up adjustment (i.e., the §481(a) adjustment), which represents deferred income for tax purposes with no book basis and, as such, is a taxable temporary difference for which a deferred tax liability is recorded.

7.7.1.2 Negative §481(a) Adjustments

In contrast to the scenario described above, accounting method changes that result in a negative adjustment and do not conform to the book treatment for the related item will generally result in one temporary difference. That is, the only temporary difference is the basis difference between book and tax because the methods were not conformed. A §481(a) adjustment is made in the year of change but, because taxpayers are allowed to take a negative adjustment in its entirety in the year of change, the §481(a) adjustment only affects the current payable and does not result in any future tax consequences.

7.7.2 Timing

When a request for a change in accounting method is reflected in a company’s financial statements depends on whether or not a company is changing from a proper or improper accounting method and whether or not the change qualifies as an automatic or non-automatic change.

7.7.2.1 Voluntary Changes from Proper Accounting Methods

Changes from proper accounting methods generally arise when there are two or more permissible methods of accounting for a particular item, and the taxpayer desires to change to a more favorable method. These changes can either be automatic or non-automatic.

Automatic changes are granted if the change being requested is one that qualifies for automatic approval by the IRS and the taxpayer complies with all of the provisions of the automatic change request procedure for that year. We believe that automatic changes (i.e., those enumerated in the applicable Internal Revenue guidance) from one permissible accounting method to another should be reflected in the financial statements when management has concluded that it is qualified, and has the intent and ability, to file an automatic change in accounting method. This treatment is based on the notion of perfunctory consent. An automatic change in accounting method is similar to other annual elections that are made by the taxpayer upon filing the tax return. Management should make its best estimate as to how it will treat such items when filing its tax return and account for the items in a consistent manner when preparing the financial statements.

Non-automatic changes, however, require the affirmative consent of the IRS. The effects of a non-automatic change from another proper method should not be reflected in the financial statements until approval is granted because there is discretion on the part of the IRS to deny the application or alter its terms. Appropriate financial statement or MD&A disclosure of pending requests for method changes should be considered.

7.7.2.2 Voluntary Changes from Improper Accounting Methods

A taxpayer may determine that it is using an improper accounting method. As a result, the company will need to consider whether the historical financial statements contained an error and the effects of any unrecognized tax benefits, including
potential interest and penalties. Refer to Section TX 17.1.1.4.7 for a more detailed discussion on discerning a financial statement error from a change in estimate.

Once a company determines that it is using an improper method, it may desire to change its accounting method voluntarily to one which is permissible by filing a Form 3115 with the IRS. When a taxpayer files for a change from an improper to a proper accounting method, the taxpayer receives “audit protection” for prior years. Additionally, because the §481(a) adjustment is typically a positive adjustment, it is generally spread over four years. A company should record in the financial statements the tax effects attributable to a voluntary change from an improper method to a permissible method when the Form 3115 has been filed with the IRS.

It is important to note that, upon financial statement recognition of a change from an improper accounting method, the taxpayer will also need to consider the impact the change will have on any previously accrued interest and penalties on a liability for unrecognized tax benefits related to the improper method (refer to Section TX 7.7.3.1). Any liability for unrecognized tax benefits previously recorded should be reclassified to a deferred tax liability, which now represents the deferred tax consequences of the §481(a) adjustment.

Similar to a change from a proper accounting method, the determination as to what temporary differences result from a change from an improper accounting method depends on whether the change (1) results in an adjustment that is taken all in one year (negative adjustment) or spread over four years (positive adjustment) and (2) whether the change is a change to conform to the book treatment for the related item.

**7.7.3 Unrecognized Tax Benefit Considerations**

Generally, filing a Form 3115 to request a change in accounting method precludes the IRS from raising the same accounting method as an issue in an earlier year. Audit protection starts at the time the application is filed. However, until a company actually files for an accounting method change, the company is at risk for having its prior open years’ tax positions adjusted by the IRS.

**7.7.3.1 Interest and Penalties**

In general, jurisdictions have statutes and regulations that include explicit provisions requiring a company to pay interest and penalties in the event a tax or other obligation is not timely met. In particular, a taxpayer is obligated by operation of law to remit these amounts until and unless the governmental authority agrees to waive some or all of the amounts otherwise owed. As noted in Section TX 7.7.3, upon filing Form 3115, a taxpayer receives audit protection and the IRS is precluded from raising the same issue in an earlier year. As a result, we believe that if an entity is changing from an improper accounting method to a proper one, the reversal of previously accrued interest and penalties should generally be recognized in the period in which the method change request is filed (i.e., when Form 3115 is filed).
PwC Observation: In general, companies that changed from an improper to a proper accounting method traditionally received audit protection, i.e., a commitment from the IRS that it will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change. Audit protection begins when the taxpayer timely files a copy of the Form 3115 with the IRS National Office. Recently, with respect to certain specific topics the IRS has provided clarification on proper accounting methods, and allowed companies to file an automatic method change request to change to a proper accounting method within a specified period of time without risk of audit adjustment for previous years. In those circumstances, companies should reflect the change in accounting method in the financial statements when management has the intent and ability to change the accounting method instead of when the copy of the Form 3115 is filed. Additionally, any unrecognized tax benefits or previously accrued interest and penalties associated with the prior accounting method would be reversed in the same period.

7.7.4 Involuntary Changes from Improper Accounting Methods

In certain cases, taxing authorities require an enterprise to change its accounting method(s) (e.g., the IRS discovers an improper accounting method during an examination). Taxpayers who are contacted for examination and required by the IRS to change an accounting method (“involuntary change”) generally receive less favorable terms and conditions than taxpayers who voluntarily request a change from an improper accounting method.

When the IRS makes an adjustment to an accounting method, it normally makes the change in one of two ways. It can impose an accounting method change or it can resolve an accounting method issue on a non-accounting-method-change basis. When an accounting method is changed, the taxpayer must use the new method in future years. When an accounting method issue is resolved on a non-accounting-method-change basis, the resolution does not constitute a change in accounting method. Consequently, resolution of an accounting issue on a non-accounting-method-change basis does not preclude a taxpayer from continuing to use its current (and improper) accounting method.

If a taxpayer continues to use its current (and improper) accounting method, the taxpayer will need to consider the effects of any unrecognized tax benefits, including potential interest and penalties.

7.7.5 Other Considerations

- Changes in accounting methods as a result of a change in tax law—In the event that a change in accounting method is tied to a change in tax law, the tax effects of the change would be reported through earnings attributable to continuing operations in the period in which the change in tax law is enacted (pursuant to ASC 740-10-45-15) unless IRS permission is required to change the accounting method, in which case the tax effects of the change would be reported in the period in which IRS permission is granted.
• Determination of earnings and profits ("E&P")—The Income Tax Regulations (the "Regulations") provide that the amount of E&P will be dependent on the accounting method used for federal income tax purposes unless a specific provision authorizes a different accounting method for E&P purposes. The Regulations do not specify the adjustment to be made to E&P upon a change in accounting method that results in either a positive or negative §481(a) adjustment. However, in general, and unless otherwise specified, just as a taxpayer should follow the new accounting method for reporting taxable income, the §481(a) adjustment should also be taken into account (whether positive or negative) over the same period in determining E&P.

• State tax implications—In instances where states do not conform to federal provisions for income tax purposes, additional tracking of temporary differences by state tax jurisdiction may be required. Furthermore, consideration should be given to the federal and state similarities and differences with respect to the process and procedures for applying for an accounting method change.
Chapter 8:
Change in the Tax Status of an Entity
Chapter Summary

An entity’s tax status may change from nontaxable to taxable, or vice versa. For instance, some entities, such as partnerships, certain limited liability companies, and Subchapter S corporations, which are generally not subject to income taxes, may change from nontaxable to taxable status, or vice versa, as a result of changes in tax laws or changes in elections. ASC 740-10-25-32 though 25-33 and ASC 740-10-40-6 provides guidance for reflecting the tax effects of changes in tax status.
Excerpts from ASC 740

ASC 740-10-25-32:
An entity's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Subtopic at the date that a nontaxable entity becomes a taxable entity. A decision to classify an entity as tax exempt is a tax position.

ASC 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.

ASC 740-10-25-34:
For example, if an election to change an entity's tax status is approved by the tax 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.

ASC 740-10-40-6:
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.

ASC 740-10-45-19:
When deferred tax accounts are recognized or derecognized as required by paragraphs 740-10-25-32 and 740-10-40-6 due to a change in tax status, the effect of recognizing or derecognizing the deferred tax liability or asset shall be included in income from continuing operations.

8.1 General Rule for Changes in Tax Status

ASC 740-10-45-19 requires that the deferred tax effects of a change in tax status be included in income from continuing operations at the date the change in tax status occurs. Deferred tax assets and liabilities should be recognized for existing temporary differences when an entity changes its tax status to become subject to income taxes. Similarly, deferred tax assets and liabilities should be eliminated when a taxable entity ceases to be taxable. In both cases, the resulting adjustment is included in income from continuing operations.

ASC 740-10-25-33 and 25-34 require that an election for a voluntary change in tax status be recognized in the financial statements on the approval date, or on the filing date if approval is not necessary. Alternatively, a change in tax status that results from a change in tax law is recognized on the enactment date, similar to other tax law changes.
Example 8-1: Accounting for Deferred Taxes on an Available for Sale Security When a Change in Tax Status Occurs

Background/Facts:
Company A, a U.S. entity with a December 31 fiscal year-end, filed a “check-the-box” election to convert Company B, its foreign subsidiary, into a U.S. branch operation. The election is effective beginning on July 1, 20X2. During the first half of 20X2, Company B experienced an unrealized loss on an available-for-sale (AFS) security it held in the local country. The unrealized loss was recognized in other comprehensive income (OCI). The unrealized loss has no impact on Company B’s local country taxes as Company B is located in a zero-rate jurisdiction, but will result in a tax deduction in the U.S. when the loss is ultimately realized since Company B is now a branch of Company A. Should the tax benefit associated with establishing the U.S. deferred tax asset related to the unrealized loss on the security on July 1, 20X2, be recorded in OCI or income from continuing operations?

Analysis/Conclusion:
The tax benefit should be recognized in income from continuing operations. In this situation, even though the pretax event (i.e., the unrealized loss) was recognized in OCI, the initial tax effect from the unrealized loss was the direct result of the election made by Company A to convert Company B to a U.S. branch operation and thereby change its tax status. In accordance with ASC 740-10-45-19, when deferred tax accounts are adjusted as a result of a change in tax status, the effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

Once the deferred tax asset is established, upon the change in tax status, the tax effect of any subsequent changes in the value of the AFS security would be subject to normal intraperiod allocation rules. The impact of that may result in a disproportionate effect being lodged in OCI (since the establishment of the deferred tax asset was reflected in continuing operations). As described in Section TX12.2.3.2.2.3 there are two approaches for clearing disproportionate tax effects within the context of AFS securities. Each individual investment could be considered a separate component (i.e., single unit of measure), or investments within a single portfolio could be aggregated into one component (i.e., aggregate portfolio approach).

In the remainder of this chapter, the term nontaxable status is used to refer to entities such as S corporations, partnerships, and limited liability companies, which generally are not subject to income taxes. The term taxable status is used to refer to entities such as C corporations, which generally are subject to income taxes.

8.2 Loss of Nontaxable Status

If an entity either initiates an action or fails to initiate an action that results in a change in its tax status, the effect of the change in status should be recognized in the period in which the change occurs. However, if an entity has begun taking the necessary steps to cure a violation, careful consideration is required in determining whether a change in tax status has occurred.
8.3 Switching Tax Status

8.3.1 Switching to Nontaxable Status

In the United States, an election to change to nontaxable status can be effective as of the beginning of the entity’s next fiscal year, or retroactively to the beginning of the current year if the election is filed within two and one-half months of the beginning of the year. Nontaxable status may be terminated by revocation or by the entity ceasing to qualify as a nontaxable entity. An election to revoke nontaxable status can be effective either for a specified prospective date, or retroactively to the beginning of the year if the election is filed within two and one-half months of the beginning of the year. Nontaxable status automatically terminates effective on the first day that the entity ceases to qualify as a nontaxable entity.

When a taxable entity switches to nontaxable status and the filing date precedes the effective date (e.g., a calendar-year entity files on March 31, 2008, to be effective January 1, 2009), the deferred taxes that will not be required after the effective date should be released to income at the filing date, if approval is not necessary. At this time, the entity will need to evaluate the expected reversal pattern of its temporary differences. Temporary differences that are expected to reverse prior to the effective date, while the entity is still taxable, should continue to be reflected in the financial statements. On the other hand, temporary differences that are expected to reverse subsequent to the effective date, when the entity will no longer be taxable, should be derecognized at the filing date, if approval is not necessary. Deferred tax balances also may be required after the effective date if the entity is subject to the built-in gains tax (see Section TX 8.4).

8.3.2 Switching to Taxable Status

When a nontaxable entity switches to taxable status, or nontaxable status is retroactively revoked, the change in status should be reflected at the filing date, if approval is not necessary. If approval is necessary, the change in status should be reflected on the approval date. Deferred taxes should be provided at the date of change for temporary differences (at that date) that will reverse after the effective date.

Example 8-2: Retroactive Switch from Nontaxable Status

On February 28, 20X1, Omega Corp. revoked its nontaxable status, changing to taxable status retroactive to January 1, 20X1. No approval is required for this change. The following information relates to temporary differences at February 28, 20X1:

<table>
<thead>
<tr>
<th></th>
<th>Net Book Value</th>
<th>Tax Basis</th>
<th>Taxable/ (Deductible) Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$2,500</td>
<td>$2,800</td>
<td>$(300)</td>
</tr>
<tr>
<td>Land</td>
<td>600</td>
<td>500</td>
<td>100</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>2,900</td>
<td>600</td>
<td>2,300</td>
</tr>
<tr>
<td>Warranty reserve</td>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Totals</td>
<td>$5,000</td>
<td>$3,900</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

(continued)
It is not expected that a valuation allowance will be needed for the deductible temporary differences at December 31, 20X1. Assuming an applicable rate of 35 percent, at February 28, 20X1, Omega Corp. would record a net deferred tax liability of $385 ($1,100 at 35 percent) and a $385 deferred tax provision to income from continuing operations. Further, a current tax provision for the taxable income for the two months ended February 28, 20X1, would be accrued at February 28, 20X1. It may be useful to disclose the current and deferred components of the total tax provision in discussing the effect of the change to taxable status.

Another disclosure to consider is the amount of the net deferred tax liability that would have been recognized at January 1, 20X1, if Omega Corp. had been taxable at that date. Also, if Omega Corp. had not yet issued its 20X0 financial statements by February 28, 20X1, those statements should disclose the change in tax status and the effects of that change, if material.

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**Example 8-3: Prospective Switch from Nontaxable Status**

On September 30, 20X1, Company A revoked its nontaxable status, thereby changing to taxable status to be effective January 1, 20X2. No approval is required for this change. The information below relates to temporary differences that existed at September 30, 20X1, and that will reverse after January 1, 20X2. It is not expected that a valuation allowance will be needed for the deductible differences. An applicable rate of 35 percent has been assumed.

<table>
<thead>
<tr>
<th></th>
<th>Net Book Value</th>
<th>Tax Basis</th>
<th>Taxable/ (Deductible) Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$2,200</td>
<td>$2,500</td>
<td>$ (300)</td>
</tr>
<tr>
<td>Land</td>
<td>600</td>
<td>500</td>
<td>100</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>3,000</td>
<td>800</td>
<td>2,200</td>
</tr>
<tr>
<td>Warranty reserve</td>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Totals</td>
<td>$4,800</td>
<td>$3,800</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

As a result of the revocation, Company A would record a net deferred tax liability of $350 ($1,000 at 35 percent) as of September 30, 20X1, and a $350 deferred tax provision to income from continuing operations.

The following information relates to temporary differences at December 31, 20X1.

<table>
<thead>
<tr>
<th></th>
<th>Net Book Value</th>
<th>Tax Basis</th>
<th>Taxable/ (Deductible) Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$2,500</td>
<td>$2,800</td>
<td>$ (300)</td>
</tr>
<tr>
<td>Land</td>
<td>600</td>
<td>500</td>
<td>100</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>2,900</td>
<td>600</td>
<td>2,300</td>
</tr>
<tr>
<td>Warranty reserve</td>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Totals</td>
<td>$5,000</td>
<td>$3,900</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

(continued)
A net deferred tax liability of $385 ($1,100 at 35 percent) would result. Because the net deferred tax liability increased from September 30 to December 31, a $35 deferred tax provision would be required, even though Company A remained, in terms of actual tax status, a nontaxable entity during that period. There would be a total tax provision of $385 (all deferred) for the year ended December 31, 20X1.

8.4 **Post-1986 S Corporation Elections/Built-in Gains**

If a U.S. entity converts from C corporation status to S corporation status (taxable to nontaxable), the IRS will impose a tax on any “built-in gain” recognized on the sale of assets that occurs within 10 years after the conversion date. (The American Recovery and Reinvestment Act of 2009 shortened the recognition period to 7 years for elections made in 2002 and 2003.) A built-in gain represents the excess of the fair market value over the tax basis of the entity's assets as of the conversion date. If an asset is sold within 10 years after the conversion date, the portion of any gain recognized that is attributable to the built-in gain would be subject to income tax. Alternatively, if an asset is sold after the 10-year period, no tax related to the built-in gain would be due.

If income tax is due upon the sale of an asset, the entity should consider whether any net operating loss carryforwards or capital loss carryforwards could be utilized to offset any tax due.

In ASC 740-10-55-64, the FASB stated that an entity converting from C corporation to S corporation status should continue to record a deferred tax liability to the extent it will be subject to the built-in gains tax. As the timing of realization of a built-in gain determines whether it is taxable, actions and elections that are expected to be implemented should be considered and could have a significant impact on the deferred tax liability to be recorded. For example, if an entity expects that depreciable fixed assets will be retained in the operations of the business, no amount would be subject to the built-in gains tax.

Additionally, when calculating the built-in gains tax on an asset-by-asset basis, the lesser of the unrecognized built-in gain (loss) or the existing temporary difference as of the conversion date is used. That is, the unrecognized built-in gain (loss) is limited to the existing temporary difference as of the conversion date.

8.4.1 **Deferred Tax Liability after the Change to S Corporation Status**

When there is a net unrealized built-in gain at the date of conversion, it might be necessary, as discussed in ASC 740-10-55-64, to continue to recognize a deferred tax liability after the change to S corporation status—the question is how to determine the amount, if any. Only assets and liabilities that have temporary differences at conversion need to be considered. Essentially, the question is what impact the temporary differences for these assets will have on the built-in gains tax that is expected to be paid. Even though the actual built-in gain is based on fair market value at the date of conversion, no consideration would be given to any appreciation above the book value as of the conversion date.

Under the tax law, any actual tax liability is based on the lower of the net recognized built-in gain and C corporation taxable income for the year. However, in the calculation of the deferred tax liability, it may be appropriate to ignore the limitation based on C corporation taxable income if it would be operative only if there were future book losses. It is inappropriate to anticipate the benefit of future book
losses under ASC 740-10-25-38. The tax benefit of the future book losses should be recognized by releasing the deferred tax liability if and when such losses are recorded.

**Example 8-4: Recording Deferred Taxes for Built-in Gains**

Assume that an entity’s S corporation election became effective on January 1, 20X6. On December 31, 20X5, the entity had the following temporary differences and built-in-gains:

<table>
<thead>
<tr>
<th>Expected to be used in operations and not sold within 10 years</th>
<th>Marketable Securities</th>
<th>Inventory</th>
<th>Fixed Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value [A]</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax basis [B]</td>
<td>1,800</td>
<td>900</td>
<td></td>
</tr>
<tr>
<td>Book value [C]</td>
<td>1,900</td>
<td>850</td>
<td></td>
</tr>
<tr>
<td>Built-in gain (loss) [A – B = D]</td>
<td>200</td>
<td>(40)</td>
<td></td>
</tr>
<tr>
<td>Temporary difference [C – B = E]</td>
<td>100</td>
<td>(50)</td>
<td></td>
</tr>
<tr>
<td>Net built-in gain temporary difference [lesser of D or E]</td>
<td>100</td>
<td>(40)</td>
<td>—</td>
</tr>
</tbody>
</table>

Assuming that (a) the marketable securities and inventory will be sold in the following year, (b) the entity has no tax loss or credit carryforwards available at December 31, 20X5, to offset the built-in gains, and (c) the applicable corporate tax rate is 35 percent, the deferred tax liability for the built-in gain at January 1, 20X6, would be calculated as follows:

- Marketable securities $100
- Inventory (40)
- Fixed assets —
- Net unrecognized built-in gain under ASC 740 60
- Applicable corporate tax rate 35%
- Deferred tax liability $21

Note: 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 the deferred tax liability.

**8.4.2 Tax-Planning Actions**

As further described in Section TX 5.4.3, anticipated tax-planning actions should be considered in determining the deferred tax liability. However, in assessing whether an action will be economically advantageous, its effect on the built-in gains tax is not the only factor considered. The effect on taxable income (loss) to be reported by the shareholders is also important, as any corporate-level tax reduces the built-in gain included in taxable income by the shareholders.


8.4.3 Financial Statement Reporting

The calculation would be made initially and reflected in the financial statements as of the date the election is made, if approval is not necessary (i.e., the date of the change in tax status). When the election precedes the effective date of the change, projections of assets on hand and estimates of their fair market values at the effective date are necessary. The analysis has to be updated in preparing subsequent balance sheets through the effective date.

The deferred tax liability will have to be reassessed at each balance sheet date subsequent to the conversion date. In addition to changes in the deferred tax liability that result from changes in expectations, the financial statements will reflect tax expense in the year(s) when the dispositions take place for differences between the built-in gains tax paid and the amount previously provided, including the tax applicable to unrecognized appreciation at the conversion date.

8.5 Increase in Tax Basis upon the Conversion of a Partnership to a Corporation

As part of a plan to go public, an entity currently organized as a partnership effects a transaction that will result in its conversion to a C corporation. This transaction generally would be recorded at predecessor basis for both book and tax purposes. In addition, the change in tax status would require the recognition of a deferred tax asset or liability for the initial temporary differences at the time of the change in status. The recognition of initial temporary differences is recorded in income from continuing operations. However, no current tax expense would result as of the date of the change in status.

If, however, the partnership had net liabilities for tax purposes, a gain, calculated based on the net liabilities that were assumed by the corporation, would be currently taxable to the individual former partners upon conversion. The new C corporation would obtain a step-up in tax basis in an amount equivalent to the gain. The question arises whether this step-up in tax basis is considered a result of the change in tax status (to which the guidance in ASC 740-10-25-32, applies) or a result of a transaction “with or among shareholders” (ASC 740-20-45-11).

We believe that the additional taxable gain recognized by the former partners, which prompted the step-up in tax basis, is a direct consequence of the change in tax status. Therefore, the benefit should be recorded in income from continuing operations, in accordance with ASC 740-10-45-18. In other words, the impact of the change in tax status that is recognized in continuing operations is determined after taking into account the step-up in basis that results from payments made by the individual partners. While an argument could be made for equity treatment in accordance with ASC 740-20-45-11, the consensus in that issue specifically excludes from its scope changes in tax status. We also believe that ASC 225-10, Income Statement would not apply in this situation, because the tax liability is imposed directly on the individual partners and not on the entity itself.

8.6 Business Combination Considerations

8.6.1 S Corporation Election Invalidated by Acquisition by C Corporation

If a C corporation acquires an S corporation in a transaction that will be accounted for as a business combination for financial reporting purposes, ownership by the C corporation may make the S corporation’s election void. This raises the question
about the appropriate deferred tax accounting for this event—the change in the tax status guidance in ASC 740-10-25-32, or the business combination guidance in ASC 805-740-25-3 through 25-4, Business Combinations.

We believe that if the S corporation election is invalidated by the acquisition of the entity, then business combination accounting is appropriate. Therefore, deferred tax assets and liabilities are recorded in acquisition accounting for the differences between the assigned values for financial reporting and the tax bases of the assets acquired and liabilities assumed.

However, if the S corporation issued stand-alone financial statements without the application of “pushdown” accounting, the effect of the business combination (i.e., loss of S status) should be accounted for as a change in the tax status of the entity. Accordingly, in the separate financial statements of the acquired entity, the effect of recognizing a deferred tax liability or asset should be included in income from continuing operations at the business combination date.

In some situations, the deferred taxes of the acquired entity are affected not only by the change in tax status, but also by changes in the individual tax bases of its assets and liabilities. This situation could arise where the acquiring entity made a IRC Section 338(h) (10) election under the U.S. tax code. In the separate financial statements of the acquired entity, the tax effect of changes in the tax bases of the assets and liabilities are recorded in equity pursuant to ASC 740-20-45-11, while the tax effect of the change in tax status is recorded in continuing operations. The application of ASC 740-20-45-11 on separate financial statements of a subsidiary is discussed further in Section TX 14.6.

**8.6.2 Common-Control Merger Involving an S Corporation**

If a C corporation acquires an S corporation in a transaction that will be accounted for as a merger of entities under common control, the combined financial statements for periods prior to the transaction should not be adjusted to include income taxes for the S corporation.

ASC 740-10-25-32 requires the recognition of deferred taxes at the date a nontaxable entity becomes a taxable entity, which is the date of the business combination. This adjustment should be included in income from continuing operations.

Although historical financial information cannot be tax-effected, it is generally appropriate to include pro forma historical financial information that includes taxes for the S corporation as though it had been combined with the C corporation for all periods presented.

**8.6.3 Change in Tax Status as Part of a Business Combination**

Section TX 8.6.1 discusses the accounting for a change in tax status that is directly caused by an acquisition (e.g., an S corporation election is invalidated by its acquisition by a C corporation). In addition to that situation, the acquirer may choose to change the tax status of the acquired entities. The question arises whether the tax effects of a “voluntary” status change of acquired entities (e.g., an election to change from a C corporation to an S corporation) should be recorded as part of the acquisition accounting or in continuing operations in accordance with ASC 740-10-40-6.
In general, a voluntary change in tax status of an acquired entity following an acquisition (even when occurring during the measurement period) should be accounted for in continuing operations in accordance with ASC 740-10-40-6. However, there may be circumstances where we believe it would be appropriate to account for a voluntary change in tax status as part of the acquisition. Items to consider when making this determination include whether:

1. As of the acquisition date, the entity qualified for and intended to make the election. (The acquirer should be able to demonstrate that the status change was part of the plans for acquiring the target and not based on factors occurring after the entities were acquired.)
2. The election is effective at (or applied retroactively to) the acquisition date.
3. Consideration is paid to the taxing authority to effectuate the change in tax status.

PwC engagement teams should consider consulting with the Accounting Services Group within PwC’s National Professional Services Group when accounting for a voluntary change in tax status as part of an acquisition.

8.7 REIT Conversion

8.7.1 Effective Date of a REIT Conversion

Example 8-5: Effective Date of a REIT Conversion

Background/Facts:
Company A, a C corporation, plans to convert into a real estate investment trust (REIT) effective as of January 1, 2006. A REIT is not required to file an election to effect the change in tax structure; rather, the REIT first reports the conversion to the IRS by filing a specific tax form (1120-REIT) several months after the end of its initial tax year as a REIT. Further, such change does not require preapproval by the IRS.

Requirements for Company A’s REIT status to become effective include:

- Setting up the legal entity structure of the REIT,
- Purging accumulated earnings and profits from its operations as a C corporation through a distribution to shareholders (E&P Purge), and
- Filing its initial tax return as a REIT on Form 1120-REIT.

Company A is assessing the impact of this event, and trying to determine when to adjust its deferred tax accounts to reflect its new REIT status. This fact pattern does not seem to be addressed by ASC 740 or any other literature and there appears to be diversity in practice. In particular, is the conversion from a C corporation to a REIT considered a change in tax status as discussed in ASC 740-10-25-33 (which can’t be reflected until the REIT election has been made—presumably when the tax return for the initial tax year is filed) or is this an event that should be reflected in an earlier period, perhaps when Company A has committed to a course of action? Further, if it is not treated as a change in tax status, when is the REIT conversion effective, given that approval is not required, nor does any sort of election need to be filed, to convert to a REIT?

(continued)
Analysis/Conclusion:

In our view, the conversion of a C corporation to a REIT is not a “change in tax status” as described in ASC 740-10-25-33. This is because a REIT is still technically a taxable entity under the Internal Revenue Code. A REIT’s earnings are taxable (although the amount subject to income taxes is reduced by a deduction for the amount of REIT income distributed to shareholders).

Because we do not view the REIT conversion to be a change in tax status, we believe it would be appropriate to reflect the effects of the REIT conversion at the date when Company A (1) completed all significant actions necessary to qualify as a REIT and (2) committed to that course of action. This is consistent with the guidance in ASC 740-10-05-9 which addresses situations where companies have “control” over the outcome of whether certain temporary differences will result in taxable amounts in future years.

In this example, Company A should account for the conversion to a REIT when it:

1. Has committed itself to this course of action in such a way that it would be impossible or practically impossible to not convert to REIT status. Approval by the appropriate parties within Company A (e.g., board of directors) and a public announcement of the change might produce this result, provided that this truly constituted a commitment.

2. Has obtained financing for the E&P purge (if necessary and considered significant).

3. Is “REIT-ready” in all material respects such that the only legal and administrative actions necessary to qualify for REIT status is to file its tax return on Form 1120-REIT (i.e., any remaining steps are considered perfunctory).

At that time, tax assets or liabilities should be adjusted to reflect the change to REIT structure.
Chapter 9: Regulated Entities
Chapter Summary

Regulated entities that meet the criteria for applying ASC 980, Regulated Operations, are not exempt from the requirements of ASC 740. In fact, the accounting for a regulatory asset or liability under ASC 980 can make applying the income tax accounting model more complex. For guidance on income tax accounting for regulated entities refer to PwC’s Guide to Accounting for Utilities and Power Companies, 2013 Edition.
Chapter 10: Business Combinations
Chapter Summary

Business combinations can give rise to a variety of complicated issues in accounting for income taxes under ASC 740. Income tax considerations can also have a significant impact on the structure of and accounting for business combinations. In 2007, the FASB issued guidance that significantly changed the accounting for business combinations and transactions with noncontrolling shareholders. This guidance became effective for fiscal years beginning on or after December 15, 2008. This chapter discusses income tax accounting and related topics in a business combination under that guidance. Further information regarding the accounting for business combinations and accounting for transactions with noncontrolling interests can be found in the PwC publication A Global Guide to Accounting for Business Combinations and Noncontrolling Interests.
Excerpts from ASC 805-740

ASC 805-740-25-2:
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.

ASC 805-740-25-3:
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, leverage 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 805-740-25-4:
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.

ASC 805-740-45-2:
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.

(continued)
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).

ASC 805-740-10-45-4:
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.

10.1 Overview

Under ASC 805, Business Combinations, an acquirer should recognize and measure deferred taxes arising from the assets acquired and liabilities assumed in a business combination in accordance with ASC 740. The acquirer should account for the potential tax effects of an acquiree’s temporary differences, carryforwards, and income tax uncertainties that exist at the acquisition date, or that arise as a result of the acquisition (ASC 805-740-25-2 and ASC 805-740-30-1).

This chapter is structured to follow the process that would typically be completed in analyzing the income tax implications of a business combination. The following highlights the steps in that process that are generally performed:

• **Determine the tax structure of the transaction and tax status of the entities involved in the business combination.** Determine the legal structure and the tax status of the entities acquired (e.g., corporate entities, partnerships, limited liability corporations), and determine the tax structure of the transaction (i.e., taxable or nontaxable). In a taxable transaction, the tax bases of the assets acquired and liabilities assumed generally are adjusted to fair value based on the rules of the specific tax jurisdiction. In a nontaxable transaction, the historical tax bases of the assets and liabilities, net operating losses, and other tax attributes of the target generally carryover to the acquirer. See further discussion of the differences in the two structures in Section TX 10.2.

• **Determine financial statement and tax bases of the net assets acquired.** Determine the financial statement reported amounts (i.e., book bases) of the identifiable assets acquired and liabilities assumed. ASC 805 requires the acquired net assets to be recorded at fair value, with certain exceptions. This chapter uses fair value as a general term to describe the financial reporting bases, determined as prescribed under ASC 805. The tax bases of the identifiable assets acquired and liabilities assumed are determined based on each specific tax jurisdiction and related tax laws and regulations. See Section TX 10.3 for further discussion.

• **Identify and measure temporary differences.** Identify the temporary differences related to the book bases and tax bases of the acquired identifiable assets and
assumed liabilities. Determine whether the temporary differences are deductible temporary differences or taxable temporary differences, and recognize the appropriate deferred tax assets (DTAs) or deferred tax liabilities (DTLs) (ASC 805-740-25-2). See Section TX 10.4 for further discussion of the evaluation of DTAs in a business combination.

- **Identify acquired tax benefits.** Determine whether there are any acquired net operating losses (NOLs), credit carryforwards, or other relevant tax attributes that should be recorded as part of the business combination (ASC 805-740-25-2). Determine whether a valuation allowance is required to reduce DTAs if they are not considered to be realizable. See Section TX 10.5 for further discussion of the evaluation of DTAs in a business combination.

- **Consider the treatment of tax uncertainties and indemnifications.** Identify and determine the accounting requirements for uncertain tax positions and indemnifications (ASC 805-740-25-2). See Section TX 10.6 for further discussion.

- **Consider deferred taxes related to goodwill.** Determine whether a DTA should be recognized for temporary differences associated with tax-deductible goodwill (ASC 805-740-25-3). See Section TX 10.7 for further discussion of recognizing deferred taxes related to goodwill.

Section TX 10.8 discusses certain income tax accounting considerations of transactions with noncontrolling shareholders. In addition, a discussion of income tax accounting considerations related to stock-based compensation awards exchanged in a business combination can be found in Chapter TX 18.

### 10.2 Determine the Tax Structure of the Transaction and Tax Status of the Entities Involved in the Business Combination

The legal structure and tax status of the entities acquired and the tax structure of the transaction should be considered to determine the appropriate deferred tax balances to record in acquisition accounting. Additionally, the tax rules of the various tax jurisdictions should be considered.

#### 10.2.1 Determining Whether the Business Combination Is Taxable or Nontaxable

The tax laws in most jurisdictions generally differentiate between taxable and nontaxable business combinations. The distinction is important, because the type of transaction determines the tax bases of the acquired assets and assumed liabilities. The acquisition of a business through the direct purchase of its assets and assumption of its liabilities (an “asset acquisition”) generally is treated as a “taxable” transaction, while the acquisition of a business through the purchase of its corporate shares (a “share” or “stock” acquisition) generally is treated as a “nontaxable” transaction. However, in some jurisdictions, a stock acquisition can be treated as an asset acquisition for tax purposes if the appropriate tax election is made and approved by the relevant taxing authorities.

#### 10.2.2 Identifying the Tax Status of the Entities Involved

Business combinations may involve the acquisition of taxable entities (e.g., corporations), non-taxable entities (e.g., partnerships and multi-member LLCs), or a combination of both. The acquired entity’s tax status will determine the deferred tax assets and liabilities to be recorded in acquisition accounting.
When the acquiree is a corporation, the acquirer generally recognizes deferred taxes on each of the acquiree’s identifiable assets and liabilities, including tax carryforwards and credits (referred to as “inside basis differences”). When the acquiree is a partnership, however, the acquirer generally recognizes deferred taxes only for differences between the financial statement carrying amount of the acquirer’s investment and its tax basis (referred to as “outside basis differences”). This is the case regardless of whether the partnership is accounted for as a consolidated entity or as an investment for financial reporting purposes.

Sometimes a portion of the outside basis difference in a partnership acquiree is attributable to assets for which deferred taxes generally would not be recognized if the acquiree was a corporation (e.g., nondeductible goodwill and the partnership’s investment in foreign subsidiaries). In these situations, an entity should choose and consistently apply a policy to either (i) look through the outside basis of the partnership and exclude from the computation of deferred taxes basis differences arising from items for which there is a recognition exception under ASC 740, or (ii) not look through the outside basis of the partnership and record deferred taxes based on the entire difference between the financial reporting and tax bases of its investment. Refer to Section TX 11.1.9 for a more detailed discussion on partnerships and other flow-through entities.

The remainder of this chapter assumes the acquisition of a taxable entity, such as a corporation.

10.3 Determine Financial Statement and Tax Bases of the Net Assets Acquired

The recognized tax bases (the amount that is attributable for tax purposes) of the assets and liabilities are compared to the financial reporting values of the acquired assets and assumed liabilities (book bases) to determine the appropriate temporary differences (ASC 805-740-25-3). Tax laws differ by jurisdiction; therefore, each tax jurisdiction should be evaluated separately to determine the appropriate tax bases of the acquired assets and assumed liabilities.

10.3.1 Determining Tax Bases in a Taxable Transaction

In a taxable transaction (e.g., an asset acquisition or a stock acquisition treated as an asset acquisition), the acquirer records the tax bases of the assets acquired and liabilities assumed at their fair values based on the applicable tax law. The allocation methodology for determining tax bases is often similar to the requirements of ASC 805. Sometimes the acquisition price exceeds the fair value of identifiable assets acquired and liabilities assumed. The excess often is treated as goodwill for tax purposes, and may be tax-deductible. However, there could be differences in the allocation methodology because the tax allocation follows the relevant local jurisdiction tax law. For example, the U.S. federal tax code requires a specific allocation method to determine the new tax bases in a taxable transaction. The allocation methodologies for book and tax purposes may differ in cases where the aggregate fair value of the net assets acquired exceeds the consideration transferred, because bargain purchases may not be recognized for tax purposes in some jurisdictions.

Differences between assigned values for financial reporting and tax purposes should be analyzed. Regulatory bodies in various jurisdictions could question differences in the allocation of values for book and tax purposes. An inaccurate determination of
fair value for tax purposes could impact the financial statements. For example, an improper tax valuation between amortizable intangible assets and goodwill could result in inaccurate deferred taxes being recorded for those jurisdictions where goodwill is not deductible.

10.3.2 Determining Tax Bases in a Nontaxable Transaction

In a nontaxable transaction (e.g., stock acquisitions), the historical tax bases of the acquired assets and assumed liabilities, net operating losses, and other tax attributes of the acquiree generally carry over from the acquired company. No new tax goodwill is created. However, tax goodwill of the acquiree that arose in a previous acquisition may carryover and will need to be considered in determining temporary differences (see Section TX 10.7.1).

10.4 Identify and Measure Temporary Differences

The acquirer should identify and measure the deductible and taxable temporary differences of the acquired business and record the resulting deferred tax assets and liabilities. The acquirer should consider applicable tax law when measuring both temporary differences and the related deferred tax assets and liabilities.

10.4.1 Basic Methodology for Recognition of Deferred Taxes on Acquired Temporary Differences and Tax Benefits

Recognition of deferred tax assets and liabilities is required for substantially all temporary differences and acquired tax loss carryforwards and credits. Exceptions include (i) temporary differences for nondeductible goodwill, and (ii) the acquired basis difference between the parent's carrying amount of the subsidiary's net assets (or investment) in the financial statements and its basis in the shares of the subsidiary (also referred to as the outside basis difference) (ASC 805-740-25-3).

The exception for nondeductible goodwill does not extend to identifiable intangible assets with an indefinite life. These assets may seem similar to goodwill, but are significantly different in their nature because, unlike goodwill, they do not represent residual values. Therefore, differences between the book bases and tax bases of all acquired identifiable intangible assets are temporary differences for which deferred taxes should be provided.

Example 10-1 provides an example for recognizing and measuring deferred taxes.

Example 10-1: Recording Deferred Taxes on Acquired Temporary Differences

Background/Facts:
Company Z acquires Company X in a stock acquisition (nontaxable transaction) for total consideration of $1,000. The fair value of the acquired identifiable net assets was $800. The carryover historical tax bases of the acquired net identifiable assets was $500. The tax rate is 40 percent in this jurisdiction.

(continued)
Analysis/Conclusion:

Company Z recorded the following journal entries in acquisition accounting:

Dr Net assets $800
Dr Goodwill 320

Cr Cash $1,000
Cr Net deferred tax liability 120

1 Goodwill is calculated as the residual after recording the identifiable net assets acquired and associated deferred tax assets and liabilities ($1,000 – ($800 – $120)).

2 The net deferred tax liability is calculated as the difference between the book bases (in this case, the fair value) of the identifiable net assets acquired and the carryover tax bases at the applicable tax rate (($800 – $500) x 40%).

U.S. GAAP requires that identified assets and liabilities be presented gross and separate from the related deferred tax balances. However, a net-of-tax valuation approach based on projected after-tax cash flows is used for leveraged leases. The income tax accounting guidance for leveraged leases is found in ASC 840.

10.4.2 Expected Manner of Recovery or Settlement

A temporary difference is the difference between the carrying amount of an asset or liability in the statement of financial position and its tax basis. It will result in taxable or deductible amounts in future years when the reported amount of the asset is recovered or the liability is settled. The tax basis of an asset or liability is the amount used or attributed to the asset or liability under the tax law (ASC 740-10-25-50). In measuring a temporary difference, tax basis is the amount recognized and measured in accordance with ASC 740 (i.e., after taking into account uncertain tax positions), which may not always be the tax basis claimed on a tax return.

The carrying amount of an asset will generally be recovered through use, sale, or both. The tax consequences of using an asset or settling a liability, are sometimes different from selling net assets and may directly affect the tax that would be payable in the future. There may be different tax rates for regular income and capital gain income. Assets may sometimes be revalued or indexed to inflation for tax purposes only if the asset is sold (i.e., the tax basis is increased for the purpose of determining capital gain income but not regular income). Moreover, the ability to file consolidated, combined, or unitary tax returns, and elections or post-acquisition transactions may affect the tax that would be payable from the recovery of an asset. In some jurisdictions, recovery of assets through use will have no tax consequences, while recovery through sale will have tax consequences. The expected manner of recovery needs to be considered to determine the future tax consequences and corresponding deferred taxes in acquisition accounting.

Refer to Section TX 3.2.2 for further discussion of the impact of indexing for tax purposes on the calculation of deferred taxes; section TX 8.6.3 for further discussion of the accounting for a change in tax status as part of a business combination.

10.4.3 Deferred Taxes Related to Outside Basis Differences

A business combination may include the acquisition of certain temporary differences for which ASC 740 provides an exception for recording deferred taxes. For example, the tax basis in shares of certain entities may differ from the financial reporting basis (i.e., the outside basis difference). No deferred tax liability is required for the outside basis difference if the parent can establish the intent and ability to indeﬁnitely delay
reversal of the difference. This exception applies only to foreign subsidiaries and foreign corporate joint ventures (that are essentially permanent in duration). For domestic subsidiaries, if the parent has the intent and can demonstrate an ability to eliminate the outside basis difference in a tax-free manner, then no deferred tax liability is required to be recorded (ASC 740-10-25-3, ASC 740-30-25-7).

A company meets the indefinite reversal criteria if it can assert the intent and ability to indefinitely reinvest earnings abroad and not repatriate the earnings (ASC 740-30-25-17). The determination of whether deferred taxes related to the outside basis differences should be recorded at the acquisition date is based on the acquirer’s intent regarding the acquired investments. For example, if the acquirer intends to repatriate earnings from the acquired entity and cause a reversal of the outside basis difference, then a deferred tax liability should be recognized in acquisition accounting. This is true even if the acquiree had previously not recorded deferred taxes on its outside basis differences.

The impact of the acquirer’s intent related to assets already owned by the acquirer should be evaluated separately from the acquirer’s intent related to assets acquired. The effect of a change in the assertion related to an acquirer’s intent and ability to indefinitely delay the reversal of temporary differences related to subsidiaries it owned prior to acquisition is recorded outside of acquisition accounting. The tax effect of a change in assertion related to current year activity (e.g., current year foreign currency translation) is recorded in the same financial statement element (i.e., income statement, OCI) as the pretax activity. The tax effect of the change related to prior years’ activity (including effects derived from foreign currency translation) is recorded in the income statement, because backwards tracing\(^1\) is not allowed under ASC 740 for these types of items (ASC 740-30-25-19, ASC 740-20-45-3).

The outside tax basis of an investment may exceed the book basis. ASC 740 prohibits the recognition of a deferred tax asset for an investment in a subsidiary or corporate joint venture that is essentially permanent in duration unless the temporary difference is expected to reverse in the foreseeable future (ASC 740-30-25-9).

Example 10-2 illustrates the application of deferred tax accounting recognition and measurement to an acquired outside taxable basis difference.

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**Example 10-2: Deferred Tax Accounting Related to Acquired Outside Basis Difference when an IRC Section 304 Restructuring Transaction is Implemented Following a Business Combination**

**Background/Facts:**
Parent, a U.S.-based multinational, acquired all of the shares of Target, another U.S.-based multinational, in a nontaxable transaction. Both U.S. companies have a Dutch holding company through which they own several lower-tier foreign subsidiaries. In conjunction with the acquisition, Parent intends to consolidate the respective businesses and achieve operational, process and tax efficiencies by restructuring the ownership of Target’s Dutch holding company. Under the restructuring plan, Parent’s

\(^1\) U.S. GAAP requires the allocation of income tax expense or benefit to elements of the financial statements (e.g., income statement, equity). Most subsequent changes in deferred taxes are recorded in income tax expense from continuing operations and are not “backward traced” to the original element affected (ASC 740-20-45-3).
Dutch holding company (Dutch Co. A) will buy from Target all of the shares of Target's Dutch holding company (Dutch Co. B). The two Dutch companies will form a parent-subsidiary consolidated tax return group in the Netherlands. Parent has historically maintained an indefinite reinvestment assertion and, thus, has not recorded a U.S. DTL for the outside basis difference related to its investment in Dutch Co. A. Parent also intends to similarly defer the U.S. tax consequences (i.e., assert indefinite reinvestment) with respect to the acquired basis difference (in Dutch Co. B) beyond any amount that will reverse in the restructuring. The following table summarizes the relevant book and tax bases immediately before the restructuring:

<table>
<thead>
<tr>
<th>Parent's Investment in Dutch Co. A</th>
<th>Target's Investment in Dutch Co. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book basis $10,000</td>
<td>Tax basis $3,000</td>
</tr>
<tr>
<td>$3,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Earnings &amp; Profits (E&amp;P) $7,000</td>
<td>Previously Taxed Income (PTI) None</td>
</tr>
</tbody>
</table>

To implement the restructuring, Dutch Co. A paid $3,000 in exchange for all of the shares of Dutch Co. B. For U.S. federal tax purposes, the transaction is subject to IRC section 304. Under that Code section, if one corporation purchases stock of a related corporation in exchange for property, the transaction generally is recharacterized as a redemption that produces a dividend. In this case, the dividends are taxable to the extent of the accumulated earnings and profits (E&P) of the two Dutch companies ($9,000), subject to the following ordering rule: Dutch Co. A’s E&P is considered first; if the value of the distribution exceeds its E&P, the excess is considered to be paid from Dutch Co. B’s E&P. If either corporation has foreign source income that has already been taxed under the IRC subpart F rules (referred to as "previously taxed income" or PTI), the distribution is considered to be made first from PTI (distribution of PTI) and is taxable only to extent of unrecognized foreign exchange gains or losses).

**Analysis/Conclusion:**

In this example, the first $2,000 is considered to be a distribution of PTI from Dutch Co. A, taxable only to the extent of any foreign exchange gain; the remaining $1,000 is considered to be a fully taxable dividend distribution from Dutch Co. A’s E&P. Therefore, the tax effect should be recorded outside of acquisition accounting. The tax impact related to a Parent’s outside basis it already owns should be accounted for outside of acquisition accounting and the following journal entry would be recorded:

\[
\begin{align*}
\text{Dr Income tax expense} & \quad \text{CU350} \\
\text{Cr Current tax payable} & \quad \text{CU350}^1
\end{align*}
\]

\[1 \text{CU1,000 fully taxable distribution x 35\% (applicable U.S. tax rate) = CU350} \]

Assuming the same facts in the illustration above except that Dutch Co. A has no accumulated E&P. In this circumstance, the first CU2,000 is considered to come from Dutch Co. A’s PTI and the remaining CU1,000 is considered to come from Dutch Co. B’s accumulated E&P. The tax impact related to an acquired outside basis difference

(continued)
should be recorded in acquisition accounting and the following journal entry would be recorded:

\[
\begin{align*}
\text{Dr Goodwill} & \quad \text{CU350} \\
\text{Cr Deferred tax liability} & \quad \text{CU350}^2,3
\end{align*}
\]

2 CU1,000 fully taxable distribution x 35% (applicable U.S. tax rate) = CU350 (For simplicity, assume no foreign tax credits are claimed for this taxable distribution and that there are no unrecognized currency exchange gains or losses related to PTI).

3 When the distribution occurs, the acquired deferred tax liability would be reversed and a current tax liability would be recognized.

In measuring deferred taxes for acquired assets and liabilities, Parent would consider the expected method of recovery or settlement and, when applicable, its intent and ability to avoid or trigger tax consequences on acquired outside basis differences. The tax impact of Parent’s intention related to an outside basis difference it already owned should be accounted for apart from the acquisition, whereas the tax impact of Parent’s intention related to an acquired outside basis difference should be recorded in acquisition accounting.

Parent’s intent related to the $2,000 acquired outside basis difference is to defer the tax consequences for the foreseeable future and therefore no DTL is recognized in acquisition accounting. Alternatively, if the IRC 304 restructuring had resulted in some portion (or all) of the acquired outside basis difference in Dutch Co. B reversing, the tax effects related to that reversal would be recorded in acquisition accounting consistent with Parent’s expectation as to the manner in which the acquired outside basis difference is expected to be recovered.

**10.4.4 Recording the Tax Effect of Contingencies and Contingent Consideration in Business Combinations**

Acquisition accounting under ASC 805 includes the recognition of acquired contingent assets or assumed contingent liabilities and contingent consideration, all of which affect the amount of book goodwill recorded at the acquisition date (ASC 805-20-25-19, ASC 805-30-25-5).

However, these items generally are not recognized for tax purposes until the amounts are fixed and reasonably determinable or, in some jurisdictions, until they are paid. These conditions often are not met until a future financial statement period. As a result, these items would not have tax basis on the acquisition date. In a taxable transaction, the tax basis in the newly created goodwill does not include an incremental amount related to these contingencies (there is no tax-deductible goodwill created in a nontaxable transaction). Therefore, the difference in treatment for these items could give rise to temporary differences for which deferred taxes should be recognized at the date of acquisition and adjusted in subsequent periods as the contingency or contingent consideration is adjusted for financial reporting purposes.

A temporary difference for which deferred taxes should be recorded generally exists if the resolution of the contingency or contingent consideration will result in a future tax consequence (i.e., deduction or income) (ASC 740-10-25-20). The tax consequence upon resolution of the contingency or contingent consideration is affected by whether the business combination was a taxable or nontaxable transaction. For example, the resolution of a contingent liability in a nontaxable transaction may result in a tax deduction, in which case a deferred tax asset should
be recorded on the acquisition date. In a taxable transaction, the resolution of a contingent liability may affect the amount of tax-deductible goodwill, in which case the exceptions to recognition of deferred taxes related to goodwill at the acquisition date may need to be considered (see Section TX 10.7).

If the resolution of the contingency or contingent consideration will increase or decrease the amount of tax-deductible goodwill, an acquirer may take one of two acceptable approaches to account for the related deferred taxes.

One approach is to consider the impact on tax-deductible goodwill in the initial comparison to book goodwill as if the contingent liability or contingent consideration was settled at its book basis at the acquisition date. This approach is explored in more detail in this section.

Another approach is to treat the contingency or contingent consideration as a separately deductible item. A deferred tax asset would be recorded in acquisition accounting because the liability, when settled, will result in a future tax deduction (i.e., tax-deductible goodwill). That is, a deferred tax asset is recognized at the acquisition date since there is a basis difference between book and tax related to the liability without regard to the impact it would have on the comparison of tax-deductible goodwill to book goodwill. The deferred tax asset would be calculated by multiplying the temporary difference by the applicable tax rate. The second approach ignores the initial comparison of book goodwill to tax-deductible goodwill for this particular component even though the liability will be added to tax-deductible goodwill when settled.

The approach adopted is an accounting policy choice and should be applied consistently for all acquisitions.

The following table summarizes the deferred tax accounting associated with the most common scenarios for contingencies and contingent consideration in a taxable transaction, using the first approach described above, and in a nontaxable transaction. Further discussion and examples are included in Sections TX 10.4.4.1 (taxable transaction) and TX 10.4.4.2 (nontaxable transaction).

### Contingencies and Contingent Consideration

<table>
<thead>
<tr>
<th>Topic</th>
<th>At Acquisition Date</th>
<th>Upon Adjustment</th>
<th>Upon Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Reporting (Pretax)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contingencies</td>
<td>Record at fair value if determinable or if not, at an amount determined by applying ASC 450-20, <em>Loss Contingencies.</em></td>
<td>Adjust the contingency periodically, as required.</td>
<td>Adjust the contingency periodically, as required.</td>
</tr>
<tr>
<td>Contingent Consideration</td>
<td>Record at fair value.</td>
<td>Record at fair value each period except for equity classified arrangements.</td>
<td>Reverse the contingency through payment or other settlement.</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Topic</th>
<th>At Acquisition Date</th>
<th>Upon Adjustment</th>
<th>Upon Settlement</th>
</tr>
</thead>
</table>
| Taxable Transaction Deferred Tax Treatment | If settlement would result in tax-deductible goodwill, then the recorded amount of the contingency is added to the tax basis goodwill balance. A deferred tax asset would be recorded for any excess tax-deductible goodwill (as adjusted) over book goodwill.  
If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the contingency is added to the tax basis of such asset. Record deferred taxes on the resulting book versus tax basis difference if required under ASC 740. | If settlement would result in tax-deductible goodwill, then record deferred taxes on the amount of the adjustment. Do not reperform the acquisition date comparison of tax-deductible goodwill to book goodwill.  
If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the contingency is added to the tax basis of such asset. However, any tax effect is reflected as part of the income statement. | Apply the same treatment as “upon adjustment” if settled at an amount different than previously recorded. |

| Nontaxable Transaction Deferred Tax Treatment Contingencies | If settlement would result in a tax deduction or tax-deductible asset (other than goodwill), then a deferred tax asset should be recorded. | If settlement would result in a tax-deductible asset (other than goodwill), the analysis is the same as on the acquisition date. | Apply the same treatment as “upon adjustment” if settled at an amount different than previously recorded. |

| Contingent Consideration | If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then the recorded amount of the contingency is added to the tax basis of the shares to determine the outside basis temporary difference. Deferred taxes should not be adjusted unless deferred taxes are already being recorded on the outside basis difference. | If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then deferred taxes should not be adjusted unless deferred taxes are already being recorded on the outside basis difference. | Apply the same treatment as “upon adjustment” if settled at an amount different than previously recorded. |

See TX 10.6 for a discussion about the effects of income tax uncertainties.

**10.4.4.1 Contingencies and Contingent Consideration—Taxable Transactions**

In a taxable business combination, the settlement of a contingency or contingent consideration will often impact the ultimate amount of tax-deductible goodwill. Following the approach of determining deferred taxes by calculating the tax basis as if the contingency or contingent consideration is settled at the book basis, the recorded amount of the contingency or contingent consideration is added to the
tax-deductible goodwill balance as if it were settled at the acquisition date. If the amount of that hypothetical tax-deductible goodwill (as adjusted for the contingency) exceeds the amount of book goodwill, then a deferred tax asset should be recorded. Because the deferred tax asset is related to goodwill, an iterative calculation is required to determine the amount of the deferred tax asset. However, if book goodwill exceeds the hypothetical tax goodwill, no deferred tax liability is recorded (ASC 805-740-25-9). Recording deferred taxes on goodwill is discussed further in Section TX 10.7.

Example 10-3 illustrates the described approach for determining deferred tax balances related to contingent consideration at the acquisition date in a taxable business combination.

**Example 10-3: Acquisition Date Deferred Taxes Related to Contingent Consideration in a Taxable Business Combination**

**Background/Facts:**
Assume contingent consideration is valued on the acquisition date in a taxable business combination at $1,000. Goodwill for book purposes (including the initial recording of contingent consideration) is $3,000. Tax-deductible goodwill is $1,800, which excludes the initial recording of contingent consideration. The applicable tax rate for all periods is 40 percent. When the contingent consideration is settled, it will be included in tax-deductible goodwill.

**Analysis/Conclusion:**
To determine deferred taxes at the acquisition date, consider the resulting tax consequence if the contingent consideration is settled for the book basis. Since the amount of contingent consideration would be added to tax-deductible goodwill when settled, the amount of contingent consideration is added to the balance of tax-deductible goodwill to determine whether there is an excess of tax or book goodwill. The goodwill balances are analyzed as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book goodwill</td>
<td>$3,000</td>
</tr>
<tr>
<td>Tax-deductible goodwill</td>
<td>1,800</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>1,000</td>
</tr>
<tr>
<td>Tax-deductible goodwill (as adjusted)</td>
<td>2,800</td>
</tr>
<tr>
<td>Excess of book over tax-deductible goodwill</td>
<td>$200</td>
</tr>
</tbody>
</table>

If book goodwill exceeds tax-deductible goodwill, no deferred taxes are recognized. However, if the tax-deductible goodwill exceeds book goodwill, a deferred tax asset is recognized. For example, assuming the same facts as above, except that the contingent consideration was valued at $1,500 at the acquisition date, the tax-deductible goodwill (as adjusted) would have been $3,300. The excess of the tax-deductible goodwill (as adjusted) over the book goodwill of $300 would have resulted in a deferred tax asset. See Section TX 10.7.2 for a discussion of how the deferred tax asset is calculated.

This approach to measuring deferred taxes is also applicable to contingent liabilities in a taxable business combination.
Adjustments to contingencies and contingent consideration in subsequent periods that are not measurement period adjustments generally are recorded for financial reporting purposes in earnings (ASC 805-30-35-1). The appropriate deferred tax treatment related to these adjustments is determined by considering the expected tax consequence, assuming the item is settled at its book basis. Deferred taxes are adjusted if the adjustment to the contingency or contingent consideration would cause a tax consequence (e.g., increase or decrease a deductible expense or asset).

The acquisition date comparison of book goodwill to tax-deductible goodwill should not be reperformed subsequent to the acquisition date unless there is a measurement period adjustment. ASC 805 treats pretax adjustments to contingencies and contingent consideration that are not measurement period adjustments as being outside of acquisition accounting with no adjustment to book goodwill. Therefore, the tax effect of adjustments to contingencies and contingent consideration should also be reflected outside of acquisition accounting.

For example, a deferred tax asset should be recognized or adjusted along with the related income tax expense or benefit when contingent consideration is increased subsequent to the acquisition date for a change in fair value, and the settlement of the contingent consideration would increase tax-deductible goodwill. This is true even if no deferred tax asset was recorded at the date of acquisition (i.e., tax goodwill did not exceed book goodwill at the acquisition date).

Similarly, consider an example where a contingent consideration liability is decreased subsequent to the acquisition date due to a change in fair value. A decrease in the contingent consideration liability subsequent to the acquisition date causes a decrease in the tax-deductible goodwill as if the contingent consideration is settled. This decrease in the contingent consideration liability which will result in a decrease in the tax-deductible goodwill when settled will be recorded by either (i) recording a deferred tax liability (i.e., when book goodwill exceeded tax-deductible goodwill at the acquisition date), or (ii) reducing a deferred tax asset (i.e., when tax-deductible goodwill exceeded book goodwill at the acquisition date).

Example 10-4 illustrates this approach for determining deferred tax balances related to an adjustment to contingent consideration in a taxable business combination.

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**Example 10-4: Deferred Taxes Related to a Contingent Consideration Adjustment in a Taxable Business Combination**

**Background/Facts:**
Assume contingent consideration is valued on the date of acquisition in a taxable business combination at $1,000 and is increased in year two to $1,700. The contingent consideration is eventually settled in year three. At the acquisition date, goodwill for book purposes (including the initial recording of contingent consideration) is $3,000. Tax-deductible goodwill is $1,800, which excludes the initial recording of contingent consideration. The applicable tax rate for all periods is 40 percent. For simplicity, the effects of amortization of tax goodwill are excluded from the example. Once the contingent consideration is settled, it will be included in tax-deductible goodwill. At the acquisition date, book goodwill of $3,000 was in excess of tax-deductible goodwill (including the expected additional basis to be recognized when settled) of $2,800; therefore, no deferred tax asset was recorded for contingent consideration. See Example 10-2 for an illustration of recording deferred taxes related to contingent consideration at the acquisition date.

(continued)
Analysis/Conclusion:

In year two, the fair value of the contingent consideration increases by $700 to $1,700. The adjustment, when settled, will result in additional tax-deductible goodwill.\(^1\) Therefore, a deferred tax asset related to the adjustment should be recorded, even though no deferred tax asset related to tax-deductible goodwill was recorded at the acquisition date, because the acquisition date comparison of book to tax goodwill is not revisited under this approach.

The following entry would be recorded:

\[
\begin{align*}
\text{Dr Expense} & \quad \$ 700 \\
\text{Dr Deferred tax asset} & \quad 280^2 \\
\text{Cr Contingent consideration} & \quad $ 700 \\
\text{Cr Deferred tax expense} & \quad 280
\end{align*}
\]

\(^1\) In some jurisdictions, a portion of the contingent consideration may be treated as tax-deductible interest. For simplicity, this example does not address that fact pattern.

\(^2\) ($700 \times 40\%).

There is no impact on the effective tax rate because the pretax expense related to the increase in contingent consideration has a corresponding deferred tax benefit.

The same treatment would apply if there is a decrease in the contingent consideration. For example, if the contingent consideration had decreased by $700, a deferred tax liability of $280 would have been recorded. When resolved, the adjustment to the contingent consideration would result in a decrease in tax-deductible goodwill (i.e., a decrease in a tax deduction).

Year Three:

Contingent consideration is settled at $1,700. Since the item is settled for the amount previously recorded, there is no further impact on earnings or deferred taxes. The deferred tax asset is not adjusted because the contingent consideration was settled at the recorded amount for book purposes, but has not yet been deducted for tax purposes (i.e., the deduction will occur over time as goodwill is amortized).

The following entry is recorded:

\[
\begin{align*}
\text{Dr Contingent consideration} & \quad $1,700 \\
\text{Cr Cash} & \quad $1,700
\end{align*}
\]

The same treatment would apply for a contingent liability in a taxable business combination.

A contingent consideration arrangement that is equity-classified is not remeasured based upon subsequent changes in fair value and the ultimate settlement is accounted for within equity (ASC 805-30-35-1).

Example 10-5 illustrates the tax accounting for equity-classified contingent consideration that is settled for more than its carrying amount.
Example 10-5: Accounting for Tax Effects from the Settlement of Equity-Classified Contingent Consideration

Background/Facts:
Assume equity-classified contingent consideration is valued on the date of acquisition in a taxable business combination at $100,000. The contingent consideration would be settled by issuing stock to the seller when certain performance metrics are met at which time the settlement value would be included in tax-deductible goodwill. Accordingly, no deferred tax is recorded for the equity-classified contingent consideration. The fair value of the contingent consideration increases by $50,000 to $150,000 in year two when it is settled for $150,000 (the fair value of the shares issued to the seller at the time of settlement).

Analysis/Conclusion:
The settlement is accounted for as a reclassification within equity at the recorded value of $100,000. However, the settlement resulted in additional tax basis in goodwill of $50,000 to be amortized (in addition to the $100,000) in future periods. The tax benefit from the additional tax basis, net of any valuation allowance if required, should be recognized in equity (ASC 740-20-45-11(g)). The guidance in ASC 740-20-45-11(g) requires that the tax effects of all changes in tax bases of assets and liabilities caused by transactions among or with shareholders be included in equity. The issuance of stock to the seller in full settlement of equity-classified contingent consideration should be regarded as a transaction with a shareholder.

10.4.4.2 Contingencies and Contingent Consideration—Nontaxable Transactions

The amount paid to settle a contingent liability assumed in a nontaxable business combination may result in a tax deduction. A deferred tax asset should be recorded in acquisition accounting for the acquired contingency if the applicable tax law(s) would allow for a deduction when the contingent liability is settled. This concept is illustrated in Example 10-6.

Example 10-6: Deferred Tax Impact of Contingent Liabilities in a Nontaxable Business Combination

Background/Facts:
Assume a contingent liability is recorded at fair value of $1,000 on the date of acquisition in a nontaxable business combination. The tax basis in the contingent liability is zero. When the liability is settled, the company will receive a tax deduction for the amount paid. The tax rate is 40 percent.

Analysis/Conclusion:
The contingent liability is a temporary difference at the acquisition date, because it has a zero tax basis and when the liability is settled it will result in a tax deduction. The following entry would be recorded at the acquisition date:

Dr DTA $400
Dr Goodwill 600
Cr Contingent liability $1,000

The deferred tax asset should be adjusted in subsequent periods as the amount of the contingent liability changes.
The settlement of contingent consideration in a nontaxable business combination often will be added to the outside tax basis as part of the amount paid for the acquiree. The contingent consideration, therefore, is added to the outside tax basis for purposes of determining the difference between outside tax basis and book basis. Deferred taxes would not be affected by the contingent consideration at the acquisition date, nor upon adjustment to the amount of contingent consideration in subsequent periods, unless a company is providing deferred taxes on outside basis differences. Therefore, subsequent changes in the amount of contingent consideration could impact an entity’s effective tax rate, because it is likely that pretax effect of changes in contingent consideration would be recorded in the income statement without a corresponding tax effect. Recording deferred taxes on outside basis differences is discussed further in Section TX 10.4.3.

Example 10-7 illustrates this approach for determining deferred tax balances related to contingent consideration in a nontaxable business combination.

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**Example 10-7: Deferred Tax Impact of Contingent Consideration in a Nontaxable Business Combination**

**Background/Facts:**
Assume contingent consideration is valued on the acquisition date in a nontaxable business combination at $1,000. In year two, the fair value of the contingent consideration increases by $1,200 to $2,200 and is settled for cash in year three at $2,200. The applicable tax rate for all periods is 40 percent. Once the contingent consideration is settled, for tax purposes it will be added to the basis of the shares acquired (i.e., outside basis). No deferred tax liability is recorded on the outside basis temporary difference in the shares acquired.

**Analysis/Conclusion:**
To determine the deferred taxes at the acquisition date, consider the resulting tax consequence if the contingent consideration is settled for its book basis. The contingent consideration, when settled, will be added to the basis of the acquired shares for tax purposes. Therefore, deferred taxes will not be recorded since the resolution of the contingent consideration will affect only the outside tax basis of the shares.

At the date of acquisition, the following entry would be recorded:

\[
\begin{align*}
\text{Dr Goodwill} & \quad \text{Cr Contingent consideration} \\
& \quad \$1,000 \quad \$1,000
\end{align*}
\]

An acquirer would need to calculate the incremental tax basis as a result of the settlement of the contingent consideration if deferred taxes were being provided on the outside basis of the entity.

**Year Two:**
The $1,200 adjustment to fair value of the contingent consideration is recognized in earnings. However, there is no corresponding tax effect recorded at that time, because the resolution of the contingent consideration will affect only the outside tax basis of the shares, on which no deferred taxes are being recorded. In this case,
adjustment of the contingent consideration will impact the effective tax rate because there is a pretax expense item without a corresponding tax effect. The effect on the rate can be demonstrated as follows (assuming income before tax and contingent consideration of $10,000 and no other permanent or temporary items):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before tax and contingent consideration</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less additional contingent consideration</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Income before tax</td>
<td>$ 8,800</td>
</tr>
<tr>
<td>Income tax before contingent consideration</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Tax effect of contingent consideration</td>
<td>0</td>
</tr>
<tr>
<td>Total income tax</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>45.5%</td>
</tr>
</tbody>
</table>

**Year Three:**

Contingent consideration is settled at $2,200.

The following entry would be recorded:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Contingent consideration</td>
<td>$2,200</td>
</tr>
<tr>
<td>Cr Cash</td>
<td>$2,200</td>
</tr>
</tbody>
</table>

In year three, there is no further impact on earnings or the effective tax rate because the contingent consideration was settled for the amount previously recorded. No deferred tax entry is required since the contingent consideration is added to the tax basis in the shares and deferred taxes are not being provided on the outside basis difference.

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**10.4.5 Deferred Taxes Related to Research and Development Activities**

Research and development activities (R&D) acquired in a business combination will be capitalized as tangible or intangible assets based on their nature. The capitalized in-process R&D (IPR&D) activities are accounted for as indefinite-lived intangible assets, subject to impairment testing until completion or abandonment of the projects. The acquirer estimates the useful life of the asset once each project is complete (ASC 805-20-35-5).

Deferred tax liabilities related to indefinite-lived assets typically are not used as a source of income to support realization of deferred tax assets in jurisdictions where tax attributes expire (e.g., jurisdictions where net operating loss carryforwards expire) unless the deferred tax liability is expected to reverse prior to the expiration date of the tax attribute. The acquirer should determine whether the deferred tax liability related to R&D will reverse in a period that would allow realization of the deferred tax assets.

Example 10-8 illustrates the approach for considering whether a deferred tax liability for R&D activities should be considered a source of income for realizing deferred tax assets.
Example 10-8: Whether a Deferred Tax Liability for R&D Activities Should Be Considered a Source of Income for Realizing Deferred Tax Assets

Background/Facts:
Company A acquires Company B in a nontaxable business combination. Company A capitalizes an acquired R&D intangible asset for $100 and records an associated DTL of $40. Under ASC 805, the R&D intangible asset is classified as indefinite-lived until the project is either abandoned or completed, at which time a useful life will be determined. Company A plans to file a consolidated tax return with Company B. Company A had a pre-existing DTA of $30 for NOLs that will expire in 10 years (for simplicity, assume this is the Company’s only DTA). Prior to the acquisition, Company A had a valuation allowance against the DTA.

Analysis/Conclusion:
To determine whether the DTL related to the R&D intangible asset can be used as a source of taxable income to provide realization of the DTA, Company A must assess the expected period of completion of the R&D project and the expected useful life of the related intangible asset representing the resulting intellectual property once the project is complete. If Company A expects the project to be completed within two years and expects the useful life of the intangible asset to be three years, then the DTL should be used as a source of income in assessing the realization of the DTA because the DTL is expected to reverse (over years three to five) before the NOL carryforward expires. If Company A reverses all or a portion of its valuation allowance as a result of this analysis, the benefit is recorded outside of acquisition accounting in continuing operations. Alternatively, if Company A has limited or no visibility into how long the research period may last and/or the useful life of the resulting intellectual property, then the reversal of the taxable temporary difference might not provide a source of taxable income for tax attributes with expiration periods.

10.4.6 Deferred Taxes Related to Acquisition-Related Costs

Under ASC 805, acquisition-related costs are not part of the fair value of the consideration that is transferred between the buyer and the seller. Such acquisition costs are expensed as incurred by the acquirer (ASC 805-10-25-23). However, acquisition-related costs may be treated one of several ways for tax purposes depending on the tax jurisdiction and the type of costs. For example, these costs could be expensed as incurred; capitalized as a separate intangible asset; included in the basis of the shares acquired; included in the basis of other assets; or included in tax-deductible goodwill.

If the acquisition costs are not immediately deductible for tax purposes, a potential temporary difference is created. We believe there are two acceptable alternatives for determining the appropriate deferred tax treatment for acquisition costs.

One alternative is to consider whether the acquisition costs would result in a future tax deduction if the business combination was not consummated. If so, then the acquisition costs represent a deductible temporary difference for which a deferred tax asset should be recognized when the costs are expensed for financial reporting. This approach is considered acceptable because the consummation of a business combination is generally not anticipated for accounting purposes. When the acquisition is consummated, companies will need to revisit the appropriate accounting for the temporary difference and consider whether the deferred tax asset should be reversed. Depending on how the acquisition costs are treated
for tax purposes (e.g., added to the outside basis of the shares), it may no longer be appropriate to record deferred taxes on such acquisition costs. Reversal of a deferred tax asset would be reflected in the income statement and would affect the effective tax rate in the period the acquisition is consummated.

Another alternative is to consider the expected ultimate tax consequence of the costs. If the costs are expected to be included in the outside basis of the shares for tax purposes, as is typically the case in a nontaxable business combination, then, unless the company expects to record deferred taxes on the outside basis temporary difference, no deferred tax asset would be established related to the acquisition costs. Therefore, the acquisition costs would be expensed with no corresponding tax effect, which would affect the effective tax rate in the period the acquisition-related costs are expensed. If the costs are expected to be included in a tax-deductible asset (e.g., tax-deductible goodwill), then deferred taxes would be provided on the acquisition costs. This approach is considered acceptable, because it is appropriate to consider the expected tax consequence of the reversal of the temporary difference in the recognition and measurement of deferred taxes (ASC 740-10-25-20). This approach requires a continuous evaluation of expectations at each reporting date and recognition of deferred tax adjustments consistent with revised expectations.

At the acquisition date, tax-deductible goodwill is compared to book goodwill to determine whether a deferred tax asset should be recorded. Under either approach set forth above, acquisition costs would not be included in the tax goodwill amount for purposes of the comparison of tax-deductible goodwill to book goodwill, because the acquisition costs are not included in financial reporting goodwill. See Section TX 10.7 for further discussion of recording deferred taxes on goodwill.

Since these costs will not be reflected in acquisition accounting for financial reporting purposes, associated deferred taxes that are recorded or later reversed will be reflected in the income statement.

The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP (ASC 805-10-25-23). Costs to issue debt or equity securities are not part of acquisition accounting. As such, any associated tax effect will be reflected in the income statement, or directly in equity, but not in acquisition accounting.

See Section 17.5.1 for discussion on acquisition-related transaction costs in calculating estimated annual effective tax rate.

10.4.7 Identifying the Applicable Tax Rate to Calculate Deferred Tax Assets and Liabilities

In determining deferred taxes, the identification of the applicable tax rate for each jurisdiction (and sometimes for each individual type of temporary difference) is important. The determination of the applicable tax rate should consider the effects of the business combination. This may be important in situations where graduated rates were historically significant for the business, because the combined business’s operations may require the application of a different statutory rate (ASC 740-10-30-8 through 30-9). See Section TX 10.5.6 for discussion of recording the impact of an expected change in the applicable tax rate on the acquirer’s deferred tax balances.

The applicable rate is determined based on enacted tax rates, even if the parties included apparent or expected changes in tax rates in their negotiations. ASC 740 requires that rate changes be reflected in the period when enacted. Further, a change
in enacted rates subsequent to the acquisition date may result in an immediate positive or negative impact on the tax provision in the postcombination period (ASC 740-10-45-15).

Companies that file financial statements with the SEC may be required to apply push-down accounting, whereby the parent’s basis in the investment is pushed down to the legal entities acquired. Regardless of whether push-down accounting is applied, the applicable tax rate(s) used to measure deferred taxes should be determined based on the relevant rate(s) in the jurisdictions where the acquired assets are recovered and the assumed liabilities are settled, as discussed in Example 10-9.

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**Example 10-9: Applicable Tax Rate**

**Background/Facts:**
A holding company acquires (in a “nontaxable” transaction) 100 percent of the shares of another business. The holding company is incorporated in a jurisdiction that does not impose income taxes, and the acquired business is in a jurisdiction where income is subject to income taxes. The holding company identifies temporary differences between the fair value (as determined under ASC 805) for financial reporting purposes and the tax bases of the individual assets acquired and liabilities assumed.

**Analysis/Conclusion:**
The consolidated financial statements should include deferred taxes related to the book versus tax basis differences of the acquired net assets. The deferred taxes should be measured at the enacted income tax rate(s) applicable to the acquired business. The tax rate applied should consider the jurisdiction in which the acquired assets are recovered and the assumed liabilities are settled, even if the parent’s basis in the investment has not been pushed down to the separate financial statements of the acquired business.

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**10.5 Identify Acquired Tax Benefits**
The acquirer should determine whether there are any net operating loss, credit, or other carryforwards to record as part of acquisition accounting. The discussion in this section does not consider the fact that certain tax uncertainties could be embedded in the net operating loss, credit, or other carryforwards (ASC 805-740-25-2). Generally, a deferred tax asset is recorded in full, but is then reduced by a valuation allowance if it is more-likely-than-not that some or all of the deferred tax asset will not be realized (ASC 740-10-30-5(e)).

**10.5.1 Realization Test for the Acquired Tax Benefits**
The methodology for determining the realizability of deferred tax assets is based on the availability of future taxable income. Refer to Chapter TX 5 for a discussion of how to assess the realizability of deferred tax assets. A buyer would not recognize a DTA unless it is more-likely-than-not the DTA will be realized. If a DTA is recognized in acquisition accounting, it would generally result in an increase in the amount of recognized goodwill. This analysis should be done on a tax jurisdictional basis as required by ASC 740.

An acquirer that will include the acquiree in a consolidated tax return should consider the tax attributes and future taxable income of the combined business.
when assessing whether acquired deferred tax assets are realizable. For example, deductible differences or carryforwards of the acquiree can be realized because (i) they may be offset by the acquirer’s tax attributes under the applicable tax laws, (ii) the acquirer has sufficient taxable temporary differences that will generate future taxable income, or (iii) the acquirer anticipates having sufficient other future taxable income to ensure realization. These new sources of future taxable income from the perspective of the combined business may make it possible to recognize deferred tax assets for the combined business at the date of acquisition.

Combined tax attributes or income may also provide evidence as to the realizability of the acquirer’s own deferred tax assets at the date of acquisition. However, changes in the assessment of realizability of the acquiring company’s deferred tax assets are not included in acquisition accounting (see Section TX 10.5.6).

10.5.2 Evaluating Future Combined Results Subsequent to the Business Combination

To determine the need for a valuation allowance at the date of acquisition, it is necessary to consider all available evidence. In jurisdictions where a consolidated tax return will be filed (i.e., acquiring and acquired business consolidated), it may be necessary to consider the expected future taxable income of the combined business.

To perform the evaluation, past results as well as expected future results should be considered. It will be necessary to adjust past results of the acquired business to reflect depreciation and amortization based on the amounts assigned in acquisition accounting. This may, at first, seem inappropriate for a business acquired in a nontaxable acquisition, because its future taxable income will be measured based on its carryover tax basis. But the objective of this analysis is to provide some indication of the future earnings power of the combined business. Temporary differences at the date of acquisition will be measured based on the differences between the carryover tax basis (in a nontaxable acquisition) and the fair values assigned in acquisition accounting. If the fair values are higher, the reversals of resulting taxable differences may themselves ensure realization of future tax benefits. Such pro forma results for the most recent prior year tend to be the most meaningful. However, results for periods more than one or two years prior to the consummation of the business combination should also be considered. Judgment will have to be applied in reviewing the available evidence and to adequately consider historical results to arrive at a meaningful outcome. See Section TX 5.3.2 for additional discussion on determining the need for a valuation allowance in a business combination.

10.5.3 Considering the Acquirer’s Taxable Differences as a Source of Realization

The acquirer’s own deferred tax liabilities may provide a source for the realization of deferred tax assets acquired in a business combination and, therefore, may be an important component in assessing the need for a valuation allowance for the deferred tax assets that arise from the acquisition. As a result, the acquirer may need to determine its temporary differences at the date of acquisition, which may be difficult if the acquisition occurs at an interim date. The acquirer’s temporary differences on the date of the acquisition should be determined in each jurisdiction and may be computed using one of the three approaches described below:

1. Assume that, as of the acquisition date, the acquirer files a short-period tax return. In some jurisdictions, the tax laws govern how annual deductions, such as depreciation, are allowed in a short-period return. The existing book bases of the assets and liabilities would then be compared with these “pro forma” tax bases to determine the temporary differences.
2. Assume that temporary differences arise evenly throughout the year. That is, if the beginning temporary difference is $100 million and the projected ending temporary difference is $220 million, the temporary difference is assumed to increase by $10 million a month as the year progresses.

3. Assume that temporary differences arise in the same pattern that pretax accounting income is earned. That is, if pretax income is earned 10, 20, 30, and 40 percent in the first through fourth quarters, respectively, then temporary differences would increase or decrease on that basis as well. That is, if the beginning temporary difference is $100 million and the projected ending temporary difference is $220 million, the expected annual increase of $120 million is assumed to occur in proportion to the pretax income (i.e., 10, 20, 30, and 40 percent in the first through fourth quarters, respectively).

The acquirer should determine the approach most suitable to its facts and circumstances.

10.5.4 Limitation of Tax Benefits by Law

In certain business combination transactions, the acquired business and its tax attributes may be integrated into the consolidated tax returns and positions of the acquirer. However, depending on the specific tax jurisdiction, there may be various limitations on the use of acquired tax benefits. Some examples of these limitations include:

- Utilization of certain attributes, such as NOLs or tax credits, may be limited due to a change in corporate ownership structure or a significant change in business operations. These limitations might be expressed as an absolute amount, a formula-based limitation (e.g., annually changing percentage of the acquired tax benefit), or a relationship to taxable income (e.g., 30 percent of taxable income can be offset by acquired NOLs).

- Use of acquired loss carryforwards may be limited to postacquisition taxable income of the acquired business.

- The acquired business may be subject to tax in a different jurisdiction or may file a separate return in the same jurisdiction as the acquirer and, thus, use of the acquired tax benefits may be limited based on the results of the acquiree’s own operations.

All restrictions are considered in assessing whether the deferred tax assets for acquired tax benefits are recognizable or realizable (e.g., which future expected taxable income is relevant or the impact of expiration periods in case of limited annual use).

10.5.5 Changes to the Acquired Deferred Tax Assets after the Business Combination

The recoverability of deferred tax assets is reassessed at each reporting period and, if circumstances lead to the conclusion that it is more-likely-than-not that part or all of deferred tax assets will eventually be utilized, the valuation allowance recorded is reduced or eliminated (i.e., partially or fully released) (ASC 805-740-45-2).

ASC 805-740 changes the accounting for the initial recognition of acquired deferred tax assets subsequent to the acquisition date. The release of a valuation allowance that does not qualify as a measurement period adjustment is reflected in income.
The release of a valuation allowance within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected first as an adjustment to goodwill, then as a bargain purchase (ASC 805-740-45-2).

The acquirer must consider whether changes in the acquired deferred tax balances are due to new information about facts and circumstances that existed at the acquisition date or are due to events arising in the postcombination period. Changes resulting from discrete events or circumstances that arise within the measurement period and did not exist at the acquisition date generally would not be recorded in acquisition accounting (ASC 805-10-25-13 through 25-14).

For example, the impact of a subsequent business combination occurring during the measurement period of a prior acquisition would likely not qualify as a measurement period adjustment. The subsequent business combination would typically not represent new information about facts and circumstances that existed at the acquisition date, but would rather be an event arising in the postcombination period. Therefore, if a subsequent business combination triggers the release of a valuation allowance established in a prior acquisition, such release would typically be recorded as a decrease in income tax expense. The guidance in ASC 805 related to measurement period adjustments to acquired deferred tax balances is consistent with the guidance for changes in other acquired assets and liabilities. See Chapter BCG 2 of the PwC publication *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests* for further discussion of measurement period adjustments.

Unlike the general transition provisions of ASC 805, whereby the guidance is applied only to business combinations consummated after the effective date, the guidance related to the release of a valuation allowance subsequent to the acquisition date also applies to business combinations consummated prior to the effective date of ASC 805 (ASC 805-10-65-1(b)).

Example 10-10 illustrates the application of the measurement period guidance to a change in valuation allowance.

**Example 10-10: Measurement Period Guidance Applied to a Change in Valuation Allowance**

**Background/Facts:**
Company A acquires Company B on July 1st. Company B’s normal business activities are construction and demolition. A full valuation allowance related to Company B’s acquired deferred tax assets is recorded in acquisition accounting. A natural disaster occurs after the acquisition date, but prior to June 30th of the following year (i.e., within the measurement period). The natural disaster directly results in Company B obtaining a major new cleanup contract. The company has not provided any natural disaster cleanup services in the past and providing such services was not a factor in determining the acquisition-date value of Company B.

(continued)
Analysis/Conclusion:
The increase in taxable earnings from the natural disaster cleanup contract could not be foreseen and was not part of the acquirer's assumptions in establishing the valuation allowance at the acquisition date. Therefore, the resulting change in the valuation allowance would not be recorded as a measurement period adjustment, but rather would be recorded in earnings.

10.5.6 Changes in the Acquirer's Deferred Tax Balances Related to Acquisition Accounting

The impact on the acquiring company's deferred tax assets and liabilities caused by an acquisition is recorded in the acquiring company's financial statements outside of acquisition accounting. Such impact is not a part of the fair value of the assets acquired and liabilities assumed.

For example, in jurisdictions with a graduated tax rate structure, the expected postcombination results of the company may cause a change in the tax rate expected to be applicable when the deferred tax assets and liabilities reverse. The impact on the acquiring company's deferred tax assets and liabilities is recorded as a change in tax rates and reflected in earnings (ASC 740-10-45-15).

Additionally, the acquirer's financial statements may have included a valuation allowance before the transaction for its deductible differences or loss carryforwards and other credits. After considering the transaction and the projected combined results and available taxable differences from the acquired business, the acquirer may be able to release all or part of its valuation allowance. While this adjustment is directly related to the consequences of the acquisition, ASC 805 requires the recognition of the benefit in income or equity, as applicable, and not as a component of acquisition accounting. Such benefit is related to the acquirer's existing assets and should not be considered in the determination of the fair values of the assets acquired and liabilities assumed (ASC 805-740-30-3).

Similarly, if a valuation allowance is required by the acquirer as an indirect result of the acquisition, this immediate charge should be reflected in the income statement at the date of the acquisition. The concept is similar to the one discussed above, such that these tax charges are specific to the acquirer's existing assets and should not be considered in the application of acquisition accounting.

Acquired deferred tax liabilities could be a source of income to support recognition of acquired deferred tax assets or the acquirer's existing deferred tax assets, or both. As discussed above, only to the extent acquired deferred tax liabilities support the acquirer's existing deferred tax assets is the effect of releasing any related valuation allowance reflected in earnings (i.e., outside of acquisition accounting). Accordingly, in circumstances in which some but not all of the combined deferred tax assets are supported by acquired deferred tax liabilities, the acquirer will need to apply an accounting policy to determine which balances are being supported. We believe there are two acceptable accounting policies: one policy is to consider the recoverability of deferred tax assets acquired in the acquisition before considering the recoverability of the acquirer's existing deferred tax assets. Another policy is to consider relevant tax law ordering rules for utilization of tax assets to determine whether the acquired or pre-existing deferred tax assets are considered realizable.

Example 10-11 illustrates the application of the accounting policy on valuation allowance considerations in acquisition accounting.
Example 10-11: Accounting Policy for Considering Whether Acquired Deferred Tax Liabilities Support Realization of Acquired or Acquirer’s Deferred Tax Assets

Background/Facts:
Company X and Company Y each have $2,000 of DTAs related to net operating loss (NOL) carryforwards generated in the last four years. Other deferred tax assets and liabilities are de minimis. Company X has historically maintained a valuation allowance against its DTAs. In the current period, Company X acquires the stock of Company Y in a nontaxable transaction and the combined business will file a consolidated tax return. As part of the acquisition, assume DTLs of $1,500 related to Company Y are recorded and the combined entity cannot rely on future taxable income for realization of DTAs. However, the acquired DTLs will reverse prior to any NOL expirations and are, therefore, a source of future taxable income for realization of DTAs. There are no tax law limitations on future realization of the NOL carryforwards. Consequently, Company X determines it needs a valuation allowance of $2,500 (combined DTAs of $4,000 less reversing DTLs of $1,500).

Analysis/Conclusion:
Deferred taxes are recorded in acquisition accounting for the acquired entity’s temporary differences and operating loss/credit carryforwards (ASC 805-740-25-2). However, any changes in the acquirer’s deferred taxes as a result of a business combination should be recorded currently in income (ASC 805-740-30-3).

In the fact pattern described above, we believe there are two alternative methods to account for the benefit that can be recognized in Company’s X financial statements:

View A — The DTLs should first be considered as a source of taxable income in relation to the acquired company’s DTAs, with any residual amount applied to the acquirer’s DTAs. This view is premised on the sequence of events, starting with the acquisition, followed by the consideration of impacts on the acquirer. In the case above, a $500 valuation allowance would be recorded in acquisition accounting (i.e., $1,500 of the $2,000 acquired DTAs are expected to be realized), and there would be no recognition of the acquirer’s pre-existing DTAs. The valuation allowance against the acquirer’s DTAs ($2,000) would not change.

View B — Realization of DTAs should be based on underlying tax law ordering for the jurisdiction (e.g., looking first to older NOLs if that is consistent with the tax law in the relevant jurisdiction). The objective would be to determine the reversal pattern of tax attributes and tax-deductible temporary differences under the tax law. However, where the order in which tax attributes and tax-deductible temporary differences will be used is not determinable, the entity should develop a systematic, rational, and consistent methodology for allocating the benefit resulting from the DTLs.

Either view A or view B is acceptable as an accounting policy election provided the policy is applied consistently to acquisitions with appropriate financial statement disclosure, including specific disclosure of any benefits or expenses recognized for changes in the acquirer’s valuation allowance (ASC 805-740-50-1).

10.5.7 Business Combinations Achieved in Stages

An acquirer sometimes obtains control of an acquiree in which it held an equity interest prior to the acquisition date. In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss (i.e., the difference
between its fair value and carrying value) in earnings. If changes in the fair value of the equity interest were previously recorded in other comprehensive income (OCI), the amount of unrealized gains or losses should be reclassified from OCI and included in the measurement of the gain or loss on the acquisition date (ASC 805-10-25-10). The recognition of a gain or loss at the acquisition date represents the recognition of the economic gain or loss that is present in the previously held equity interest.

Prior to obtaining control, deferred taxes would have been based on the difference between the carrying amount of the investment in the financial statements and the tax basis in the shares of the investment (i.e., outside basis difference). Unless a current tax is triggered, remeasuring the previously held equity interest to fair value will increase the book basis with no corresponding increase in the tax basis, thus changing the outside basis difference and associated deferred tax. Since the acquirer’s gain or loss from remeasuring the acquirer’s previously held investment is reflected in net income, the corresponding tax effect of the change in outside basis difference caused by such gain or loss should be reflected in the acquirer’s income tax expense from continuing operations. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated OCI to net income (e.g., unrealized gains or losses on AFS securities and CTA). Generally, the corresponding reclassification adjustment from OCI to net income will also include any related income tax expense or benefit that was previously recognized in OCI.

Example 10-12 illustrates the impact on the outside basis difference from remeasuring a previously held investment to fair value.

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**Example 10-12: Impact on Outside Basis Difference from Remeasuring a Previously Held Investment**

**Background/Facts:**
Company A has a 20 percent equity-method investment in Company B with a carrying value of $1,000 and a tax basis of $800. Company A has recorded a corresponding deferred tax liability of $80 ($1,000 – $800 x 40%). Company A acquires the remaining 80 percent of Company B. The fair value of Company A’s previously held investment in Company B is $1,500 at the acquisition date.

**Analysis/Conclusion:**
Company A would remeasure its investment in Company B to $1,500 and record a gain of $500 for financial reporting purposes. Company A’s book versus tax basis difference in the previously owned shares of Company B would increase from $200 ($1,000 – $800) to $700 ($1,500 – $800) at the acquisition date. Assuming a 40 percent tax rate, Company A would record the following tax entry to increase the deferred tax liability from $80 to $280:

\[
\begin{align*}
\text{Dr Deferred tax expense} & \quad 200^1 \\
\text{Cr Deferred tax liability} & \quad 200
\end{align*}
\]

\[^1\text{Increase in outside basis difference of$500 x 40\% tax rate.}\]

Upon obtaining control, the acquirer may no longer need to recognize deferred taxes on the outside basis of the investment due to the provisions of ASC 740 (e.g., there is a means for tax-free recovery of the investment). In this case, the accounting for
the deferred tax related to the previously held investment depends on whether the subsidiary is foreign or domestic.

If the subsidiary is domestic and the parent has the intent and ability under the tax law to recover its investment in a tax-free manner, then the entire deferred tax liability related to the outside basis difference on the previously held investment is reversed. The effect of reversing the deferred tax is recorded in the acquirer’s income tax expense from continuing operations and does not impact acquisition accounting. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated OCI to net income (e.g., unrealized gains or losses on AFS securities and CTA). Generally, the corresponding reclassification adjustment to OCI will also include any related income tax expense or benefit that was recognized in OCI.

If the subsidiary is foreign, then generally a portion of the deferred tax liability related to the outside basis difference on the previously held investment must be retained. ASC 740 requires that a deferred tax liability continue to be recorded for the temporary difference related to the investor’s share of the undistributed earnings of a foreign investee prior to the date it becomes a subsidiary. The deferred tax liability should remain as long as dividends from the subsidiary do not exceed the parent company’s share of the subsidiary’s earnings subsequent to the date it became a subsidiary (ASC 740-30-25-16). Effectively, the deferred tax liability at the acquisition date for the outside basis temporary difference caused by undistributed earnings of the foreign investee is “frozen” until that temporary difference reverses.

Outside basis differences can arise from activities other than from undistributed earnings (e.g., currency translation adjustments). In such cases, it is unclear as to what portion of the deferred tax liability should be retained.

One view is that upon gaining control of an equity- or cost-method investee, the deferred tax liability for the entire outside basis difference, including any basis difference resulting from adjusting the investment to fair value, is frozen until that temporary difference reverses. A second view is that only the portion of the deferred tax liability that relates to undistributed earnings of the investee as of the date control is obtained is frozen. The approach selected is an accounting policy choice that should be applied consistently from acquisition to acquisition. However, in some jurisdictions, the recovery of an investment in a foreign equity investee does not have tax consequences to the investor. In such circumstances, a deferred tax liability for holding gains would not be recognized (and then frozen) when control is obtained as such gains would never be taxable and therefore do not constitute temporary differences.

Upon gaining control of the investee, the acquirer will apply acquisition accounting and recognize the assets acquired and liabilities assumed, including goodwill. The acquirer must then identify and measure associated deferred tax assets and liabilities. Consider a situation where the acquiring company obtains a step-up tax basis in the net assets acquired for the portion most recently purchased, but does not obtain a step-up tax basis for the portion previously held (i.e., carryover tax basis related to the previously held investment). The method for calculating tax bases would result in larger inside book-over-tax-basis differences as a result of the acquirer’s previously held investment, which, in turn, would impact the amount of goodwill recorded in acquisition accounting. Example 10-13 illustrates this concept.
Example 10-13: Impact on Inside Basis Differences from a Previously Held Investment

**Background/Facts:**
Company A has a 20 percent equity-method investment in Company B, with a carrying value of $1,000 and a tax basis of $800. Company A acquires the remaining 80 percent of Company B for $8,000 and elects, under the tax law, to obtain a step-up of the inside tax bases of the net assets acquired for the 80 percent purchased (i.e., elected to treat the transaction as taxable). The fair value of the previously held 20 percent investment at the acquisition date is $2,000.

**Analysis/Conclusion:**
The resulting inside tax bases would be a combination of the 20 percent carryover tax basis and the 80 percent fair value ($800 + $8,000 = $8,800).

For financial reporting, the net assets acquired are recorded at fair value (as prescribed by ASC 805). The net assets acquired, including goodwill, are recorded at $10,000.1

The book bases exceed the tax bases by $1,200 ($10,000 – $8,800). The excess is attributable to the carryover inside tax bases resulting from the 20 percent previously held investment.2 Therefore, a deferred tax liability generally would be recorded as part of acquisition accounting.3

In a taxable transaction where the acquirer did not have a prior investment in the acquiree, the inside tax bases would equal the consideration transferred at the date of acquisition. Consequently, no book and tax inside basis differences generally exist, and, therefore, no deferred taxes would be recorded on the acquisition date.

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1 $2,000 fair value of 20 percent previously held investment plus $8,000 consideration transferred for the remaining 80 percent.
2 Fair value of 20 percent previously held investment less carryover tax bases ($2,000 – $800 = $1,200).
3 Consideration would need to be given to the prohibition against recording a deferred tax liability on excess book over tax-deductible goodwill (see Section TX 10.7).

Deferred taxes related to inside basis differences are recorded in acquisition accounting. Deferred taxes are one element of the acquired assets and assumed liabilities. ASC 805 requires the acquirer to recognize and measure deferred taxes arising from the net assets acquired and other temporary differences of the acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with ASC 740, ASC 805-740-25-2 and ASC 805-740-30-1. The resulting deferred taxes arise from recording the individual assets acquired and liabilities assumed in the acquisition and should therefore be recorded in acquisition accounting. The deferred taxes related to the net assets acquired would impact goodwill.

**10.6 Consider the Treatment of Tax Uncertainties**
The issuance of ASC 805 did not alter the guidance as it relates to the initial accounting and recording of uncertain tax positions in business combinations. In a taxable business combination, positions may be taken in allocating the acquisition price and in filing subsequent tax returns, which are expected to be challenged by the taxing authority and perhaps litigated. Similarly, in nontaxable business combinations there may be uncertainties about the tax basis of individual assets or the preacquisition tax returns of the acquired business. Both types of situations are considered to be uncertain tax positions.
10.6.1 Recording Tax Uncertainties

The recording of income-tax-related uncertainties is performed in accordance with ASC 740. ASC 740, a comprehensive two-step structured approach to accounting for an uncertainty in income taxes, provides specific guidance on recognition, measurement, and other aspects of reporting and disclosing uncertain tax positions. For a position to qualify for benefit recognition, the position must have at least a more-likely-than-not (i.e., greater than 50 percent) chance of being sustained, based on the position’s technical merits, upon challenge by the respective taxing authorities (i.e., step one). If the position does not have at least a more-likely-than-not chance of being sustained, none of the benefit associated with that tax position is recognized.

After concluding that a particular position has a more-likely-than-not chance of being sustained and, therefore, should be recognized in the financial statements (i.e., step one), a company must carry out step two. Under that step, the amount of tax benefit that can be recorded in the financial statements is determined. ASC 740 uses a measurement methodology that is based on cumulative probability, resulting in the recognition of the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with a taxing authority having full knowledge of all relevant information (ASC 740-10-25-6 and ASC 740-10-30-7).

The seller may provide indemnifications related to tax uncertainties to the acquirer. There is a potential inconsistency in recognizing and measuring an asset for an indemnification at fair value if the related liability is measured using a different measurement attribute, such as those discussed above related to tax uncertainties. Therefore, ASC 805 prescribes 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 any contractual limitations and the need for a valuation allowance for uncollectible amounts (ASC 805-20-25-27 through 25-28). At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized at the acquisition date on the same basis as the indemnified item, subject to any contractual limitations on its amount and assessment of collectability (ASC 805-20-35-4). Caution should be exercised in measuring the amount of the indemnification arrangement because a number of indemnification arrangements do not fully cover the related tax uncertainty (e.g., in some cases both parties agree to share in the risk). The indemnification asset should be recorded as an asset, separate from the associated liability. Determining whether or not to record deferred taxes related to the indemnification asset will depend on the expected tax consequences from recovering the asset. The analysis would be similar to that used in determining the deferred tax accounting for contingent consideration as discussed in Section TX 10.4.4. See Chapter BCG 2 of the PwC publication A Global Guide to Accounting for Business Combinations and Noncontrolling Interests and Section TX 16.10 for further discussion related to indemnifications.

10.6.2 Subsequent Resolution of Tax Uncertainties in a Business Combination

Under ASC 805, adjustments to uncertain tax positions made subsequent to the acquisition date are recognized in earnings, unless they qualify as measurement period adjustments. Measurement period adjustments are recorded first as an adjustment to goodwill, then as a bargain purchase. See Section TX 10.5.5 for a discussion of evaluating whether an adjustment within the measurement period relates to circumstances that were included in the acquirer’s assessment at the date of the acquisition (ASC 805-740-45-4).
Unlike the general transition provisions of ASC 805, the guidance for recognition of adjustments to acquired income tax uncertainties also applies to existing uncertainties arising in a business combination consummated prior to the effective date of ASC 805 (ASC 805-10-65-1(b)).

### 10.7 Deferred Taxes Related to Goodwill

Goodwill for financial reporting purposes is a residual amount. Acquired goodwill for financial reporting purposes is capitalized as an asset and is not amortized. Some business combinations, particularly taxable business combinations, can generate goodwill that is deductible for tax purposes (also referred to as “tax-deductible goodwill”).

The amount assigned to goodwill for book and tax purposes could differ, due to different valuation and allocation rules and differences in determining the amount of consideration transferred (e.g., different treatment of contingencies or costs incurred for the transaction). ASC 740 describes the separation of goodwill into components to assist in determining the appropriate deferred tax accounting related to goodwill at the acquisition date. The first component (component-1) equals the lesser of (i) goodwill for financial reporting or (ii) tax-deductible goodwill. The second component (component-2) equals the remainder of each, that is, (i) the remainder, if any, of goodwill for financial reporting in excess of tax-deductible goodwill or (ii) the remainder, if any, of tax-deductible goodwill in excess of the goodwill for financial reporting (ASC 805-740-25-8).

The following chart displays the concept of component-1 and component-2 goodwill:

<table>
<thead>
<tr>
<th></th>
<th>Book Goodwill</th>
<th>Tax-Deductible Goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Component-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Component-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Excess of Book Over Tax)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 10.7.1 Excess of Tax-Deductible Goodwill over Book Goodwill

An excess of tax-deductible goodwill over goodwill for financial reporting is a temporary difference for which a deferred tax asset is recognized (ASC 805-740-25-9).

In a nontaxable transaction where the historical tax bases of the acquired business carryover to the acquirer, there may be tax-deductible goodwill from prior acquisitions of the acquiree that carries over in the current acquisition. In this instance, a question arises as to how to treat the carryover tax deductible goodwill in
determining deferred taxes. In general, we believe that the carryover tax deductible goodwill should be compared to the book goodwill arising in the current transaction for purposes of determining whether a recognizable temporary difference exists (see Section TX 10.7.2).

In analyzing component-1 and component-2 goodwill, the expected impact on tax-deductible goodwill of contingent consideration and contingent liabilities should be considered. See Section TX 10.4.4 for further discussion of the relationship between the comparison of book goodwill to tax-deductible goodwill and contingent liabilities or contingent consideration. See TX 10.4.6 for further discussion of the treatment of acquisition-related costs and the comparison of book goodwill to tax-deductible goodwill.

### 10.7.2 Recognition of a Deferred Tax Asset for Excess Tax-Deductible Goodwill

ASC 805 prescribes the recognition of a deferred tax benefit resulting from tax-deductible goodwill that is in excess of book goodwill. The tax benefit of the excess tax goodwill is recognized as a deferred tax asset at the acquisition date, which increases the values assigned to the acquired net assets and correspondingly decreases book goodwill. This, however, further increases (i) the difference between book goodwill and tax-deductible goodwill and (ii) the corresponding deferred tax balance (ASC 805-740-55-9 through 55-13). To deal with this iterative process, the computation of the deferred tax asset can be reduced to the following equation:

\[
\left( \frac{\text{Tax Rate}}{1 - \text{Tax Rate}} \right) \times \text{Preliminary Temporary Difference (PTD)} = \text{DTA}
\]

The resulting amount of deferred tax asset reduces book goodwill. If book goodwill is reduced to zero, any additional amounts recognized will result in a bargain purchase gain. Example 10-14 provides an example of the iterative calculation.

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### Example 10-14: Recording a Deferred Tax Asset for Excess Tax-deductible Goodwill, No Bargain Purchase Gain

**Background/Facts:**
A taxable acquisition results in initial book goodwill of $450 million. A separate determination for taxes results in tax-deductible goodwill of $600 million. The gross PTD between book and tax goodwill is $150 million. Assume an applicable tax rate of 40 percent.

**Analysis/Conclusion:**
The deferred tax asset for the excess tax-deductible goodwill is (in millions):

\[
(\frac{40\%}{1 - 40\%}) \times $150 = \text{DTA of } $100
\]

The acquirer would record a deferred tax asset for $100 million with a corresponding decrease in book goodwill. Therefore, final goodwill for financial reporting purposes would be $350 million, and a deferred tax asset of $100 million would be established. The resulting deferred tax asset appropriately reflects the temporary difference related to goodwill, as illustrated below:

\[
(\text{Tax goodwill} - \text{book goodwill}) \times 40\% = \text{DTA} \\
($600 - $350) \times 40\% = $100
\]
Example 10-15 illustrates a situation where the formula used to determine the deferred tax asset related to excess tax-deductible goodwill requires modification.

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Example 10-15: Recording a Deferred Tax Asset for Excess Tax-deductible Goodwill with Bargain Purchase Gain

**Background/Facts:**
A taxable acquisition results in initial book goodwill of $200 million. A separate determination for taxes results in tax-deductible goodwill of $600 million. The gross PTD between book and tax goodwill is $400 million. Assume an applicable tax rate of 40 percent.

**Analysis/Conclusion:**
When the initial calculation of the DTA related to goodwill exceeds the amount of book goodwill, the total DTA to be recognized will be equal to the tax effect of tax-deductible goodwill (i.e., tax-deductible goodwill less book goodwill of zero). Therefore, the company will record a DTA of $240 million (i.e., $600 million tax goodwill less $0 book goodwill x 40%). A portion of the DTA recognized in acquisition accounting will reduce initial book goodwill to zero. The remaining amount of the DTA is recorded as a bargain purchase gain. The following demonstrates the recognition of a deferred tax asset for excess tax-deductible goodwill with a bargain purchase gain based upon the facts described above.

The initial calculation of the deferred tax asset for excess tax-deductible goodwill is (in millions):

\[ (\frac{40\%}{1 - 40\%}) \times 400 = \text{DTA or } 267 \]

However, the DTA is in excess of book goodwill. Recording a DTA of $267 million would result in a complete elimination of the book goodwill and a tax benefit of $67 million. In that case, the DTA would not appropriately reflect the temporary difference related to goodwill, as illustrated below:

\[ (\text{Tax goodwill} - \text{book goodwill}) \times 40\% = \text{DTA} \]
\[ (600 - 0) \times 40\% = 240, \text{which does not equal the } 267 \text{ DTA as previously calculated} \]

The following formula can be used to determine the amount of PTD required to eliminate all book goodwill:

\[ (\frac{40\%}{1 - 40\%}) \times \text{PTD} = \$200 \text{ (book goodwill)} \]

Solving for PTD = $300

A deferred tax asset is recorded and goodwill is adjusted to the extent of the calculated limit of PTD, calculated as follows:

\[ (\frac{40\%}{1 - 40\%}) \times 300 = \$200^1 \]

1 Recorded as a DTA and as an adjustment to goodwill.

The remaining amount of deferred tax asset is recorded as a bargain purchase gain. The following formula can be used to determine the amount of the gain:

\[ (\text{PTD original result} - \text{PTD revised limit}) \times 40\% = \text{gain} \]
\[ (400 - 300) \times 40\% = 40^2 \]

2 Recorded as a DTA and as a bargain purchase gain.

(continued)
The following entry would be recorded (in millions):

<table>
<thead>
<tr>
<th>Dr DTA</th>
<th>$240</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Goodwill</td>
<td>$200</td>
</tr>
<tr>
<td>Cr Bargain purchase gain</td>
<td>40</td>
</tr>
</tbody>
</table>

The resulting deferred tax asset appropriately reflects the temporary difference related to goodwill, as illustrated below:

\[
(Tax \ goodwill - book \ goodwill) \times 40\% = DTA \\
(600 - 0) \times 40\% = 240
\]

Measurement period adjustments are recorded retrospectively and, therefore, may affect goodwill (ASC 805-10-25-17). If after the measurement period adjustments, tax-deductible goodwill exceeds book goodwill, the associated deferred tax asset should be recorded or adjusted. This adjustment will be recorded against goodwill.

10.7.3 Situations in Which the Iterative Formula May Not Apply

Use of the equation described in Section TX 10.7.2 is not appropriate in every situation. Complexities may arise that require modification of the formula and, in some cases, preclude its use altogether. These complexities may include either of the following situations:

- The formula uses a single statutory tax rate. However, there may be situations where the temporary differences arising in the acquisition would be tax-effected at different rates (i.e., where there are different rates in a carryback period or a rate change has been enacted for future years, or where the temporary differences give rise to more than one type of taxable income). In these situations, successive calculations may be required to determine the deferred tax asset.

- To the extent that a valuation allowance is required for all or part of the deductible temporary differences, there may be no or only a partial iterative effect on goodwill. Again, successive calculations may be required to determine the deferred tax asset.

10.7.4 Excess of Book Goodwill Over Tax-Deductible Goodwill

When there is an excess of book over tax goodwill, as of the acquisition date, no deferred tax liability is recorded for the excess book goodwill. Establishing a deferred tax liability would increase further the amount of goodwill, as it would decrease the value of the net assets acquired. This would, in turn, require an increase in the deferred tax liability, which would again increase goodwill, etc. As a consequence, this approach is not followed, as it would result in the grossing up of goodwill and the deferred tax liability, which the FASB determined would not add to the relevance of financial reporting. Implicit in this treatment of goodwill is an assumption that its carrying amount will be recovered on an after-tax basis.

10.7.5 Recognition of Deferred Tax Liabilities Related to Tax-Deductible Goodwill Subsequent to the Acquisition Date

In periods subsequent to the acquisition, component-2 goodwill may result in an excess of book goodwill over tax-deductible goodwill, and changes in the temporary difference for the component-2 book goodwill are disregarded; deferred taxes are provided only for differences arising between the book and tax basis of component-1
goodwill (e.g., due to amortization for tax purposes or impairment for book purposes). When component-2 goodwill is an excess of tax-deductible goodwill over book goodwill, changes in the entire temporary difference are recorded. For example, amortization of component-2 tax-deductible goodwill will reduce the corresponding deferred tax asset until the tax basis is equal to the book basis and will create a deferred tax liability for the basis difference created by tax amortization thereafter (ASC 805-740-25-9).

### 10.7.6 Deferred Tax Liabilities Related to Tax-Deductible Goodwill and Indefinite-Lived Intangible Assets—Source of Taxable Income

A deferred tax liability related to goodwill may be created in periods subsequent to an acquisition, as described in Section TX 10.7.5. Deferred tax liabilities related to an asset with an indefinite useful life (goodwill and indefinite-lived intangible assets) in jurisdictions where there is a finite loss carryforward period will ordinarily not serve as a source of income for the realization of deferred tax assets, because the deferred tax liability will not reverse until some indefinite future period when the asset is sold or written down due to impairment. Therefore, a company may need to record a full valuation allowance on its deferred tax assets and report a net deferred tax liability. In situations where there are indefinite carryforward periods, these deferred tax liabilities would generally be considered to be a source of taxable income. This should be evaluated on a facts and circumstances basis.

### 10.7.7 Deferred Tax Considerations in Testing Goodwill for Impairment

Goodwill is allocated to organizational units called reporting units for financial reporting purposes, and is subject to periodic and trigger-based impairment tests. A goodwill impairment test is done in two steps. In step one, in order to identify a potential impairment, the fair value of the reporting unit is compared to its carrying value (including goodwill). If fair value is less than carrying value, step two of the test is performed to determine the amount of the goodwill impairment, if any. In step two, the implied fair value of goodwill is determined in the same manner that the amount of goodwill recognized in a business combination is determined. That is, the fair value of the reporting unit is assigned to the assets and liabilities of the unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination. If the carrying amount of goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized for that excess amount (ASC 350-20). See Chapter BCG 11 of PwC’s A Global Guide to Accounting for Business Combinations and Noncontrolling Interests for further discussion of goodwill impairment.

To determine the fair value of the reporting unit during step one of the test, an assumption as to whether the reporting unit would be sold in a taxable or nontaxable transaction is made. Whether the reporting unit would be bought or sold in a taxable or nontaxable transaction is a matter of judgment that depends on the relevant facts and circumstances, and must be evaluated carefully on a case-by-case basis. See Chapter BCG 11 of PwC’s A Global Guide to Accounting for Business Combinations and Noncontrolling Interests for the things to consider when making the determination. Regardless of the assumption used, when determining the carrying value of the reporting unit, deferred tax balances that relate to the assets and liabilities of the reporting unit are included in the carrying value of the reporting unit (ASC 350-20-35-7).

When an entity is determining whether to assign deferred tax assets for NOL and credit carryforwards to a reporting unit, the entity should apply the criteria in ASC
350-20-35-39 through 35-40 (i.e., include the assets that will be employed in the operations of the reporting unit and that will be considered in determining the reporting unit's fair value). These deferred tax assets could be used by the reporting unit and should be assigned to a reporting unit if they were included in determining the fair value of the reporting unit. For example, if the reporting unit is a separate legal entity and the assumption used in determining the fair value of the reporting unit was that it would be sold in a nontaxable transaction where the carryforwards would transfer to the buyer, then the deferred tax assets from the carryforwards generated by that entity should be assigned to the reporting unit in determining the reporting unit's carrying value. Consider the following two scenarios.

**Example 10-16: Allocation of NOL-Generated Deferred Tax Assets and Tax Credit Carryforwards to Reporting Unit**

One of Entity A's reporting units is represented by a separate legal entity, Sub X. Sub X has generated NOL and credit carryforwards for which Entity A has recognized deferred tax assets. Entity A believes that it would be feasible to sell the stock of Sub X in a nontaxable transaction, which would allow the transfer of Sub X's NOL and credit carryforwards. Entity A also believes that marketplace participants would base their estimates of Sub X's fair value on a nontaxable transaction. Entity A has determined that it would receive the highest economic value if it were to sell Sub X in a nontaxable transaction.

We believe that the DTAs related to Sub X's NOL and credit carryforwards would meet the criteria in ASC 350-20-35-39 through 35-40. Therefore, these DTAs should be included in the carrying amount of the reporting unit.

**Example 10-17: No Allocation of NOL-Generated Deferred Tax Assets and Tax Credit Carryforwards to Reporting Unit**

Entity B has NOL and credit carryforwards for which it has recognized DTAs. Entity B's NOL and credit carryforwards are usable only at the consolidated level, since Entity B's reporting units are not separate legal entities, and not expected to be sold in a nontaxable transaction. Therefore, in determining the fair value of its reporting units, Entity B assumes that its reporting units would be sold in taxable transactions, which do not provide for the transfer of tax attributes (such as NOLs or the tax basis) to the buyer.

We believe that Entity B would not assign the DTAs for the NOL and credit carryforwards to its reporting units, because those DTAs do not meet the criteria in ASC 350-20-35-39 through 35-40.

If a company files a consolidated tax return and has established a valuation allowance against its deferred tax assets at the consolidated level, it should allocate the valuation allowance to each reporting unit based on the deferred tax assets and liabilities assigned to each reporting unit. It would not be appropriate for the company to evaluate each reporting unit on a “separate” return basis and thereby assess the need for a valuation allowance for each individual reporting unit. Unlike situations where separate financial statements of a consolidated entity are being prepared, the purpose of allocating a valuation allowance to reporting units is to
determine the existing carrying value of the reporting unit. Therefore, it is appropriate to allocate the existing valuation allowance of the consolidated entity, rather than do an analysis “as if” the entity had filed a separate income tax return.

In step one of the goodwill impairment test, the fair value of a reporting unit should be based on an assumption regarding the structure of the disposal transaction and is a matter of judgment that depends on the relevant facts and circumstances (ASC 350-20-35-25). The assumed structure of the disposal transaction can affect the price a buyer is willing to pay for the reporting unit and the seller’s tax cost on the transaction. For example, in a taxable transaction, the net assets of the entity are considered sold and the buyer records a fair value tax basis in the net assets.

The buyer may be willing to pay more to acquire a reporting unit in a taxable transaction if the transaction provides a step-up in the tax basis of the acquired net assets. In a nontaxable transaction, the stock of the company is sold and the buyer records a fair value tax basis in the acquired stock, but carryover (or predecessor) tax basis in the net assets. The buyer may be willing to pay more to acquire a reporting unit in a nontaxable transaction if the reporting unit has significant net operating loss or tax credit carryforwards that the buyer would be able to utilize.

The gross proceeds expected to be realized from the disposal must be reduced by the seller’s tax cost. The seller’s tax cost should reflect, and can vary with, the structure of the disposal. For example, in a nontaxable sale, the seller’s gain (or loss), and thus the seller’s tax cost, is measured by reference to its tax basis in the stock of the reporting unit; in a taxable sale, the seller’s taxable gain (or loss) is measured by reference to the tax basis in the net assets of the reporting unit. The effect of existing tax attributes of the seller would be considered in measuring the seller’s tax cost.

In step two of the goodwill impairment test, the implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination (ASC 350-20-35-14). The determination of deferred income taxes included in the step two analysis should be calculated using the same assumption (i.e., taxable or nontaxable) that was used in determining the fair value of the reporting unit in step one (ASC 350-20-35-20).

In a nontaxable transaction, the historical tax bases of assets and liabilities, net operating losses, and other tax attributes of the target usually carry over to the buyer. Since identifiable net assets will be reflected at fair value for book purposes, the amount of deferred income taxes used in the analysis should reflect the difference in the fair value book bases and the carryover tax bases. A deferred tax asset is included in the step two analysis if there is carryover tax basis in deductible goodwill and it exceeds the implied fair value of book goodwill. Determining the amount of a deferred tax asset on goodwill requires an iterative calculation (see Section TX 10.7.2).

Generally, in a taxable transaction, the acquirer does not carry over the existing tax bases of the assets and liabilities within the target, nor does it carry over net operating losses and other tax attributes. Instead, the acquirer records on its tax-basis balance sheet the acquired assets and the assumed liabilities at their respective fair values for tax reporting purposes (pursuant to applicable tax law). In this case, since the tax basis in the acquired assets and assumed liabilities would generally equal the book basis, there would be no deferred taxes in the step two goodwill analysis.

Refer to Section BCG 11.5.2.5 of PwC’s A Global Guide to Accounting for Business Combinations and Noncontrolling Interests for a further discussion.
10.7.7.1 Deferred Tax Accounting for a Goodwill Impairment

When goodwill is impaired for financial reporting purposes, there may be a deferred tax impact. As discussed in Section TX 10.7, goodwill is separated into two components at the acquisition date, and as discussed in Section TX 10.7.5, no deferred tax is provided for changes in component-2 book goodwill. In situations where goodwill is not deductible for tax purposes, a goodwill impairment would have no corresponding tax effect. However, if goodwill is tax deductible, then the goodwill impairment must be allocated to the components.

We believe a reasonable methodology to allocate a goodwill impairment loss between the components would include the allocation of the loss proportionally to the book carrying amount of component-1 and component-2 goodwill. The amount allocated to component-1 book goodwill will either decrease a previously created deferred tax liability or create/increase a deferred tax asset. The amount allocated to component-2 book goodwill will have no deferred tax effect.

Example 10-18 illustrates the tax effect of a goodwill impairment loss when there is excess book-over-tax goodwill.


**Background/Facts:**
Company A performs its annual goodwill impairment test and concludes that the goodwill for reporting unit X suffered an impairment loss of $400 million. The assets and liabilities in the reporting unit had been acquired four years ago in an asset acquisition accounted for as a business combination (i.e., a taxable transaction) and the related tax goodwill is deductible over 15 years. Assume an applicable tax rate of 40 percent:

**Analysis/Conclusion:**

<table>
<thead>
<tr>
<th>Component-1 Goodwill</th>
<th>Component-2 Goodwill</th>
<th>Book Basis</th>
<th>Tax Basis</th>
<th>Deferred Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance at acquisition date</strong></td>
<td></td>
<td>$ 900</td>
<td>$ 300</td>
<td>$1,200</td>
</tr>
<tr>
<td><strong>Tax amortization</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balance before impairment test</strong></td>
<td></td>
<td>900</td>
<td>300</td>
<td>1,200</td>
</tr>
<tr>
<td><strong>Impairment loss</strong></td>
<td></td>
<td>(300)</td>
<td>(100)</td>
<td>(400)</td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td></td>
<td>$ 600</td>
<td>$ 200</td>
<td>$ 800</td>
</tr>
</tbody>
</table>

The goodwill impairment loss of $400 million is allocated proportionately to component-1 and component-2 book goodwill based on their relative carrying amounts. Deferred taxes represent the temporary difference between component-1 goodwill and its tax basis multiplied by the applicable tax rate. The deferred tax asset of $24 million ($600 – $660) x 40%) would be subject to a valuation allowance if its recovery is not more-likely-than-not. No tax benefit is recorded for the component-2 goodwill impairment, because there is no current or future tax benefit associated with the component-2 book goodwill. In connection with recording the goodwill impairment loss of $400 million, Company A would record a tax benefit of $120 million.
If a deferred tax asset was recorded on the acquisition date for excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes (i.e., component-2 goodwill), subsequent impairment charges may (i) increase an existing or create a new deferred tax asset, or (ii) decrease or eliminate a deferred tax liability that was created subsequent to the acquisition through the amortization of tax-deductible goodwill.

Example 10-19 illustrates the tax effect of a goodwill impairment loss when there is excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition.


Background/Facts:
Company A acquired a business in a nontaxable transaction and accounted for the acquisition under ASC 805. At the acquisition date, Company A has goodwill for financial reporting purposes of $400 and tax-deductible goodwill of $900 (carried over from a prior acquisition). A deferred tax asset (DTA) for the excess tax-deductible goodwill of $200 is recorded at the acquisition date. The DTA (using a 40 percent tax rate) and resulting financial reporting goodwill were computed by applying the iterative calculation described in Section TX 10.7.2. The tax goodwill is deductible ratably over 10 years. In year 4, Company A performs its annual goodwill impairment tests and concludes that the goodwill for reporting unit X suffered an impairment loss of $200.

Analysis/Conclusion:
When a DTA is recorded on the acquisition date for excess tax-deductible goodwill, subsequent impairment charges will cause a remeasurement of deferred taxes.

In this example, activity for years 1–4 is presented below (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial Goodwill</th>
<th>Tax Basis Goodwill</th>
<th>Annual Tax Amortization</th>
<th>Deferred Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>At Acquisition</td>
<td>$400</td>
<td>$900</td>
<td>—</td>
<td>$200</td>
</tr>
<tr>
<td>Year 1</td>
<td>400</td>
<td>810</td>
<td>90</td>
<td>164</td>
</tr>
<tr>
<td>2</td>
<td>400</td>
<td>720</td>
<td>90</td>
<td>128</td>
</tr>
<tr>
<td>3</td>
<td>400</td>
<td>630</td>
<td>90</td>
<td>92</td>
</tr>
<tr>
<td>4</td>
<td>400</td>
<td>540</td>
<td>90</td>
<td>56</td>
</tr>
<tr>
<td>Book Impairment Loss</td>
<td>(200)</td>
<td>—</td>
<td>—</td>
<td>80</td>
</tr>
<tr>
<td>Post-Impairment Carrying Amount (Year 4)</td>
<td>$200</td>
<td>$540</td>
<td>—</td>
<td>$136</td>
</tr>
</tbody>
</table>

In general, when tax-deductible goodwill exceeds goodwill for financial reporting purposes, the decrease in tax basis from tax amortization first reduces the DTA recorded on the acquisition date before creating a DTL. The goodwill impairment loss reduces the carrying amount of book goodwill. There is no component-2 book goodwill, so there is no need to allocate the impairment between components. In this

(continued)
example, the book basis impairment loss reduces the carrying amount of goodwill for financial reporting purposes and results in an increase in the existing DTA. The resulting post-impairment DTA of $136 (($200 – $540) x 40%) would require a valuation allowance if its realization is not more-likely-than-not.

In contrast, an impairment loss in later years may reduce an existing DTL. For example, assume reporting unit X suffered a $200 impairment loss in year 8.

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial Goodwill</th>
<th>Tax Basis Goodwill</th>
<th>Annual Tax Amortization</th>
<th>Deferred Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>At Acquisition</td>
<td>$400</td>
<td>$900</td>
<td>$—</td>
<td>$200</td>
</tr>
<tr>
<td>Year 1</td>
<td>400</td>
<td>810</td>
<td>90</td>
<td>164</td>
</tr>
<tr>
<td>2</td>
<td>400</td>
<td>720</td>
<td>90</td>
<td>128</td>
</tr>
<tr>
<td>...</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>400</td>
<td>270</td>
<td>90</td>
<td>(52)</td>
</tr>
<tr>
<td>8</td>
<td>400</td>
<td>180</td>
<td>90</td>
<td>(88)</td>
</tr>
<tr>
<td>Book Impairment Loss</td>
<td>(200)</td>
<td>—</td>
<td>—</td>
<td>80</td>
</tr>
<tr>
<td>Post-Impairment Carrying Amount (Year 8)</td>
<td>$200</td>
<td>$180</td>
<td>$—</td>
<td>$ (8)</td>
</tr>
</tbody>
</table>

In this case, the $200 million book basis impairment loss reduces the carrying amount of goodwill for financial reporting purposes, and reduces the existing DTL from $88 to $8.

**10.7.8 Disposal of Goodwill**

In many jurisdictions goodwill is associated with the stock of a specific legal entity, whereas for book purposes goodwill is associated with a reporting unit. The reporting unit may include several legal entities or be limited to a portion of a legal entity. This can result in differences between the book and tax accounting for goodwill upon the disposal of a business. If the disposed business is a legal entity, any tax-deductible goodwill associated with that entity would be included in the determination of the taxable gain or loss. If the disposed operations are a business, ASC 350-20-35-52 requires the allocation of a reporting unit’s goodwill to (1) the business that was disposed of and (2) the remaining parts of the reporting unit, based on their relative fair values on the date of disposal. Once goodwill is characterized as component-1 or component-2, it retains this characterization as long as a reporting entity retains that goodwill. Therefore, upon disposal of a business that includes some or all of a reporting entity’s goodwill, a deferred tax adjustment would generally be required for disposal of component-1 but not for disposal of component-2 goodwill. Examples 10-20 and 10-21 illustrate the disposal of a business, including a portion of component-1 goodwill, resulting in a deferred tax adjustment to the reporting entity. Example 10-22 illustrates the disposal of a business, including a portion of component-2 goodwill, resulting in no deferred tax adjustment to the reporting entity.
Example 10-20: Disposal of Tax-Deductible Goodwill with Retention of Book Goodwill

Background/Facts:
Entity A acquired Entity B in a taxable business combination (i.e., Entity A treated the purchase as an asset acquisition for tax purposes), which gave rise to book and tax-deductible goodwill in equal amounts of $100. The business of Entity B and the associated goodwill are fully integrated into one of Entity A’s reporting units. In a later period, Entity A decides to dispose of the shares of Entity B, including Entity B’s operations. For tax purposes, the entire remaining tax-deductible goodwill of $70 ($100 initial basis less assumed tax amortization of $30) is included in the disposal. For book purposes, goodwill of $20 is allocated on a relative fair value basis to the disposed operation. As a result, $80 of the book goodwill is retained by the surviving reporting unit within Entity A ($100 initial value less $20 included in the disposed operation).

Analysis/Conclusion:
The disposal will result in a basis difference in the goodwill retained by Entity A, with book goodwill exceeding tax-deductible goodwill by $80. This gives rise to a deferred tax liability for the entire $80 taxable basis difference (i.e., Entity A compares nil tax-deductible goodwill to book goodwill of $80).

Example 10-21: Disposal of Book Goodwill with Retention of Tax-Deductible Goodwill

Background/Facts:
Entity A from the above example instead disposes of a significant portion of its operations but not its shares in Entity B. For tax purposes, the goodwill associated with the shares of Entity B would remain with Entity A. For book purposes, $80 of goodwill is allocated to the disposed operations on a relative fair value basis and included in the determination of the disposal gain or loss. Book goodwill of $20 remains in the reporting unit.

Analysis/Conclusion:
The disposal of component-1 goodwill will result in a basis difference in goodwill retained by Entity A, consisting of the remaining tax goodwill ($70) exceeding book goodwill ($20) by $50, which will give rise to a deferred tax asset (subject to the measurement criteria of ASC 740).


Background/Facts:
Entity A acquired Entity B in a nontaxable business combination. For tax purposes, the transaction resulted in a carryover basis in Entity B’s assets and liabilities. Because the tax basis carried over, and Entity B’s assets for tax purposes did not contain any tax-deductible goodwill, all of the goodwill recorded in purchase accounting was component-2 book goodwill (as defined in ASC 805-740-25-9).

(continued)
Entity B was subsequently integrated into Reporting Unit 2, and, as a result, Entity B's goodwill was combined with the rest of Reporting Unit 2's goodwill. Entity A's structure is as follows:

In the current year, Entity A sold Business 3, which includes Entity B. The goodwill in Reporting Unit 2 was allocated to Business 3, based on the relative fair value of Business 3 and the retained operations of Reporting Unit 2, pursuant to ASC 350-20-35-53. This resulted in only a small amount of book goodwill being allocated to Business 3. Entity A had a significantly larger tax basis in Business 3, in large part due to Entity A's acquisition cost for Entity B's shares. The difference between the book and tax goodwill included in the measurement of the book and tax gain or loss produces a small gain for book purposes and a significant loss for tax purposes. The current tax benefit from the transaction has a disproportionate impact on the current-year effective tax rate.

**Question:**
Should Entity A record a deferred tax liability for the excess of book over tax goodwill remaining in Reporting Unit 2?

**Analysis/Conclusion:**
No deferred tax liability should be recognized in this instance. If for book purposes there is goodwill, with no tax basis, a deferred tax liability would not be recorded, pursuant to ASC 740-10-25-3(d). On the date Entity A acquired Entity B, the entire amount of book goodwill was classified as component-2 goodwill, because there was no tax goodwill in the transaction, and no deferred tax liability was recorded. The fact that only a portion of that goodwill was subsequently attributed to Entity B when it was disposed of does not change that characterization. Thus, the goodwill remaining in Reporting Unit 2 after the sale of Entity B continues to be component-2 goodwill for which no deferred tax liability would be recorded.
10.7.9 Bargain Purchase

Bargain purchase refers to a situation where the fair value of the net assets acquired exceeds the fair value of consideration transferred. Such excess is sometimes referred to as “negative goodwill.” In these situations the acquirer must reassess whether it has correctly identified all of the assets acquired and liabilities assumed and review the procedures used to measure the components of the acquisition to ensure all available evidence as of the acquisition date has been considered. The aggregate amount of fair value assigned to the acquired net assets may, after this review, still exceed the acquisition consideration and result in a bargain purchase gain (ASC 805-30-25-2).

The tax rules for each separate jurisdiction may require a different treatment for bargain purchases than that required under ASC 805. Tax rules often require the allocation of negative goodwill to certain assets through the use of the residual method, resulting in decreased tax bases. In the United States, for example, for tax purposes, the acquisition price is assigned to assets categorized in seven distinct asset classes, first to the assets in Class I and then successively through to Class VII. The consideration transferred is not allocated to a successive class until it has been allocated to the assets in the previous class based on their full fair values. This methodology can result in several classes of assets without tax bases and in temporary differences for a significant portion of all assets. The allocation of negative goodwill to reduce the tax bases of acquired net assets causes the book bases to exceed their respective tax bases, resulting in the recognition of deferred tax liabilities. The recognition of deferred tax liabilities then results in a reduction in the bargain purchase gain for financial reporting, and may result in the recognition of goodwill. Example 10-23 illustrates the recording of deferred tax balances in a bargain purchase situation.

Example 10-23: Recording Deferred Tax Balances in a Bargain Purchase (U.S. Tax Jurisdiction)

Background/Facts:
Company A acquires Company B in a taxable acquisition. Total acquisition consideration amounted to $230 million, and the acquired fair value of the net assets equal $290 million, which results in the following allocation (in millions). Assume an applicable tax rate of 40 percent.

Analysis/Conclusion:

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class I – Cash</td>
<td>$ 50</td>
<td>$ 50</td>
</tr>
<tr>
<td>Class II – CDs</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Class III – Accounts receivable</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Class IV – Inventory</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Class V – Tangible Property</td>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td>Class VI – Intangibles</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Class VII – Goodwill</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$290</td>
<td>$230</td>
</tr>
</tbody>
</table>

(continued)
Further, assuming tangible property consists of three pieces of equipment, their new tax bases would be determined as follows (in millions):

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Book Value</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>B</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>C</td>
<td>25</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>30</td>
</tr>
</tbody>
</table>

For financial statement purposes, this transaction is a bargain purchase. Therefore, the assets are recorded at their fair value determined under ASC 805, and the bargain element of the transaction is recorded in earnings (ASC 805-30-25-2). The differences between the book and tax bases of the net assets acquired result in the recognition of deferred tax liabilities of $24 million (($290 – $230) x 40% tax rate). Therefore, the total amount of net assets recorded in acquisition accounting is $266 million ($290 – $24). The bargain purchase gain would be calculated as follows (in millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of net assets acquired</td>
<td>266</td>
</tr>
<tr>
<td>Less: Consideration transferred</td>
<td>(230)</td>
</tr>
<tr>
<td>Bargain purchase gain</td>
<td>361</td>
</tr>
</tbody>
</table>

1 The bargain purchase gain is reflected in earnings.

### 10.8 Recording the Tax Effects of Transactions with Noncontrolling Shareholders

Once a parent controls a subsidiary, changes can occur in the ownership interests in that subsidiary that do not result in a loss of control by the parent. If changes occurring in a parent’s ownership interest after control is obtained do not result in a change in control of the subsidiary, those changes should be accounted for as equity transactions (ASC 810-10-45-23).

A noncontrolling interest (NCI) is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. In a transaction that results in a change in the parent’s ownership interest while the parent retains its controlling financial interest, the carrying amount of the NCI is adjusted to reflect the change in its ownership interest in the subsidiary’s net assets. Any difference between the fair value of the consideration received or paid and the amount by which the NCI is adjusted, is recognized in equity attributable to the parent (ASC 810-10-45-23).

The parent’s ownership interest in a subsidiary may change as a result of a variety of transactions while the parent retains its controlling financial interest. For example, a parent may purchase some of the subsidiary’s shares or sell some of the shares that it holds, a subsidiary may reacquire some of its own shares, or a subsidiary may issue additional shares. See Chapter BCG 6 of the PwC publication *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests* for further discussion of the accounting for transactions with noncontrolling shareholders.

The direct tax effect of a transaction with noncontrolling shareholders that does not cause a change in control is generally recorded in equity (ASC 740-20-45-11(c)). However, care should be taken to distinguish between direct and indirect tax effects, because the treatment in the financial statements may differ for each, and sometimes the tax effect of a transaction comprises both direct and indirect components. For purposes of this section of the Guide, direct effects are those resulting from application of the relevant tax law to the transaction. Direct effects
do not include those resulting from a change in an accounting assertion, election or assessment even though such a change may have been undertaken by the reporting entity in contemplation of the transaction. The remainder of this section discusses the accounting for direct and indirect tax effects of transactions with noncontrolling shareholders.

10.8.1 Direct Tax Impact of a Transaction with Noncontrolling Shareholders

The direct tax effect, net of any related valuation allowance, of a transaction with noncontrolling shareholders that does not cause a change in control is generally recorded in equity (ASC 740-20-45-11(c)). Subsequent release of the related valuation allowance would also be recorded in equity. Example 10-24 illustrates the recording of a direct tax effect of a transaction with noncontrolling shareholders.

Example 10-24: Recording the Direct Tax Effect of a Transaction with Noncontrolling Shareholders

**Background/Facts:**
Parent owns 100 percent of Company B, which has net assets of $200 million. Parent’s tax basis in its investment in Company B is $200 million (equal to the book basis). Company B issues additional shares to Company C, an unaffiliated third party, for cash of $80 million. The issuance of the additional shares dilutes Parent’s interest to 80 percent. After issuance of the additional shares, the ownership interests in the net assets of Company B are as follows (in millions). Assume an applicable tax rate of 40 percent.

**Analysis/Conclusion:**

<table>
<thead>
<tr>
<th></th>
<th>Total Net Assets</th>
<th>Ownership Interest</th>
<th>Net Assets Attributable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent – consolidated</td>
<td>$280(^1)</td>
<td>80%</td>
<td>$224</td>
</tr>
<tr>
<td>Company C</td>
<td>280</td>
<td>20</td>
<td>56</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td></td>
<td>100% $280</td>
</tr>
</tbody>
</table>

\(^1\) $200 + $80 proceeds = $280.

The transaction would result in the following impact in the consolidated financial statements, before consideration of income taxes (in millions):

- Dr Cash $80
- Cr NCI $56
- Cr Equity 24

Assume the transaction is not a current taxable event to Parent. The transaction caused a $24 million increase in the book basis of Parent’s investment in Company B, but no change in the tax basis, thus creating a taxable temporary difference.

Unless Parent can establish its intent and ability to indefinitely delay reversal of the difference, Parent would record a DTL for the taxable temporary difference. Since the

(continued)
transaction is recorded directly in equity, the tax effect of the transaction, assuming a 40 percent tax rate, is also recorded directly in equity, as follows (in millions):

\[
\begin{array}{ll}
\text{Dr Equity} & $9.6^2 \\
\text{Cr DTL} & $9.6 \\
\end{array}
\]

\[\text{2 } $224 \text{ book basis } - $200 \text{ tax basis } \times 40\% = $9.6.\]

### 10.8.2 Indirect Tax Impacts of a Transaction with Noncontrolling Shareholders

It is important to distinguish between direct and indirect tax effects, because the treatment in the financial statements may differ for each. For example, the purchase by a parent company of an additional interest in a controlled subsidiary may allow the parent for the first time to file a consolidated tax return. The ability to file a consolidated tax return may allow the company to change its assessment regarding its ability to realize existing deferred tax assets, causing the company to release all or a portion of its valuation allowance. Even though a transaction with noncontrolling shareholders may have caused the change in circumstances that allows the parent to realize (or conclude it may not realize) its deferred tax assets in the future, the change in valuation allowance results from a change in management’s assessment regarding the realization of deferred tax assets and is, therefore, an indirect effect of the transaction. The tax effect of a change in judgment about the realisation of deferred tax assets in future years is generally reflected in earnings, but is subject to the intraperiod allocation requirements (ASC 740-20-45-8(a)).

Some transactions may cause a direct and an indirect tax effect. Example 10-25 illustrates the recording of the direct and indirect tax effects of a transaction with noncontrolling shareholders.

### Example 10-25: Recording the Tax Effects of a Transaction with Noncontrolling Shareholders

**Background/Facts:**
Parent owns and controls 100 percent of Company B, which is domiciled in a foreign jurisdiction. Parent's book basis and tax basis in its investment in Company B is $300 million and $200 million, respectively. The difference between the book basis and tax basis is attributable to undistributed earnings of Company B. Parent has not historically recorded a deferred tax liability on the taxable temporary difference because of its intent and ability to indefinitely delay reversal of the difference. Parent sells 20 percent of Company B for $250 million. The sale of Parent’s investment is taxable at a rate of 40 percent.

**Analysis/Conclusion:**
The transaction would result in the following impact in the consolidated financial statements, before consideration of income taxes (in millions):

\[
\begin{array}{ll}
\text{Dr Cash} & $250 \\
\text{Cr NCI} & $60^1 \\
\text{Cr Equity} & 190 \\
\end{array}
\]

\[\text{1 } \text{Book basis of } $300 \times 20\% = $60.\]

(continued)
Parent’s current tax consequence from the tax gain on sale of its investment in Company B is $84 million (($250 selling price – ($200 tax basis x 20% portion sold)) x 40% tax rate). The total tax consequence of $84 million comprises two components:

1. $8 million, which is the difference between the book basis and the tax basis (i.e., undistributed earnings of Company B) of the portion sold (($300 book basis – $200 tax basis) x 20% portion sold x 40% tax rate). This component is an indirect tax effect of the transaction. The tax consequence results from a change in assertion regarding the indefinite delay of the reversal of the outside basis difference, which is triggered by the decision to sell a portion of the investment in Company B. The outside basis difference is attributable to undistributed earnings of Company B and the tax effect of the change in assertion related to the outside basis difference is recorded in earnings (ASC 740-30-25-19).

2. $76 million, which is the difference between the selling price and the book basis for the portion sold (($250 selling price – ($300 book basis x 20% portion sold)) x 40% tax rate). This second component represents the economic gain on the sale and is a direct tax effect of the transaction. Because the difference between fair value and carrying amount of NCI is recorded in equity, the direct tax effect should also be recorded in equity.

The tax consequences are recorded as follows (in millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Income tax expense</td>
<td>$81</td>
</tr>
<tr>
<td>Dr Equity</td>
<td>762</td>
</tr>
<tr>
<td>Cr Current tax payable</td>
<td>$843</td>
</tr>
</tbody>
</table>

1. ($300 book basis – $200 tax basis) x 20% x 40% = $8.
2. ($250 selling price – $60 book basis) x 40% = $76.
3. ($250 selling price – $40 tax basis) x 40% = $84.

The change in assertion related to the indefinite delay of the reversal of the outside basis difference will impact the effective tax rate in the period in which the change occurs.

Recording a tax related to unremitted earnings of the foreign subsidiary is a change in assertion regarding indefinite reinvestment and is generally recorded in continuing operations. In fact, the tax liability related to the unremitted earnings of the subsidiary may be required to be recorded in a period preceding the actual sale transaction, because the liability should be recorded when the company’s assertion regarding indefinite reinvestment changes.

In light of the disposal of a portion of the Parent’s investment in Company B, Parent should also reassess its intent and ability to indefinitely delay reversal of the remaining outside basis difference in the portion retained and assess whether a DTL should be recorded on such difference.

10.9 Transactions under Common Control

Common control transactions occur frequently, particularly in the context of group reorganizations, spin-offs, and initial public offerings. Combinations between entities that are under common control are excluded from the scope of business combinations. However, the guidance on accounting for common control transactions did not change and is carried forward in ASC 805-50.
Common control transactions are generally accounted for based on the nature of the transaction. For example, transactions involving the transfer of an asset (such as a building) are accounted for at historical carrying values. Transactions involving the transfer of a business will result in a change in reporting entity for the entity receiving the assets and require the application of the procedural guidance in ASC 805-50. Transfers of net assets, depending upon whether its nature is considered to be similar to assets or a business, will be accounted for either at historical carrying values or based on the procedural guidance. Companies will need to use judgment to determine the nature of the transaction. The accounting for common control transactions are discussed more fully in BCG Appendix A of PwC's publication A Global Guide to Accounting for Business Combinations and Noncontrolling Interests.

10.9.1 Accounting and Reporting by the Receiving Entity

10.9.1.1 Basis of Transfer

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests should initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of the transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because push-down accounting had not been applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control (ASC 805-50-30-5).

10.9.1.2 Procedural Guidance for Presenting a Change in Reporting Entity

If a transaction combines two or more commonly controlled entities that historically have not been presented together, the resulting financial statements are, in effect, considered those of a different reporting entity. This results in a change in reporting entity, which requires retrospectively combining the entities for all periods presented as if the combination had been in effect since inception of common control (ASC 250-10-45-21). Certain adjustments to the financial statements of the new reporting entity may be required. The types of adjustments that may be necessary are discussed in the procedural guidance of (ASC 805-50).

The procedural guidance, does not specifically address the accounting for the deferred tax consequences that may result from a transfer of net assets or the exchange of equity interests between entities under common control. Although such a transaction is not a pooling of interests, we believe that the historical guidance related to recording the tax effects of pooling of interests transactions should be applied by analogy. In the periods prior to the combination date, a combining entity’s deferred tax assets (e.g., operating loss carryforward) cannot offset the other entity’s taxable income unless allowed under the tax law. However, future taxable income of the combined operations subsequent to the combination date should be considered in assessing the need for a valuation allowance in the restated periods prior to the combination date. Similarly, any tax law limitations on the use of combined attributes subsequent to the transfer or exchange date should also be considered. Accordingly, in restating periods prior to the transfer or exchange, a valuation allowance against deferred tax assets that is necessary for the combined entity may be more or less than the sum of the valuation allowance in the entities’ separate financial statements.

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2 FAS 109, par. 270–271.
before the transfer or exchange. If the transfer or exchange causes any change in
the combined entities’ valuation allowance, the reduction or increase should be
recognized as part of the adjustment to restate the entities’ prior-period financial
statements on a combined basis.

For purposes of restating periods prior to the transfer or exchange, hindsight is
required to take into account (i) that the transfer or exchange has occurred and (ii) the
amount of any resulting tax law limitations on the use of carry-over tax benefits after
the transfer or exchange. However, hindsight is precluded for purposes of assessing
pre-transfer or exchange estimates of future taxable income. In other words, any
reduction in the valuation allowance for either entity’s deferred tax assets would be
reflected in the years that the deductible differences or carryforwards arose, provided
that one of the following conditions exists:

- Estimates that would have been made at the time of future combined taxable
  income (i.e., after the transfer or exchange, other than reversing differences and
carryforwards of the other entity) would have been sufficient for realization of the
delayed tax assets.

- The other entity’s taxable differences existing at that time will generate sufficient
  future post-transfer or exchange taxable income to ensure realization of the
delayed tax assets.

- A valid tax-planning strategy ensures realization of the delayed tax assets.

If none of these conditions were met in the year that the deductible differences and
carryforwards arose, the reduction in the valuation allowance will be reflected in the
first subsequent year in which one or more of these conditions are met.

In addition to adjustments that may be required to restate prior periods discussed
above, in a taxable transfer or exchange new tax bases of assets and liabilities may
be established. Because a new basis is not established for book purposes, taxable
temporary differences may be reduced or eliminated, and deductible temporary
differences may be increased or created. As of the transfer or exchange date,
the tax effects attributable to any change in tax basis (net of valuation allowance,
if necessary) should be charged or credited to contributed capital. If a valuation
allowance is provided against the deferred tax assets at the combination date, any
subsequent release of the valuation allowance should be reported as a reduction
of income tax expense and reflected in continuing operations, unless the release is
based on income recognized during the same year and classified in a category other
than continuing operations, consistent with the guidance at Section TX 12.2.2.2.3.

Example 10-26: Assessing Valuation Allowances for a Transfer of Entities Under
Common Control

Background/Facts:
Entity X controls both Entity Y and Entity Z. Entity Y acquires Entity Z in a nontaxable
acquisition in March 2005 (fiscal year-end for each entity is December 31). The
acquisition is accounted for in Entity Y’s financial statements in a manner similar to
how the entity would have accounted for a pooling of interests. Entity Y’s prior-period
financial statements will be restated retroactively for the effects of the “acquisition”
(i.e., transfer of entities under common control).

(continued)
Historically, Entity Y has been a profitable entity. Entity Z has not had a history of profitability, and before the acquisition it had a full valuation allowance for its DTAs. Following the acquisition/combination, Entity Y will file a consolidated tax return, one that includes the results of Entity Z.

**Question:**
In Entity Y’s restatement of its prior-period financial statements to include Entity Z, how should the need for a valuation allowance relative to Entity Y and Entity Z’s DTAs be assessed?

**Analysis/Conclusion:**
The DTAs should be evaluated for realizability in accordance with ASC 740 at the time of the combination and for prior periods. The fact that the companies will file a consolidated tax return for periods after the legal combination in March 2005 should be taken into consideration. By analogy to the historical guidance on recording the tax effects of pooling-of-interest transactions, in determining the need for a valuation allowance for prior periods, the estimated combined future taxable income of Entity Y and Entity Z after their legal combination in March 2005 should be considered. If the valuation allowance is reduced as a result of the common control transaction, the reduction should be recorded as a decrease in income tax expense in the period that it became apparent that future taxable income could be a source of recovery (i.e., potentially a period prior to the period of the actual legal combination/transfer). In determining the appropriate period for reversal, hindsight is precluded for purposes of assessing estimates of future taxable income.

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**10.10 Other Considerations**

**10.10.1 Asset Acquisitions and Nonmonetary Exchanges**

The acquisition of an asset or group of assets that does not meet the definition of a business is accounted for as an asset acquisition. Such assets may be acquired through a monetary or nonmonetary exchange transaction. Typically in a monetary exchange, the book and tax basis of the asset acquired are equal at the transaction date. Therefore, there is no deferred tax to record. Even if there is an acquired temporary difference (i.e., the book and tax basis differ at the transaction date) there would generally be no immediate income tax expense (ASC 740-10-25-51). For example, consider an asset acquired by purchasing the shares of an entity (not a business) in which the tax basis of the asset is lower than the price paid to acquire the shares and carries over to the acquirer. The resulting deferred tax liability is recognized by increasing the recorded amount of the asset. This accounting increases the deferred tax liability, which further increases the asset. To address the iterative effect, the deferred tax liability can be determined by using a “simultaneous equations method.”

Assets acquired through a nonmonetary exchange may result in a temporary difference, generally giving rise to a deferred tax liability due to differences in book and tax basis. For example, consider a transaction whereby the tax law provides for the acquirer's tax on the exchange transaction to be deferred and the acquirer's tax basis in the asset disposed carries over to be the tax basis in the asset received (e.g., a like-kind exchange). A deferred tax liability should be recorded because the basis difference does not arise from the acquired asset's initial recognition, but instead arises because of the deferral of the tax on the asset disposed. As a result, the tax effect flows through the income statement in the same period as the accounting gain.

Example 10-27 illustrates the income tax accounting for a tax-free exchange of nonmonetary assets.
**Example 10-27: Income Tax Accounting for a Tax-Free Exchange of Nonmonetary Assets**

**Background/Facts:**
Entity X acquires Asset B in exchange for Asset R. The fair value of Asset B is $150. The carrying value of Asset R is $100 and the tax basis is $80, resulting in an existing deferred tax liability of $8 (assuming a 40 percent tax rate). For tax purposes, the transaction is structured such that Entity X can defer the taxable gain on the exchange. The tax basis in Asset R of $80 will become the tax basis in Asset B. Assume that the nonmonetary exchange has commercial substance, and is not an exchange transaction to facilitate sales to customers. Therefore, the exchange is measured at fair value.

**Analysis/Conclusion:**
Entity X records a gain of $50 on disposal of Asset R (based on the difference in the fair values of Asset B and Asset R) and a corresponding DTL of $20 on the gain.

Entity X records the following entries on the transaction date:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Asset B</td>
<td>$150</td>
</tr>
<tr>
<td>Dr Income Tax Expense</td>
<td>$101</td>
</tr>
<tr>
<td>Cr Asset R</td>
<td>$100</td>
</tr>
<tr>
<td>Cr Gain on Sale</td>
<td>$50</td>
</tr>
<tr>
<td>Cr DTL</td>
<td>$20</td>
</tr>
</tbody>
</table>

1 Gain on sale of $50 x 40% = $20.

The total DTL related to Asset B is $28 (($150 book basis – $80 tax basis) x 40% = $28). The above entry increases the DTL from $8 to $28.

The accounting for asset acquisitions that are not business combinations is discussed in BCG Appendix C of PwC’s publication *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests*.

**10.10.2 Fresh Start Accounting**

A company emerging from bankruptcy that prepares financial statements in accordance with ASC 852 Reorganizations (ASC 852) (i.e., “fresh-start” accounting), might have recorded a valuation allowance against its deferred tax assets at the plan confirmation date. Under ASC 852-740-45-1, the benefit from releasing a valuation allowance related to preconfirmation deferred tax assets after the plan confirmation date is recorded as a reduction to income tax expense. Similarly, adjustments to uncertain tax positions made after the confirmation date should generally be recorded in earnings (in income tax expense), consistent with the guidance for business combinations. PwC’s *Guide to Accounting for Bankruptcies and Liquidations* provides additional guidance on the topic.

**10.10.3 LIFO Inventories Acquired in a Nontaxable Business Combination**

Temporary differences that arise from last-in, first-out (LIFO) inventories are not an exception to the basic principles of ASC 740. However, accounting for deferred taxes on LIFO inventories may present some unique issues in the context of a business combination. Example 10-25 illustrates how LIFO inventories acquired
in a nontaxable business combination would be reflected in the acquiring entity's financial statements and U.S. federal income tax return when the separate LIFO pools of each entity are combined or combinable for tax purposes. Less complex and more common situations are cases in which the acquired entity is not liquidated into the acquiring entity, and cases in which the LIFO inventories consist of dissimilar products and thus are not combined.

Example 10-28: Inventories Acquired in a Nontaxable Business Combination

Entity P and Entity S use the LIFO-inventory cost method. Entity P acquires Entity S in 1996 in a nontaxable business combination. For federal income tax purposes, the historical LIFO cost basis of the inventory of Entity S survives the acquisition.

Entity S is immediately liquidated into Entity P, and its entire operations are combined with Entity P. The inventories of Entity P and Entity S are similar (both largely consist of Product A), and will be treated as a single pool.

Assume the following facts about Product A:

- Entity S and Entity P have 10 units and 80 units, respectively, of Product A on hand on the acquisition date.
- In acquisition accounting, one unit of Product A inventory was valued at $10.

The table below presents (1) “Product A inventory by LIFO layer” held by Entity P and Entity S before Entity S’s liquidation, and (2) the “combined Product A inventory by LIFO layer” held by Entity P after liquidating Entity S:

<table>
<thead>
<tr>
<th></th>
<th>Financial Statements</th>
<th>Income Tax Return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Units</td>
<td>Amount</td>
</tr>
<tr>
<td><strong>Entity P</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base 1964</td>
<td>60</td>
<td>$360</td>
</tr>
<tr>
<td>Layer 1990</td>
<td>20</td>
<td>160</td>
</tr>
<tr>
<td>Total</td>
<td>80</td>
<td>$520</td>
</tr>
<tr>
<td><strong>Entity S</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base 1989</td>
<td>6</td>
<td>42</td>
</tr>
<tr>
<td>Layer 1992</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>Layer 1996</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>Total</td>
<td>10</td>
<td>78</td>
</tr>
<tr>
<td><strong>Entity P (after liquidating Entity S)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base 1964</td>
<td>60</td>
<td>$360</td>
</tr>
<tr>
<td>Layer 1989</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Layer 1990</td>
<td>20</td>
<td>160</td>
</tr>
<tr>
<td>Layer 1992</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Layer 1996</td>
<td>10</td>
<td>100(^1)</td>
</tr>
<tr>
<td>Total</td>
<td>90</td>
<td>$620</td>
</tr>
</tbody>
</table>

\(^1\) On the acquisition date, the LIFO inventories of Entity S are reflected in Entity P’s financial statements as one layer, at a fair value of $10 per unit.

\(^2\) For federal income tax purposes, the acquired LIFO inventories are carried over at the same LIFO basis and LIFO layers. Under ASC 740, a deferred tax liability would be recognized in acquisition accounting for the excess of book value for LIFO inventories over the tax basis.
On the acquisition date of a nontaxable business combination, the financial statement carrying value for acquired assets (e.g., property, plant and equipment) will generally exceed the carryover tax basis. This situation can create additional differences between book and tax. For example, a higher value for property, plant and equipment for book over tax will create higher depreciation costs for book over tax. If that depreciation is included in the cost of inventory, then the cost of inventory in periods subsequent to the acquisition will be higher for book than for tax.

10.11 Questions and Answers—Additional Implementation Guidance

Measuring Acquiree’s and Acquirer’s Deferred Taxes

10.11.1 Question 1: If an acquiree’s unborn foreign tax credits reduce the amount of the acquirer’s deferred tax liability on its outside basis differences, where are the effects recorded?

Answer: The tax effects of unborn foreign tax credits are recorded outside of acquisition accounting. An acquirer might have a deferred tax liability for an investment in a foreign subsidiary. In measuring such deferred tax liability, the acquirer considers the expected manner of recovery (e.g., dividends, liquidation). The tax rate used to measure the liability should reflect any applicable deductions, credits or withholding tax.

An acquirer may have “unborn” foreign tax credits (FTCs). That is, foreign taxes that have been paid or accrued by the foreign subsidiary but which are not yet eligible as a credit to the parent because the earnings remittance, or other tax triggering event, has not yet occurred. These unborn FTCs do not currently exist as a separate tax asset, but will be generated upon reversal of an outside basis difference (e.g., remittance of earnings). If the acquiree’s unborn FTCs change the measurement of the acquirer’s deferred tax liability on its outside basis differences, the reduction in the acquirer’s deferred tax liability is recorded outside of acquisition accounting.

The result is different if the FTCs have been generated and exist as a separate tax asset of the acquiree. For example, an acquiree may have a deferred tax asset for FTC carryforwards (i.e., for credits that have already been generated). The deferred tax asset is recorded in acquisition accounting. In this situation, even though the FTC carryforwards may reduce the amount of tax paid when the acquirer’s taxable temporary difference reverses, the FTC carryforward is a separate tax asset acquired in the business combination, and therefore, should be reflected in acquisition accounting. This is true even if the acquiree previously had a valuation allowance against the FTC carryforward deferred tax asset but the acquirer determines a valuation allowance is not required.

10.11.2 Question 2: If an acquirer’s unborn foreign tax credits reduce an acquiree’s outside basis difference, where are the effects recorded?

Answer: The tax effects of an acquirer’s unborn foreign tax credits are recorded in acquisition accounting. An acquirer may have “unborn” FTCs (See Section TX 10.11.1) that are used in measuring deferred taxes on outside basis differences. The impact of the unborn FTCs should be considered in measuring the acquiree’s deferred tax liability which is recorded in acquisition accounting.

The result is different if the FTCs have been generated and exist as a separate tax asset. For example, the benefit from releasing a valuation allowance against an acquirer’s deferred tax asset for FTC carryforwards (i.e., for credits that have already
been generated) is recorded outside of acquisition accounting. The distinction is that FTC carryforwards are a separate tax return attribute for which a deferred tax asset is recorded, whereas an unborn FTC is not a separate tax asset and is only considered in measuring other deferred taxes (e.g., an acquiree’s outside basis difference).

10.11.3 Question 3: Are there circumstances when the effects of tax elections and post-acquisition transactions can be recognized as part of the acquired net assets recorded in acquisition accounting rather than recognized outside of acquisition accounting?

Answer: Business combinations often involve a considerable amount of business, legal and tax planning. Tax effects can arise from events ranging from tax-specific elections to more complex reorganizations and business integration actions. These events may alter income taxes expected to be incurred on recovery of acquired temporary differences. The question that often arises is whether to account for the tax effects of such events in acquisition accounting.

The fair value accounting guidance in the business combination standard is based upon market participant assumptions, under which the effects of buyer-specific decisions and transactions are generally excluded from acquisition accounting. However, the standard excludes income taxes from the fair value recognition and measurement accounting. In accounting for income taxes in acquisition accounting, the requirements in ASC 740 must be followed [ACS 805-20-25-16 through 25-17, ASC 805-740-25-2 and ACS 805-740-30-1].

ASC 740 provides the recognition and measurement framework for income taxes. There is, however, no direct guidance that addresses whether the tax effects of elections or post-acquisition transactions should be included in acquisition accounting and practice in this area is evolving. We believe a buyer’s expected manner of recovery should be considered in the recognition and measurement of deferred taxes relating to acquired temporary differences. This requires consideration of specific facts and circumstances, and the relevant tax laws, to determine whether the tax effects of a particular event should be recorded in acquisition accounting.

The decision might be straightforward when, for example, the seller and buyer agree to make a tax election to treat a share purchase as an asset purchase for tax purposes, thus providing a step-up in the inside tax bases of acquired assets. The buyer is thus able to acquire, through deal negotiation, assets with stepped-up tax bases and should account for the tax election effects in acquisition accounting. However, often the decision is not straightforward and, in those circumstances, consultation with the Accounting Services Group within PwC’s National Professional Services Group should be considered.

We believe the following factors should generally be considered:

• Whether the election or transaction is available and contemplated as of the acquisition date, or within the measurement period though based on information and facts that existed at the acquisition date.

• Whether the election or transaction is primarily within the acquirer’s control with no significant complexities or uncertainties as to whether the transaction will actually be completed.

• Whether the acquirer is required to make a payment (separate from consideration exchanged for the business) or forgo tax attributes to obtain the tax benefits; in
This regard, the mere realization, or settlement of an acquired deferred tax liability is not considered a separate payment.

- Whether other significant costs will be incurred to implement the transaction.

For tax effects to be recorded in acquisition accounting, the election or transaction should be known or knowable and considered as of the acquisition date (even if the final decision to implement it occurs after the acquisition date). This might include, for example, transactions that the seller initiated or started prior to the acquisition which the buyer intends to complete. Actions that are based on information that was not known or knowable, or circumstances that did not exist as of the acquisition date are based upon new information and their effects should be accounted for outside of acquisition accounting. Acquisition accounting effects must also be primarily within the acquirer's control. If implementation is contingent on obtaining third-party approval (including a tax ruling) or meeting legal or regulatory requirements, it generally is not primarily within the acquirer's control. If a separate payment (or sacrifice of tax attributes) is required to obtain tax benefits the effects would generally be recorded outside of acquisition accounting. If significant costs other than payment to a taxing authority must be incurred to implement the transaction it may indicate that, consistent with the expensing of such costs, the tax effects should also be expensed.

It is also important to distinguish transactions that occur after the measurement period from those that are substantially completed within measurement period. The tax effects of the former would generally be recognized outside of acquisition accounting, while tax effects of the latter would be recognized in acquisition accounting assuming the guidelines set forth above were supportive.

In cases where a step-up in basis of tax-deductible goodwill is obtained through a transaction that occurs after the measurement period, a deferred tax asset is recorded if the new tax basis exceeds the book basis in the goodwill (ASC 740-10-25-54) (a deferred tax liability is not recorded if the book basis exceeds the new tax basis). We are aware of another acceptable view under which the newly arising tax goodwill is viewed as a separate unit of account and is not compared to the pre-existing book goodwill. Under that view, a deferred tax asset is recorded through the income tax provision for the full tax basis, subject to the deferral provisions related to intra-entity asset transfers (ASC 740-10-25-3(e)). The view applied for such a tax basis step-up in goodwill constitutes an accounting policy that should be followed consistently in similar circumstances.

Note that certain post-acquisition transactions might involve a transfer of intellectual property (IP) acquired in a nontaxable stock acquisition to an IP holding entity. These transactions might result in current tax based upon the IP's fair market value on the transfer date or future tax based on future income derived from the IP. Sometimes the IP transfer value determined for tax purposes includes goodwill value and the question is whether it is appropriate to recognize a deferred tax liability in excess of the otherwise determined deferred tax liability on the acquired taxable temporary difference in the IP. We believe that recognition of an acquired deferred tax liability in excess of the underlying acquired taxable difference is prohibited under ASC 740 as it would be tantamount to recognition of a deferred tax liability on acquired non-deductible goodwill. The additional tax (over and above the acquired deferred tax liability) should be recognized through the income tax provision no sooner than the transfer period, subject to the tax recognition exception for intra-entity transfers of assets (ASC 740-10-25-3(e)).
For additional guidance related to the foregoing topics, refer to:

- TX 2.3.4.1.3 for discussion of the accounting for intra-entity IP migration arrangements;
- TX 8.6.3 for discussion of the accounting for a change in tax status as part of a business combination;
- TX 10.4.2 for discussion of expected manner of recovery and implications on tax payable from the recovery of acquired assets;
- TX 10.4.3 and Example 10-2 for discussion of the accounting for outside basis differences and indefinite reinvestment assertion; and
- TX 10.11.2 for discussion of the accounting for acquirer’s unborn foreign tax credits and their effect on measurement of acquired deferred tax liabilities.

Examples 10-29 and 10-30 illustrate the above guidance on accounting for tax effects of certain post-acquisition elections and transactions. (Example 10-2 illustrates application of deferred tax recognition and measurement to an acquired outside basis difference when an acquirer implements an IRC Section 304 restructuring following a business combination).

**Example 10-29: Accounting for Income Tax Effects of a Tax-Free Merger Occurring Within the Acquisition Accounting Measurement Period**

**Background/Facts:**
Company X, a US multinational, has acquired, through a wholly-owned acquisition holding company in Brazil, the stock of Company Y, a foreign company domiciled in Brazil. The acquisition, accounted for under the business combination standard, is treated as a nontaxable acquisition in Brazil, and Company Y's tax bases carry over to the holding company.

Pursuant to Brazilian tax law, affiliated entities located in Brazil can do a merger to combine legal entities and operations generally without incurring a tax cost. There are often business and tax motivations for such mergers, including streamlined operations, reduced administrative and legal costs, and a tax basis step-up in the acquired assets. These mergers can be executed anytime after an acquisition and, from a tax law perspective, are typically considered more-likely-than-not to be sustained, provided the entities have business substance. No formal approval or ruling from the taxing authority is required, and external approvals (e.g., obtaining certain business permits) generally are considered perfunctory.

During the initial due-diligence process, Company X explored the merits of a merger in Brazil but had not definitively concluded at the acquisition date whether to undertake the merger. Subsequently, Company X concludes that it will merge the Brazilian holding company into Company Y (i.e., downstream merger). The decision is based on further analysis of information and facts that existed at the acquisition date. The measurement period per ASC 805-10-25-14 is still open. The merger transaction results in a tax basis step-up in Company's Y assets, including acquired tax-deductible goodwill.

**Analysis/Conclusion:**
Under this fact pattern, the anticipated deferred income tax benefit from a tax basis step-up should be incorporated into the recognition and measurement of
acquired deferred taxes. This is because the merger transaction and its intended favorable tax consequences are available and considered by Company X as of the acquisition date. That is, the merger transaction and its expected tax effects are based on information and facts existing as of the acquisition date. It is also primarily within Company X's control and ability as there is no substantive approval or review process. Additionally, Company X is not required to make a separate tax payment or incur significant costs separate from the consideration exchanged to acquire Company Y.

Example 10-30: Deferred Tax Accounting When a Planned Post-acquisition Restructuring Will Impact the Ability to Benefit from Acquired Net Operating Losses

Background/Facts:
Company X acquires in a nontaxable transaction 100 percent of the stock of Company Y. Company Y has state net operating loss carryforwards (NOLs) at the acquisition date in the single state in which it operates. The change in control of Company Y does not impact the utilization of the NOLs under state law. Company X has no presence in that state, which is a non-unitary separate filing state. There is sufficient evidence that the NOLs would be realized in the future based on the operations of Company Y in place as of the acquisition date; however, Company X has a definitive plan to move Company Y’s headquarters and operations to another state shortly after the acquisition. Because of this planned post-acquisition restructuring action, Company X does not expect the NOLs related to Company Y’s previous state of domicile to be realized.

Analysis/Conclusion:
In the fact pattern described above, we believe there are two alternative views:

View A—Record a DTA for the full amount of acquired state NOLs as part of acquisition accounting and record a valuation allowance and related deferred tax expense in continuing operations for the portion of the NOLs not expected to provide a future tax benefit (assuming the relocation occurs shortly after the acquisition). Under this view, the buyer is precluded from considering the effects of restructuring actions it expects to take after the acquisition by analogy to the guidance in ASC 805-20-25-2, which requires that restructuring costs the buyer expects but is not obligated to incur be recorded outside of acquisition accounting.

View B—Record a DTA and a valuation allowance for the portion of the NOLs not expected to provide a future tax benefit as part of acquisition accounting. Under this view, Company X’s expected manner of recovery should be considered in assessing recoverability of acquired DTAs. In that regard, all available evidence shall be considered, including planned actions that are primarily within Company X’s control and would affect its ability to realize a benefit from acquired state NOLs.

While both views above represent acceptable positions based on the facts presented, there may be situations where only one view would be supportable. For example, View A may be the only supportable answer if Company X did not have any intention of relocating Company Y at the acquisition date, but decided to do so as a result of having been subsequently offered significant government economic incentives.

(continued)
In some circumstances, these two views may also be applicable in choosing the jurisdictional tax rate to be applied to acquired temporary differences when a post-acquisition relocation is anticipated. For example, if the acquirer plans to relocate an acquiree’s operation from State X to State Y, the view chosen would determine how to account for the effect of the difference in the states’ tax rates on acquired temporary differences.

In situations where either view is supportable, appropriate financial statement disclosures should be provided.

### Deferred Taxes Related to Goodwill

#### 10.11.4 Question 4: For purposes of determining whether to record a deferred tax asset for goodwill, how should book goodwill be compared to tax-deductible goodwill in a business combination involving multiple jurisdictions?

**Answer:** Tax-deductible goodwill in each jurisdiction will need to be compared to book goodwill allocated to each jurisdiction to determine the related temporary differences. ASC 740-10-30-5 requires that deferred taxes, including goodwill, be determined separately for each tax-paying component in each jurisdiction.

Example 10-31 illustrates this guidance.

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### Example 10-31: Comparison of Book Goodwill to Tax-Deductible Goodwill Involving Multiple Jurisdictions

**Background/Facts:**

Company A buys Subsidiary B in a nontaxable business combination. Subsidiary B has operations in the U.S. and Germany. As a result of the transaction, Company A recorded a total amount of $600 book goodwill. $500 of that total amount is associated with U.S. operations, while the remaining $100 is associated with German operations. Carryover tax-deductible goodwill acquired in the transaction totals $500; $200 of which is associated with legal entities in the U.S. and $300 of which is associated with legal entities in Germany.

**Analysis/Conclusion:**

The comparison of book to tax-deductible goodwill at a jurisdictional level yields the following results:

<table>
<thead>
<tr>
<th>U.S. Goodwill</th>
<th>German Goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Component-1</strong></td>
<td><strong>Component-1</strong></td>
</tr>
<tr>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td><strong>Component-2</strong></td>
<td><strong>Component-2</strong></td>
</tr>
<tr>
<td>300</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total Goodwill</strong></td>
<td><strong>Total Goodwill</strong></td>
</tr>
<tr>
<td>$500</td>
<td>$200</td>
</tr>
</tbody>
</table>

At the acquisition date, the acquirer would not record a DTL for goodwill associated with the U.S. jurisdiction because book goodwill exceeds the tax-deductible goodwill. However, for goodwill associated with the German jurisdiction, the acquirer would record a DTA in acquisition accounting because tax-deductible goodwill exceeds book goodwill.
**Tax Indemnifications**

10.11.5 Question 5: Where should adjustments to an indemnification asset for an income tax liability be recorded in the income statement?

**Answer:** Adjustments to the indemnification asset should be recorded in pretax income, not as a part of income tax expense. ASC 740 narrowly defines the term “income taxes” as domestic and foreign taxes based on income (ASC 740-10-20). Recoveries under an indemnification agreement do not appear to fit within the scope of this definition. Therefore, although dollar-for-dollar changes in the income tax liability and the related indemnification will offset on an after-tax basis, pretax income and income tax expense will move inversely as the amount of the income tax liability and related indemnification asset change.

**Measurement Period Adjustments**

10.11.6 Question 6: An acquirer might release all or a portion of its valuation allowance as a result of an acquisition. What is the appropriate accounting if a measurement period adjustment impacts that earlier valuation allowance release?

**Answer:** Measurement period adjustments to acquired assets and assumed liabilities are reflected retrospectively (i.e., as of the acquisition date) in the financial statements. In general, any changes to an acquiring company’s deferred tax assets that result directly from measurement period adjustments should also be retrospectively recorded. Example 10-32 illustrates this guidance.

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**Example 10-32: Measurement Period Adjustments Related to Deferred Taxes**

**Background/Facts:**
Company A acquired Company B in a nontaxable business combination in the first quarter of 2010. One of Company B’s more significant assets was an office building that had no remaining tax basis. Company A recorded the office building at a provisional fair value of $1,000 and recorded a corresponding DTL of $400 (40 percent rate) at the acquisition date. Company A had pre-existing DTAs of $600, for which there was a full valuation allowance in prior periods. Solely as a result of the business combination and the existence of acquired DTLs, Company A released $400 of its valuation allowance and recognized the benefit in the income statement at the acquisition date.

In the second quarter of 2010, Company A completed its measurement of the acquisition-date fair value of the office building when it received a third-party appraisal report. The appraisal indicated that the fair value of the building at the acquisition date was $700, resulting in a DTL of $280 (and not the $400 previously recorded). Accordingly, the valuation allowance reversal in the first quarter was overstated by $120.

**Analysis/Conclusion:**
The accounts should be retrospectively adjusted to reflect the final valuation of the building, the resulting revised depreciation and the corresponding tax effects, including the adjustment of $120 to the valuation allowance.
10.11.7 Question 7: How should companies determine whether a change in an income tax uncertainty is a measurement period adjustment?

Answer: A change in an income tax uncertainty that is based upon facts and circumstances that existed as of the acquisition date is recorded as a measurement period adjustment (ASC 805-10-25-13 through 25-14). For example, during the initial due diligence, the acquirer may have identified uncertain tax positions of the acquiree and made a preliminary estimate of the amount, if any, of the related liability. That preliminary estimate is recorded in acquisition accounting. If during the measurement period, the acquirer performs a more detailed analysis of information that existed at the acquisition date and determines that an adjustment is necessary, the adjustment should be recorded retrospectively in acquisition accounting. Similarly, if during the measurement period the acquirer discovers an uncertain tax position that was not identified in its due diligence but which existed at the acquisition date, the accounting for that position should be recorded retrospectively in acquisition accounting.

ASC 740-10-25-14 provides that subsequent changes in judgment that lead to changes in an uncertain tax position should be recognized in the period in which the change in facts occurs. Changes in judgment about an uncertain tax position should result from new information and not from a new evaluation or new interpretation of information that was previously available. “New information” in this context represents a change in circumstances, and the resulting adjustment from the change in judgment would not be a measurement period adjustment.

If the adjustment arises from an identifiable post-acquisition event, then it should be recorded outside of acquisition accounting (even if still within the measurement period). On the other hand, if the adjustment results from the discovery of facts and circumstances that existed at the acquisition date, then it should be recorded as part of acquisition accounting.

Post Measurement Period Adjustments

10.11.8 Question 8: How should an adjustment be recorded when a company determines that the balances recorded in its acquisition accounting are incorrect subsequent to the completion of the measurement period?

Answer: The treatment of any resulting adjustment will depend on its nature:

1. Whether the information leading to the adjustment was readily available at the time of the acquisition and involved a clear misapplication of facts, or

2. Whether the adjustment is the result of events or additional information arising subsequent to the acquisition.

In other words, is the adjustment the result of an error in the application of the facts as they existed or is the adjustment the result of a change in estimate? If the former, the adjustment should be treated as an error and evaluated in the context of the initial acquisition accounting, after appropriate considerations of the materiality of the error on past periods. If the latter, the adjustment should be recorded through the income statement in the current period. See Section TX 17.1.1.4.8 for further discussion on discerning an error from a change in accounting estimate.
Interplay between Acquisition Accounting and the Exceptions to Deferred Tax Accounting for Intercompany Asset Transfers and Foreign Currency Differences

10.11.9 Question 9: What are the income tax accounting implications of acquiring an entity with pre-existing deferred charges resulting from intercompany transfers of assets?

Answer: The exception in ASC 740-10-25-3(e), which prohibits the recognition of the tax effects of intercompany transfers of assets, does not apply at the acquisition date. That is, a deferred tax liability (or asset) is recorded for the amount of the assigned value (resulting from the purchase price allocation) that exceeds (or is less than) the acquirer’s actual tax basis. After the acquisition date, any current and deferred taxes on any intercompany transfers of assets are subject to the exception in ASC 740-10-25-3(e). See Section TX 2.3.4 for further discussion on the tax effects of intercompany transactions.

10.11.10 Question 10: What are the income tax accounting implications of acquiring an entity where the acquiree’s functional currency is not the local currency?

Answer: If an entity functional currency differs from its local currency, certain of the entity’s assets and liabilities (e.g., nonmonetary assets) will be remeasured in future periods at “historical” currency rates. The historical rate for assets and liabilities acquired in a business combination is the rate at the date of the combination. The exception in ASC 740-10-25-3(f) that prohibits recognition of deferred taxes for differences that arise from changes in exchange rates or indexing for tax purposes on assets and liabilities that are remeasured at historical exchange rates does not apply at the acquisition date. Therefore the difference between the fair value of acquired assets and liabilities measured in the functional currency at the acquisition date and the tax basis is a temporary difference for which a deferred tax asset or liability is established on the acquisition date.

The exception in ASC 740-10-25-3(f) does apply to changes in the temporary difference post-acquisition (see Section TX 2.3.5).

Exchanges of Assets between Companies

10.11.11 Question 11: What are the income tax accounting implications of a business combination where the consideration transferred includes an equity investment (e.g., an equity investment is exchanged for control of the investee)?

Answer: An acquirer may transfer assets other than cash as part of the consideration transferred in a business combination. The difference between the fair value and the carrying value of the transferred asset is recognized as a gain or loss in earnings unless the assets remain in the combined group (ASC 805-30-30-8). See Section BCG 2.6.3.2 of PwC’s publication A Global Guide to Accounting for Business Combinations and Noncontrolling Interests, for further guidance. The tax consequences to the acquirer from transferring assets as part of consideration paid are recorded in the acquirer’s financial statements outside of acquisition accounting. However, sometimes the transfer is tax-free, in which case no income tax effect is recorded. Example 10-33 illustrates the income tax accounting for a transfer of an equity interest in exchange for control of a subsidiary and the transfer is tax-free.
Example 10-33: Income Tax Accounting for a Transfer of an Equity Interest in Exchange for Control of a Subsidiary and the Transfer is Tax-Free

Background/Facts:
Entity X owns 15 percent of Entity Y, which is a private entity. Entity X appropriately accounts for its investment by using the cost method. The two companies enter into an agreement whereby Entity Y exchanges a wholly owned subsidiary (Sub S) in return for Entity X's 15 percent ownership interest in Entity Y.

Both the carrying value and the tax basis of Entity X's investment in Entity Y is $300. The fair value is $1,000. The fair value of Sub S is less than the fair value of the Entity Y shares held by Entity X. Therefore, Entity Y infuses cash into Sub S just prior the exchange to equalise the value. After the cash infusion, the fair value of Sub S is $1,000. The fair value of Sub S's identifiable assets and liabilities is $700. The tax bases of the assets and liabilities are equal to $500.

The exchange of Entity X's investment in Entity Y for Entity Y's investment in Sub S is tax-free. Entity X's tax basis in its investment in Entity Y will become Entity X's tax basis in its investment in Sub S. Assume that there is no uncertainty relative to the tax-free nature of the transaction.

After the transaction, Entity X will have the intent and ability to recover its investment in Sub S in a tax-free liquidation, and therefore will not record a DTL for any resulting book-over-tax outside basis difference in its investment in Sub S. Entity X's tax rate is 40 percent.

Analysis/Conclusion:
Entity X recorded the following entries in acquisition accounting:

| Dr Net assets | $700¹ |
| Dr Goodwill | 380² |
| Cr Deferred tax liability | $ 80³ |
| Cr Gain on investment | 700⁴ |
| Cr Investment in Entity Y | 300⁵ |

¹ Fair value of the identifiable assets and liabilities of Sub S.
² Goodwill is calculated as the residual after recording the identifiable net assets acquired and associated DTAs and DTLs ($1,000 – ($700 – $80))
³ The DTL is calculated as the difference between the book bases of the identifiable net assets acquired and the carryover tax bases at the applicable tax rate (($700 – $500) x 40%).
⁴ The gain on investment is the difference between the fair value and the carrying value of Entity X's investment in Entity Y ($1,000 – $300).
⁵ Carrying value of Entity X's investment in Entity Y.

There is no tax consequence from exchanging Entity X's investment in Entity Y for Entity Y's investment in Sub S. Therefore, the gain from transferring the investment in Entity Y will impact Entity X's effective tax rate.
Impact of Deferred Taxes on the Measurement and Presentation of Bargain Purchase Gains:

10.11.12 **Question 12:** How do deferred taxes related to acquired assets and liabilities impact the measurement and income statement presentation of the bargain purchase gain?

**Answer:** Deferred taxes are recognized as part of the acquired identifiable assets acquired and liabilities assumed. Therefore, the amount of the bargain purchase gain is directly affected by any such deferred taxes. However, like positive book goodwill, the bargain purchase gain is merely a residual for accounting purposes and generally would not be directly taxable. While not directly addressed in the Standards, we believe the gain should be presented on a single line in pretax income from continuing operations. The deferred taxes included in the determination of the bargain purchase gain should not be shown on the income tax line (i.e., the bargain purchase gain should not be grossed-up to exclude deferred taxes).

Transition Considerations

10.11.13 **Question 13:** How should excess tax-deductible goodwill from acquisitions made prior to the effective date of ASC 805 be accounted for?

**Answer:** In general, where specific transition guidance is not provided, companies should continue to follow the previous guidance for acquisitions consummated prior to the adoption of ASC 805.

Under historical U.S. GAAP guidance, if tax-deductible goodwill exceeded book goodwill as of the acquisition date, no deferred tax asset was recorded. The tax benefit of the excess tax basis is recognized when it is realized on the tax return. ASC 805 amended the guidance for accounting for excess tax-deductible goodwill at the acquisition date. However, no transition guidance was provided for accounting for excess tax-deductible goodwill that arose in acquisitions consummated prior to the effective date of ASC 805.

Therefore, companies should continue to follow the historical guidance for recording the income tax benefit from amortizing component-2 tax-deductible goodwill for acquisitions consummated prior to the effective date of ASC 805. For those acquisitions, the tax benefit from the component-2 tax-deductible goodwill is recorded as the benefit is realized on the tax return, first as a reduction to goodwill from the acquisition, second as a reduction to other noncurrent intangible assets related to the acquisition, and third to reduce income tax expense. Example 10-34 illustrates the historical guidance for recording the income tax benefit from amortizing component-2 tax-deductible goodwill.

---

3 FAS 109, par. 263 prior to being amended by ASC 805-740.
Example 10-34: Recording the Income Tax Benefit from Amortizing Component-2 Tax-deductible Goodwill for Acquisitions Consummated Prior to the Effective Date of ASC 805

Background/Facts:
As of the acquisition date, which was before the effective date of ASC 805, the book basis and tax basis of goodwill are $600 and $800, respectively. No deferred tax asset is recognized for the component-2 tax goodwill.

At the acquisition date, goodwill is separated into two components as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Component-1</td>
<td>$600</td>
<td>$600</td>
</tr>
<tr>
<td>Component-2</td>
<td>—</td>
<td>200</td>
</tr>
<tr>
<td>Total goodwill</td>
<td>$600</td>
<td>$800</td>
</tr>
</tbody>
</table>

For tax purposes, a goodwill amortization deduction of $400 is realized in each of years 1 and 2. For simplicity, the consequences of other temporary differences are ignored in this example. Income before income taxes in each of years 1 and 2 is $1,000. The tax rate is 40 percent for all years.

Analysis/Conclusion:
Income taxes payable for years 1 and 2 are:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before tax amortization</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Tax amortization of goodwill</td>
<td>(400)</td>
<td>(400)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>$ 240</td>
<td>$ 240</td>
</tr>
</tbody>
</table>

The tax deduction from amortizing goodwill is taken pro rata from component-1 and component-2 goodwill. Therefore, component-1 goodwill is deductible $300 per year in years 1 and 2 (($600 / $800) x $400), providing a tax benefit of $120 ($300 x 40%) in each year. Component-2 goodwill is deductible $100 per year in years 1 and 2 (($200 / $800) x $400), providing a tax benefit of $40 ($100 x 40%) in each year.

The tax benefit from amortizing component-2 tax goodwill is recorded as a reduction to book goodwill when the deduction is realized on the tax return, creating a difference between the component-1 book and tax bases. Deferred taxes are provided for the difference that is created between the book and tax basis in component-1 goodwill, which is also recorded as a reduction to book goodwill. This reduction in book goodwill creates an additional deferred tax consequence. To address the iterative process, the computation of the total tax benefit related to component-2 goodwill amortization to record against goodwill can be reduced to the following equation:

\[
\text{(Tax Rate / (1 – Tax Rate)) x Realized Tax Benefit = Total Tax Benefit}
\]

\[
(40\% / (1 – 40\%) \times 100) = 67
\]

(continued)
The basis difference between the component-1 goodwill for years 1 and 2 are computed as follows:

<table>
<thead>
<tr>
<th>Acquisition date Component-1 goodwill</th>
<th>Component-1 Book Basis</th>
<th>Component-1 Tax Basis</th>
<th>Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax benefit of component-2 goodwill amortization</td>
<td>$600</td>
<td>$600</td>
<td>$—</td>
</tr>
<tr>
<td>Deferred tax benefit from reducing component-1 goodwill by the component-2 amortization tax benefit</td>
<td>(27)¹</td>
<td>533</td>
<td>600</td>
</tr>
<tr>
<td>Tax amortization of component-1 goodwill</td>
<td>(300)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>End of Year 1 component-1 goodwill</strong></td>
<td>533</td>
<td>300</td>
<td>93</td>
</tr>
<tr>
<td>Tax benefit of component-2 goodwill amortization</td>
<td>(40)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax benefit from reducing component-1 goodwill by the component-2 amortization tax benefit</td>
<td>(27)¹</td>
<td>466</td>
<td>300</td>
</tr>
<tr>
<td>Tax amortization of component-1 goodwill</td>
<td>(300)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>End of Year 2 component-1 goodwill</strong></td>
<td>$466</td>
<td>—</td>
<td>$186</td>
</tr>
</tbody>
</table>

¹ Recording the $40 tax benefit as a reduction to goodwill creates a temporary difference for component-1 goodwill. The resulting deferred tax benefit is recorded as a reduction to goodwill, which again changes the temporary difference for component-1 goodwill. The benefit was calculated as follows: \( \frac{40\%}{(1 – 40\%)} \times 40 = 27\).

The deferred expense is a result of the change in the DTL each period. In year one, the DTL increased from zero to $93, resulting in a deferred tax expense of $93. Similarly, in year two, the DTL increased from $93 to $186, resulting in a deferred tax expense of $93.

Income tax expense for financial reporting for years 1 and 2 is:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income tax expense:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>240</td>
<td>240</td>
</tr>
<tr>
<td>Deferred</td>
<td>93</td>
<td>93</td>
</tr>
<tr>
<td>Benefit applied to reduce goodwill²</td>
<td>67</td>
<td>67</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 600</td>
<td>$ 600</td>
</tr>
</tbody>
</table>

² The current and deferred tax expense is reported net of the current and deferred tax benefit from the goodwill amortization deduction. Therefore, an adjustment of $67 (current of $40 and deferred of $27) in each year is necessary to remove the benefits from income tax expense and record it as a reduction to goodwill.
Chapter 11:
Outside Basis Differences and Other Special Areas
Chapter Summary

ASC 740-30 provides guidance on a number of complex issues, including (1) the accounting for an entity’s investments in subsidiaries, joint ventures, and certain other less-than-50-percent-owned investees, and (2) several industry-specific temporary differences. This chapter focuses largely on the accounting for foreign and domestic outside basis differences. It also addresses unique challenges associated with flow-through structures, including partnerships, foreign branch operations, and foreign corporations that generate U.S. subpart F income. Finally, it addresses the tax accounting issues associated with foreign currency translation and hedging of investments in foreign subsidiaries.
Excerpts from ASC 740

Recognition of a Deferred Tax Liability

ASC 740-30-25-5:
A deferred tax liability shall be recognized for both of the following types of taxable temporary differences:

a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992.

b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 740-30-25-18 for a corporate joint venture that is essentially permanent in duration.

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.

ASC 740-30-25-6:
Paragraph 740-30-25-18 provides that a deferred tax liability is not recognized for either of the following:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 740-30-25-17.

b. Undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992, and that meet the criteria in paragraph 740-30-25-17. The criteria in that paragraph do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and as required by the preceding paragraph, a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference.

Determining Whether a Temporary Difference is a Taxable Temporary Difference

ASC 740-30-25-7:
Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference shall be assessed. It is not a taxable temporary difference if the tax law provides a means by which

(continued)
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.

ASC 740-30-25-8:
Some elections for tax purposes are available only if the parent owns a
specified percentage of the subsidiary's stock. The parent sometimes
may own less than that specified percentage, and the price per share
to acquire a noncontrolling interest may significantly exceed the per-
share equivalent of the amount reported as noncontrolling interest in the
consolidated financial statements. In those circumstances, the excess
of the amount for financial reporting over the tax basis of the parent's
investment in the subsidiary is not a taxable temporary difference if
settlement of the noncontrolling interest is expected to occur at the
point in time when settlement would not result in a significant cost. That
could occur, for example, toward the end of the life of the subsidiary,
after it has recovered and settled most of its assets and liabilities,
respectively. The fair value of the noncontrolling interest ordinarily will
approximately equal its percentage of the subsidiary's net assets if those
net assets consist primarily of cash.

Recognition of Deferred Tax Assets

ASC 740-30-25-9:
A deferred tax asset shall be recognized for an excess of the tax basis
over the amount for financial reporting of an investment in a subsidiary
or corporate joint venture that is essentially permanent in duration
only if it is apparent that the temporary difference will reverse in the
foreseeable future.

ASC 740-30-25-10:
For example, if an entity decides to sell a subsidiary that meets the
requirements of paragraph 205-20-45-1 for measurement and display as
a discontinued operation and the parent entity's tax basis in the stock of
the subsidiary (outside tax basis) exceeds the financial reporting amount
of the investment in the subsidiary, the decision to sell the subsidiary
makes it apparent that the deductible temporary difference will reverse
in the foreseeable future. Assuming in this example that it is more likely

(continued)
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.

ASC 740-30-25-11:
The need for a valuation allowance for the deferred tax asset referred to in paragraph 740-30-25-9 and other related deferred tax assets, such as a deferred tax asset for foreign tax credit carryforwards shall be assessed.

ASC 740-30-25-12:
Paragraph 740-10-30-18 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences.

ASC 740-30-25-13:
Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

ASC 740-30-25-14:
A tax benefit shall not be recognized, however, for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized under the requirements of paragraph 740-30-25-18.

### 11.1 Accounting for the Outside Basis of Investments

#### 11.1.1 Difference Between Outside and Inside Bases

Tax practitioners refer to a parent’s basis in the stock of its subsidiary as the “outside basis” and the subsidiary’s basis in its various assets and liabilities as the “inside basis.” Specifically, a parent’s outside basis difference in a subsidiary is the difference between the parent’s tax basis in the stock of the subsidiary and the book basis in its investment. In considering the parent’s outside basis in the subsidiary, it is important to note that “parent” does not necessarily mean the ultimate parent. The “parent” could, in fact, be a subsidiary that owns another subsidiary. Outside basis differences need to be considered at every level of an organization’s legal entity structure.

An outside basis difference most frequently exists as a result of unremitting earnings. The parent’s book basis in the subsidiary is increased by the subsidiary’s earnings that have been included in consolidated net income, but have not been remitted to the parent. There is no corresponding increase in the parent’s tax basis in the subsidiary’s stock if the subsidiary is not consolidated for tax purposes. The resulting excess-book-over-tax basis is a temporary difference if it will result in taxable income
upon its reversal. Typically, reversal of the outside basis difference will occur through dividends from the subsidiary, sale of the subsidiary’s stock by the parent, liquidation of the subsidiary, or a merger of the subsidiary into the parent.

However, it should be noted that unremitting earnings represent only one component of the outside basis difference. Other components of the outside basis difference may include, but are not limited to, cumulative translation adjustments (CTA), changes in a parent’s equity in the net assets of a subsidiary resulting from transactions with noncontrolling shareholders (i.e., the subsidiary’s capital transactions and transactions between parent and noncontrolling shareholders), and other comprehensive income (OCI) items such as unrealized gains or losses on available-for-sale securities. Frequently, there are changes in the outside tax basis that arise in business combinations and reorganizations for which there is no corresponding change in the outside book basis. Basis differences that, upon ultimate sale or liquidation, result in taxable income or deductions are considered temporary differences. For consolidated subsidiaries, the parent’s book basis in its investment does not appear as a separate asset in the consolidated balance sheet. However, for the purposes of applying ASC 740, any outside basis difference must still be considered.

11.1.2 Domestic Versus Foreign Subsidiaries

11.1.2.1 Classification as Domestic or Foreign

Although the indefinite reversal exception applies to the outside basis differences in foreign subsidiaries, it does not apply to domestic subsidiaries, except for certain temporary differences that arose before December 15, 1992 (see ASC 740-30-25-18(b)). Therefore, the classification of a subsidiary as either foreign or domestic can have a significant impact on the accounting for the outside basis difference of a subsidiary or corporate joint venture. For example, ASC 740-30-25-5 and ASC 740-30-25-7 require that deferred taxes be provided on a book-over-tax outside basis difference in a domestic subsidiary unless “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.” However, deferred taxes on a book-over-tax outside basis difference in a foreign subsidiary must be recorded unless the entity can make a positive assertion that this basis difference will not reverse in the foreseeable future (see ASC 740-3-25-17 through 25-18).

In making this determination, we believe that companies should look to the relevant tax law in the jurisdiction of the parent that holds the investment to determine whether the investment should be classified as foreign or domestic. For example, if a subsidiary of a U.S. parent is treated as a domestic subsidiary under U.S. tax law, it should be accounted for under ASC 740 as a domestic subsidiary.

In general, under U.S. tax law, a U.S. corporation that owns or controls (directly or indirectly) 100 percent of the capital stock of a corporation organized under the laws of a contiguous foreign country may elect to treat the foreign corporation as a domestic corporation for the purposes of filing a U.S. consolidated tax return, provided that the foreign corporation’s sole purpose is to comply with the laws of the foreign country as to the title and operation of property. Thus, if a U.S. entity elects to treat a Canadian or Mexican subsidiary as a domestic subsidiary for U.S. federal tax-return purposes, we believe that under ASC 740 the Canadian or Mexican subsidiary should be accounted for as a U.S. domestic subsidiary.
11.1.2.2 Tiered Foreign Subsidiaries

Whether a subsidiary is domestic or foreign is determined at each level in the corporate structure. Accordingly, a second-tier foreign subsidiary owned by a first-tier foreign subsidiary in the same country would be a domestic subsidiary for purposes of applying the recognition provisions in ASC 740-30. Thus, a first-tier foreign subsidiary would have to provide deferred foreign taxes for the outside basis difference of a second-tier subsidiary domiciled in the same country, if it does not meet any of the exceptions applicable to a domestic subsidiary that permit it to not record a deferred tax liability or a deferred tax asset.

In determining whether an exception applicable to a domestic subsidiary is available, an entity with tiers of subsidiaries in the same foreign country must determine whether the tax laws of the particular foreign country permit the following:

- Consolidation for tax purposes and the elimination in the consolidated tax return of intercompany dividends.
- Exclusion of a parent's taxable income of dividends from its domestic subsidiaries, if tax consolidation is not permitted.
- Tax-free liquidation or statutory merger of a subsidiary into its parent.

Example 11-1: Third-Tier Subsidiary in a Foreign Jurisdiction Classified as Domestic under ASC 740-30

Assume that U.S. Parent P1 owns 100 percent of U.K. subsidiary S1, that U.K. subsidiary S1 owns 100 percent of U.K. subsidiary S2 and Swiss subsidiary S3 and that, under U.K. tax law, S2 is a domestic subsidiary of S1.

In preparing P1's U.S. GAAP consolidated financial statements, any outside basis difference related to S1's investment in S2 represents an outside basis in a domestic subsidiary. Therefore, S1's investment in S2 should be evaluated using the exceptions to comprehensive recognition available to outside basis differences.
related to domestic subsidiaries to determine whether a temporary difference exists. Any outside basis difference related to S1’s investment in S3 represents an outside basis in a foreign subsidiary and should be evaluated using the exceptions to comprehensive recognition available to outside basis differences related to foreign subsidiaries (e.g., ASC 740-30-25-17).

### 11.1.3 Overview of Potential Deferred Tax Assets and Liabilities Related to Outside Basis Differences

The determination as to whether a temporary difference should be recorded for outside basis differences depends on a number of factors. These include the form of the entity, whether it is domestic or foreign, and management’s intentions for the entity. The recording of deferred taxes on outside basis differences is summarized in the table below.

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Potential Deferred Tax Asset</th>
<th>Potential Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>Record a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future (ASC 740-30-25-9). Refer to Section TX 11.1.8. If the entity’s status changed from equity method investee, refer to Section TX 11.1.10.2.</td>
<td>Outside basis differences that arose in fiscal years beginning after December 15, 1992: Record a deferred tax liability unless the reported amount of the investment can be recovered tax-free without significant cost, and the entity expects to ultimately use that means of recovery (ASC 740-30-25-5 and ASC 740-30-25-7). Refer to Sections TX 11.1.4.3 and TX 11.1.4.5.</td>
</tr>
<tr>
<td>Foreign</td>
<td>Record a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future (ASC 740-30-25-9). Refer to Section TX 11.1.8.</td>
<td>Recording a deferred tax liability depends on the extent to which the parent has the ability and intent to indefinitely prevent the reversal of the outside basis difference with a tax consequence (i.e., whether indefinite reversal is asserted and the criteria are met). If indefinite reversal cannot be asserted, a deferred tax liability should be recorded (ASC 740-30-25-18(a)). Refer to Section TX 11.1.5 and, if the entity’s status changed from equity method investee, Section TX 11.1.10.2.</td>
</tr>
</tbody>
</table>

Outside basis differences that arose in fiscal years beginning on or before December 15, 1992:

No deferred taxes should be recorded unless it becomes apparent that the temporary difference will reverse in the foreseeable future (ASC 740-30-25-18(b)). Refer to Section TX 11.1.4.2.
<table>
<thead>
<tr>
<th>Corporate Joint Venture</th>
<th>Potential Deferred Tax Asset</th>
<th>Potential Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>Record a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future (ASC 740-30-25-9). Refer to Section TX 11.1.8.</td>
<td>Outside basis differences that arose in fiscal years beginning after December 15, 1992: Record a deferred tax liability (ASC 740-30-25-5). Refer to Section TX 11.1.4.1.</td>
</tr>
<tr>
<td>Foreign</td>
<td>Record a deferred tax asset only if it is apparent that the temporary difference will reverse in the foreseeable future (ASC 740-30-25-9). Refer to Section TX 11.1.8.</td>
<td>Recording a deferred tax liability depends on whether (1) the corporate joint venture is permanent in duration and (2) the parent has the ability and intent to indefinitely prevent the reversal of the temporary difference with a tax consequence (i.e., whether indefinite reversal is asserted and the criteria are met). If both of these circumstances exist, no deferred tax liability should be recorded for the portion of the outside basis difference asserted to be indefinitely reinvested (ASC 740-30-25-18(a)). Refer to Section TX 11.1.5. If indefinite reversal cannot be asserted, a deferred tax liability should be recorded (ASC 740-30-25-19). Refer to Section TX 11.1.6.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity Method Investee or Cost Investment (not a joint venture)</th>
<th>Potential Deferred Tax Asset</th>
<th>Potential Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership of 50% or less, not a corporate joint venture</td>
<td>Because ownership is 50% or less and does not constitute a corporate joint venture, ASC 740-30-25-9, does not apply. Consequently, a deferred tax asset should be recognized. Refer to Section TX 11.1.8 and, if the entity’s status changed from a subsidiary, Section TX 11.1.10.2.</td>
<td>Record a deferred tax liability (ASC 740-30-25-5(b)). Refer to Section TX 11.1.7 and, if the entity’s status changed from a subsidiary, Section TX 11.1.10.2.</td>
</tr>
<tr>
<td>Ownership of 20% or less, not a corporate joint venture</td>
<td>Generally, a deferred tax asset should be recorded. Refer to Section TX 11.1.8.</td>
<td>Generally, a deferred tax liability should be recorded. Refer to Section TX 11.1.7.</td>
</tr>
</tbody>
</table>

1 Investments of 20% or less are generally accounted for at fair value (in accordance with ASC 320, Investments—Debt and Equity Securities) or by using the cost method. Differences between the carrying amount and the tax basis of the investment represent normal temporary differences for which deferred taxes should be provided.
### Partnership or Other Flow-Through Entity (which is taxed as a partnership)

<table>
<thead>
<tr>
<th>Potential Deferred Tax Asset</th>
<th>Potential Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign or Domestic</td>
<td>A deferred tax asset should generally be recorded. Refer to Section TX 11.1.9. However, there are circumstances where we believe that a deferred tax asset should be recorded only if the temporary difference is expected to reverse in the foreseeable future as required by ASC 740-30-25-9.</td>
</tr>
<tr>
<td>A deferred tax liability should be recorded. Refer to Section TX 11.1.9.</td>
<td></td>
</tr>
</tbody>
</table>

### Certain Foreign Operations Treatment

| Branch | Generally, income and losses generated by a branch are subject to taxation in both the foreign and domestic jurisdictions. When this is the case, deferred taxes should be recorded at both jurisdictional levels. The deferred taxes recorded in the domestic jurisdiction should also include deferred taxes on the foreign temporary differences. Refer to Section TX 11.6.1. |
| Foreign subsidiary that generates subpart F income | Generally, U.S. deferred taxes related to the temporary differences on a foreign subsidiary’s assets and liabilities should be recorded if their reversal will generate subpart F income. Refer to Section TX 11.6.2. |

### 11.1.4 Potential Deferred Tax Liabilities, Domestic Subsidiaries, and Domestic Corporate Joint Ventures

#### 11.1.4.1 In General

ASC 740 extends the scope of the indefinite reversal exception in ASC 740-30-25-17 for foreign unremitted earnings to include any excess outside book basis in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration. For purposes of applying the indefinite reversal exception, a corporate joint venture is defined in ASC 323-10-20 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. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complimentary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement that 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 minority public ownership, however, does not preclude a corporation from being a corporate joint venture.

Further, to qualify for the indefinite reversal exception, a corporate joint venture must be essentially permanent in duration (i.e., it cannot have a life limited by the nature of the venture or other business activity).
In contrast, the grandfathering of the indefinite reversal exception for a domestic subsidiary or domestic corporate joint venture extends only to undistributed earnings earned in fiscal years beginning prior to December 15, 1992 (see ASC 740-30-25-18(b)). This means that a company will need to consider whether a deferred tax liability should be established on the excess outside book basis difference of a domestic subsidiary or domestic corporate joint venture for undistributed earnings for fiscal years beginning after December 15, 1992. If it is anticipated that ultimate receipt by the U.S. parent will occur in a tax-free manner, the unremitted earnings are not considered to be a taxable temporary difference. The same is true for other outside basis differences. However, U.S. subsidiaries that are stock life insurers or savings and loans associations may require special consideration. The rules for whether excess book-over-tax outside basis differences should be recognized as taxable temporary differences depend on when those differences arose.

PwC Observation: It is technically incorrect to refer to unremitted earnings as a separate book/tax basis difference because it is only a component—although generally the most significant component—of the outside basis difference.

11.1.4.2 Domestic Subsidiaries and Domestic Corporate Joint Ventures: Excess Book-Over-Tax Outside Basis Differences That Arose in Fiscal Years Beginning on or before December 15, 1992

A deferred tax liability on unremitted earnings of a domestic subsidiary or domestic joint venture that arose in fiscal years beginning on or before December 15, 1992 should not be recognized unless it is apparent that the temporary difference will reverse in the foreseeable future (ASC 740-30-25-18(b)).

A last-in, first-out (LIFO) assumption is used to determine whether reversals relate to unremitted earnings for fiscal years beginning on or before December 15, 1992, or whether they relate to later years. Assume, for example, that a calendar-year entity has not recognized a deferred tax liability on $2,000,000 of undistributed earnings of a domestic subsidiary that arose in 1992 and earlier years. The entity has another $1,000,000 of undistributed earnings from the same subsidiary that arose in 1993 and later years for which a deferred tax liability is provided. The subsidiary pays a dividend of $50,000, which the entity elects, for tax purposes, to distribute from the larger carryforward earnings that underlie the $2,000,000 unrecorded deferred tax liability. For financial reporting purposes, however, because of the LIFO assumption, this reversal would be applied to reduce the $1,000,000 amount, leaving the base-year amount intact. Because the temporary difference, on which deferred taxes were provided, was reduced to $950,000, the related deferred tax liability must also be reduced.

However, deferred taxes should be recorded for unremitted earnings of a domestic subsidiary or a domestic corporate joint venture that arose in fiscal years beginning on or before December 15, 1992, if it becomes apparent that the temporary difference will reverse in the foreseeable future (i.e., if indefinite reversal can no longer be asserted).

11.1.4.3 Domestic Subsidiaries: Excess Book-Over-Tax Outside Basis Differences That Arose in Fiscal Years Beginning after December 15, 1992

ASC 740-30-25-5 states that a deferred tax liability should be recognized for certain types of taxable temporary differences, including the “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.” However, an assessment of whether differences between book and tax outside bases are, in fact, taxable temporary differences also must be made (under ASC 740-30-25-7, an excess book outside basis difference “is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the entity expects that it will ultimately use that means”).

11.1.4.4 Domestic, 50 Percent-or-Less-Owned Investees: Excess Book-Over-Tax Outside Basis Differences That Arose in Fiscal Years Beginning after December 15, 1992

ASC 740-30-25-5(b) requires recognition of a deferred tax liability for the excess book-over-tax basis of an investment in a 50-percent-or-less-owned investee except as provided in ASC 740-30-25-18 for a corporate joint venture (as defined in ASC 323) that is essentially permanent in duration. In addition, it should be noted that the exception under ASC 740-30-25-7 for recording a deferred tax liability (described in Section TX 11.1.4.5 below) is not applicable. In providing deferred taxes, understanding the expected form of realization by the investor—dividends vs. capital gains—is often critical (see Section TX 11.1.8).

11.1.4.5 Exception for Domestic Subsidiaries under ASC 740-30-25-7

11.1.4.5.1 Ability and Intent to Recover Tax-free the Investment in the Domestic Subsidiary

ASC 740-30-25-7 states that a book-over-tax outside basis difference in an investment in a more-than-50-percent-owned domestic subsidiary is not a 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.”

In the case of a U.S. subsidiary that is at least 80 percent owned, U.S. tax law provides a means by which the subsidiary can be liquidated or merged into the parent on a tax-free basis. Accordingly, a U.S. parent corporation may be able to use these means to recover its outside basis difference in the subsidiary in a tax-free manner. As long as the U.S. parent has the ability to use one of these tax-free means of recovery and expects to ultimately use that means to recover its outside basis difference, it should not record a deferred tax liability for this difference.

Note, however, that satisfaction of the relevant tax requirements alone is not sufficient to support this assertion. For example, assume that a U.S. parent corporation has a wholly-owned U.S. subsidiary that is a regulated entity. A tax-free liquidation or merger of that entity into the parent may not be possible without regulatory approval. If regulatory approval is more than perfunctory, the parent corporation cannot assert that its basis in the subsidiary can be recovered on a tax-free basis.

Similar tax-free liquidation and merger rules apply in various foreign jurisdictions. Accordingly, an analysis of whether the exception set forth in ASC 740-30-25-7 may be asserted must be performed with respect to each subsidiary to determine if the applicable tax law provides a means of recovering the outside basis difference tax-free.

If a subsidiary is less than 80 percent owned, but more than 50 percent owned, the parent may still be able to assert that the basis difference can and is expected to be
recovered tax-free. Such a position would be based on the parent’s assertion that it is able to effectuate and expects to effectuate the acquisition of the additional ownership necessary to avail itself of any tax-free means to recover the outside basis difference. (Note that the additional ownership must be acquired at no significant additional cost (see Section TX 11.1.4.5.2)). However, if the parent later determines that it is no longer able to or no longer expects to acquire the additional interest necessary to avail itself of a tax-free recovery of the outside basis difference, it must record a deferred tax liability on the outside basis difference.

Example 11-2: Application of ASC 740-3-25-7 to a Change in Assertion to Effectuate a Tax-free Liquidation

Background/Facts:
Company A owns 60 percent of Company B. Appropriately, Company A has not recorded a deferred tax liability on the outside basis in Company B. The decision not to record the deferred tax liability was based on Company A’s assertion that it would be able to effectuate a purchase of an additional 20 percent in Company B, without significant cost, to avail itself of a tax-free liquidation (as per the guidance in ASC 740-30-25-7).

Since Company A first reached that conclusion, circumstances have changed. Company A no longer expects to acquire the 20 percent necessary to avail itself of the tax-free liquidation provisions.

Question:
How should the tax consequences of the change in assertion be reported?

Analysis/Conclusion:
Once Company A’s expectations change (i.e., once it no longer expects to acquire the noncontrolling interest in Company B that is necessary to effectuate a tax-free liquidation), the assertion that allowed A not to record deferred taxes on the outside basis difference is no longer applicable. This is analogous to ASC 740-30-25-19, which states, “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 company, it shall accrue as an expense of the current period income taxes attributable to that remittance.” The original outside basis difference for which deferred taxes were not provided due to this assertion (and therefore for which charges were not taken) should be multiplied by the applicable tax rate and should be recorded as a deferred tax liability. A corresponding charge should also be recorded through the income statement.

Example 11-3: Recording an Outside Basis Deferred Tax Liability When an Investment in a Domestic Subsidiary Is Impaired for Tax Purposes

Background/Facts:
Company A, a Luxembourg parent company, owns 100 percent of the stock of Company B, a Luxembourg subsidiary. For statutory and income tax reporting purposes, Company A is required to annually determine the fair value of its investment in Company B and recognize an impairment if the fair value is lower than the statutory carrying value. Company A performs this assessment in the current year

(continued)
and concludes that its investment is impaired. The resulting write-down is currently deductible for Luxembourg income tax purposes. However, the tax benefit is also subject to recapture if the value of the investment increases in future periods. That is, to the extent the investment value increases, the write-down must be recaptured into taxable income. A potential increase in fair value may be attributable to future earnings as well as other exogenous factors that may affect the value of Company B. This write-down represents the only difference between the book and tax basis in Company A’s investment in Company B and, therefore, Company A’s book basis in Company B (i.e., its outside basis) is greater than its tax basis for Luxembourg income tax purposes.

Under Luxembourg law, a parent company may liquidate or dispose of a subsidiary and receive dividends in a tax-free manner. Company A has no intention of selling its investment in Company B or liquidating the subsidiary. In fact, Company A will continue to operate Company B and hopes to “turn around” the investment.

Question:
Does Company A need to record a deferred tax liability for the excess book-over-tax basis in its investment in Company B?

Analysis/Conclusion:
Yes. ASC 740-30-25-5 and ASC 740-30-25-7 require that deferred taxes be provided on a book-over-tax outside basis difference in a domestic subsidiary unless 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. In this situation, Company A is planning to continue operating Company B and, therefore, it does not have the ability to avoid potential recapture of the tax benefit claimed for the tax write-down of the investment in Company B. Accordingly, Company A should record a deferred tax liability for the outside basis difference related to its investment in Company B.

11.1.4.5.2 Meaning of “Significant Cost” under ASC 740-30-25-8

If a parent corporation does not own the requisite percentage of a domestic subsidiary’s stock to effectuate a tax-free recovery of the outside basis, the parent may still be able to assert that it expects to recover its outside basis difference in the subsidiary tax-free, as long as it can do so without incurring “significant cost.” Specifically, ASC 740-30-25-8 states the following:

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.
Furthermore, as indicated above, “significant cost” occurs if the cost to purchase a noncontrolling interest would exceed its book value. However, under the “end of time” scenario, once the subsidiary’s net assets have been converted to cash and it has no significant unrecorded intangible assets or contingent liabilities, the noncontrolling interest in the subsidiary would be worth approximately its book value. A subsequent purchase of this noncontrolling interest by the parent would be deemed a settlement of a liability at its book value and would not involve a “significant cost.” As a result, a tax-free liquidation or merger would be available, and the parent would never expect the unremitted earnings—any book-over-tax outside basis difference—to result in taxable income. While it is true that this scenario is only hypothetical, it is important to recognize that, in many circumstances, it may be just as difficult to assume (1) that the parent will receive the unremitted earnings in cash as opposed to reinvesting them in the subsidiary and (2) that the cash will be received by the parent in a taxable transaction.

If a parent has not provided deferred taxes based on the “end of time” scenario, the entity would need to consider whether it must provide deferred taxes on its outside basis difference when a change in facts/expectations occurs. Under the FASB staff’s view, once the parent decides to acquire the noncontrolling interest for a premium over book value, the entity cannot continue to assert its ability to use the “end of time” scenario. Accordingly, it must provide a deferred tax liability on the outside basis difference (or, if lower, the significant cost) with a related charge to income. Subsequently, in accounting for the acquisition of the noncontrolling interest, the release of the deferred tax liability would be recorded either in equity or income, depending on whether the tax effect would be considered a “direct” or “indirect” tax effect from a transaction with a noncontrolling shareholder (Chapter TX 10 provides additional guidance on transactions with noncontrolling shareholders).

However, we believe that one must consider the entity’s reasons behind the acquisition. If the acquisition is driven by substantive business reasons (e.g., the parent’s belief that the noncontrolling interest is significantly undervalued or the parent’s desire to fully integrate the subsidiary’s operations into its own operations), and not primarily or largely by the desire to effect a tax-free merger or liquidation, we do not believe that the related costs should be considered incremental significant costs to effectuate the tax-free recovery of the outside basis. For this reason, the parent may be able to continue to assert its ability to recover the outside basis difference in the subsidiary tax-free and, as a consequence, may not need to provide deferred taxes on the outside basis difference in the subsidiary.

An entity with less than 50 percent ownership in an investment cannot avoid recording a deferred tax liability, even if it intends to purchase stock so that it owns more than 50 percent. Before it can use the exception, an entity must have control of the subsidiary. Permitting use of a tax-planning action to gain control would mean that the action could be used by more than one entity for the same investee, and two entities cannot control the same investee.

**11.1.4.5.3 Potential State Tax Considerations**

On occasion, the outside basis difference of a U.S. subsidiary may constitute a temporary difference for deferred state tax computations, even if it is not a temporary difference for federal deferred tax computations. However, if the U.S. parent is able to project that the unremitted earnings will ultimately be received in a liquidation that is tax-free for federal purposes, it will often be able to avoid a provision for state taxes.
Even if a tax-free liquidation is not available in all states in which the parent files returns or is not projected by the parent for other reasons, the unremitted earnings may still not be considered a temporary difference for certain states. For example, if the unremitted earnings are eventually expected to be remitted as dividends, there will be no deferred state tax if either one of the following two circumstances is true:

- The parent is operating only in states in which it files on a combined or consolidated basis with the subsidiary, and intercompany dividends can be eliminated 100 percent in those returns.
- The subsidiary is consolidated in the parent’s federal return, and the parent is operating only in states that do not adjust federal taxable income (the typical starting point for determining state taxable income) for the federal 100 percent dividends-received deduction.

If it is expected that unremitted earnings will be received through a sale of stock, state tax will generally be avoided if the parent’s tax basis for state tax purposes has been increased by the subsidiary’s taxable income (for those subsidiaries that have no difference between inside and outside tax bases). This would be the case in states where the parent files with the subsidiary a combined or consolidated return in which the federal consolidated return rules are followed.

When the unremitted earnings are a temporary difference for a particular state, the deferred state tax provision would need to consider (1) whether the state permits or requires a combined method of reporting (and, if so, whether the subsidiary is engaged in a unitary business); (2) whether the dividend or gain on sale or liquidation will be treated as business or nonbusiness income; (3) which expected apportionment factor should be applied; and (4) whether a dividends-received deduction is available in lieu of the 100 percent federal dividends-received deduction.

**11.1.4.5.4 Consideration of Lower-Tier Foreign Subsidiaries Owned by a Domestic Subsidiary**

As discussed in Section TX 11.1.4.5.2 above, ASC 740-30-25-8 discusses an excess book-over-tax outside basis difference related to a domestic subsidiary. It presents a scenario that would permit a parent to assume an ultimate tax-free liquidation of a domestic subsidiary that is less than 80 percent owned. After the subsidiary has recovered all of its assets and has settled all of its liabilities, the parent would be able to buy the noncontrolling interest for its book value.

But suppose the domestic subsidiary owns a lower-tier foreign subsidiary for which the indefinite reversal exception is used. The domestic subsidiary would not be able to recover its investment in the lower-tier foreign subsidiary without triggering the tax on the foreign subsidiary’s undistributed earnings or other outside basis differences.

However, if the parent anticipates that the domestic subsidiary would recover all its assets except its investment in the lower-tier foreign subsidiary and that the foreign subsidiary would also recover all of its assets and settle all of its liabilities, the net book value of the domestic subsidiary would exceed its fair value because of the potential tax on the foreign subsidiary’s outside basis difference. This would enable the parent to buy the noncontrolling interest of the domestic subsidiary without incurring significant cost (the purchase would be at a discount to book value). The parent could then proceed with a tax-free liquidation of the domestic subsidiary without triggering the tax on the outside basis of the foreign subsidiary.
### 11.1.4.6 Special Considerations for Savings & Loan Associations and Stock Life Insurance Companies

ASC 740-10-25-3(a)(3) and (a)(4), allow the indefinite reversal criteria to be applied to the inside basis differences resulting from pre-1988 tax bad debt reserves of U.S. savings and loan associations (S&Ls) and from policyholders’ surplus of stock life insurance companies that arose in fiscal years ending on or before December 15, 1992.

When such institutions are subsidiaries included in a consolidated U.S. tax return, outside basis differences will result from these items. ASC 740-10-25-3 also discusses the indefinite reversal criteria for outside basis differences of domestic subsidiaries arising from pre-1993 undistributed earnings, as well as outside basis differences arising from pre-1988 tax bad debt reserves of an S&L subsidiary or policyholders’ surplus of a stock life insurance subsidiary that arose before 1993. These outside differences mirror the related inside differences; they will reverse when the inside differences reverse and therefore do not require separate consideration.

As for outside basis differences that are not covered by the exception under ASC 740-30-25-18, one must consider the method by which the book investment in the S&L subsidiary or the stock life insurance subsidiary will be recovered. ASC 740-20-25-7 indicates that it may be unnecessary to provide deferred taxes on an outside basis difference of a domestic subsidiary if the subsidiary can be liquidated tax-free. An S&L or a stock life insurance company could be liquidated into its parent tax-free. However, such liquidation would trigger tax on the inside differences to which indefinite reversal has been asserted for the pre-1988 tax bad debts reserve of the S&L or the pre-1993 policyholders’ surplus of the life insurer. Accordingly, if a tax-free liquidation of the subsidiary is contemplated to avoid deferred taxes on an outside basis difference of an S&L or life insurance subsidiary, deferred taxes would need to be provided on the inside differences.

At times, certain domestic subsidiaries cannot be liquidated under the applicable tax law in a tax-free manner. For example, in the United States, a wholly owned life insurance company cannot be liquidated tax-free into a noninsurance company. In these instances, should a deferred tax liability be recognized for an outside basis difference that results from an inside basis temporary difference? The answer depends on several factors as discussed in the following example.

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**Example 11-4: Application of the Tax-free Liquidation Assertion under ASC 740-30-25-7 to an Investment in a Wholly Owned Life Insurance Company**

**Background/Facts:**
Company B, a life insurance company, is a wholly owned subsidiary of Company A. The companies file a consolidated tax return. The tax rate for all years is 40 percent. Prior to a change in the tax law, Company B added amounts to policyholders’ surplus accounts, which permitted tax deductions totaling $100. After 1984, the tax law changed and the deduction was no longer allowed. Under ASC 740-10-25-3(a)(4), deferred taxes have not been provided on the temporary difference related to the policyholders’ surplus accounts. During the current year, a $200 difference between pretax book and tax income arose as a result of originating taxable temporary differences. Company B has provided deferred taxes on these temporary differences.

(continued)
Company A's outside basis in its investment in Company B is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outside basis at beginning of year</td>
<td>$1,100</td>
<td>$1,000</td>
</tr>
<tr>
<td>Pretax income</td>
<td>600</td>
<td>400</td>
</tr>
<tr>
<td>Income taxes:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current ($400 x 40%)</td>
<td>(160)</td>
<td>(160)</td>
</tr>
<tr>
<td>Deferred ($200 x 40%)</td>
<td>(80)</td>
<td></td>
</tr>
<tr>
<td>Outside basis at year-end</td>
<td>$1,460</td>
<td>$1,240</td>
</tr>
</tbody>
</table>

The following calculation is used to determine whether Company A should recognize deferred taxes on its outside basis difference at year-end (the calculation assumes that the sale of the stock of the subsidiary would be at a price equal to the pretax book investment in the subsidiary):

Outside basis at year-end $1,460
Deferred taxes provided by Company B on inside basis differences 80
Adjusted investment (pretax) $1,540
Less: tax basis of investment at year-end 1,240
Calculated gain on liquidation $ 300 40%
Tax consequences on the date of liquidation $ 120
Deferred taxes (80)
Deferred taxes not provided on policyholder surplus ($100 x 40%) (40)
Deferred taxes to be provided by Company A on its outside basis difference $ 0

**Question:**
Should Company A recognize a deferred tax liability for an outside basis difference that results from an inside basis temporary difference?

**Analysis/Conclusion:**
In this example, Company A would not recognize deferred taxes on the outside basis difference because the tax consequences of the items creating the outside basis difference have already been reflected by Company B and recovery of the net assets of Company B at recorded amount would eliminate the outside basis difference. However, if Company A decides to sell the stock of Company B, causing the temporary difference to reverse in the foreseeable future, the outside basis difference related to the temporary difference under ASC 740-10-25-3(a)(4) would then have tax consequences. Accordingly, Company A would recognize deferred taxes of $40, unless it could develop an alternative scenario that would cause the subsidiary's outside basis difference to reverse without resulting in taxable income and without triggering tax on the inside basis difference.

One possible scenario that could be considered would involve a downstream merger of Company A into Company B. Such a merger would need to occur at an indefinite future date after Company A has recovered all of its assets, except for its investment in Company B, and has settled all of its liabilities. (This scenario would require a reasonable expectation that Company A's assets, excluding its investment in Company B, will exceed its liabilities.) The downstream merger would require the approval of the appropriate regulatory authorities. Presumably, the regulators would not object to an additional cash infusion into the regulated entity. It would also be necessary to consider whether conversion of Company A's net assets to

(continued)
cash could be achieved without triggering tax on exempt undistributed earnings or other differences in the outside basis of any other subsidiaries. Further, ASC 740-30-25-8, requires that the contemplated tax-free reversal of the outside temporary difference should be effected without significant cost. Accordingly, the portion of the outside basis difference attributable to pre-1993 policyholders' surplus would not be a taxable temporary difference, provided that (1) this scenario reflects Company A's expectation of the ultimate disposition of the outside basis temporary difference in Company B, (2) it is extremely unlikely that regulators would preclude the downstream merger, and (3) the scenario would not result in a significant cost.

11.1.5 Potential Deferred Tax Liabilities, Foreign Subsidiaries, and Foreign Corporate Joint Ventures

11.1.5.1 Outside Basis Differences: Undistributed Earnings and Other Differences

Under U.S. tax laws, when earnings of a foreign subsidiary enter into the taxable income of the U.S. parent, a foreign tax credit may be available to eliminate or at least mitigate the effect of double taxation of the subsidiary's earnings (i.e., taxation both by the foreign country in which the subsidiary operates and by the United States). The tax laws of most foreign countries include a mechanism that provides similar relief.

U.S. law with respect to taxation of foreign operations is extremely complex. For this reason, the FASB concluded that calculating the parent's taxes payable on repatriation would be too difficult relative to their assessment of the related benefit. The Board instead decided to preserve the indefinite reversal exception, which does not require the recognition of a deferred tax liability for the excess of the amount of financial reporting over the tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration, unless it becomes apparent that the basis difference will reverse in the foreseeable future.

Accordingly, ASC 740-30-25-18(a) provides that a deferred tax liability is not recognized for “an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or foreign corporate joint venture (as defined in ASC 323-10-15-3) that is essentially permanent in duration.” This outside basis difference may be the result of undistributed earnings or other differences. ASC 740-30-25-3 states, “it shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. 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.” These excerpts from ASC 740-30-25 reflect the general rule that book-over-tax basis differences attributable to undistributed earnings of a subsidiary should be presumed to reverse in the foreseeable future. Therefore, the establishment of deferred taxes is generally required with respect to book-over-tax outside basis differences attributable to undistributed earnings of a foreign subsidiary, unless the indefinite reversal criteria of ASC 740-30-25-17 are met.

In addition, ASC 740-30-25-18(a) extends the indefinite reversal exception to the entire excess book-over-tax outside basis difference in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration. While the largest portion of the outside basis difference typically arises from unremitted earnings, other changes in the parent’s outside basis may result from other comprehensive income, including cumulative translation adjustments, and other changes in the subsidiary’s equity. We believe that the difference between the book and tax basis
in the investment represents a single outside basis difference. Accordingly, it would be inappropriate to separate the outside basis difference into multiple temporary differences. For example, an entity should not record a deferred tax asset for one portion of the outside basis difference while not recording a deferred tax liability for another portion of the difference based on an indefinite reversal exception. However, this discussion is not meant to limit an entity’s ability to assert that only a portion of the single outside basis difference is subject to the indefinite reversal exception. See discussion at Section TX 11.1.5.3.

**PwC Observation:** The continuation of the indefinite reversal exception is only for the transfer of unremitted earnings across national boundaries, and not for transfers of unremitted earnings within a foreign country. As a result, management should examine book-over-tax outside basis differences at every level within the organization to ensure proper compliance with ASC 740-30.

### 11.1.5.2 Indefinite Reversal Exception

**Excerpts from ASC 740**

**ASC 740-30-25-17:**
The presumption in paragraph 740-30-25-3 that all undistributed earnings will be transferred to the parent entity may be overcome, and no income taxes shall be accrued by the parent entity, for entities and periods identified in the following paragraph if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent entity shall have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. These criteria required to overcome the presumption are sometimes referred to as the indefinite reversal criteria. Experience of the entities and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent entity’s representation of indefinite postponement of remittances from a subsidiary. The indefinite reversal criteria shall not be applied to the inside basis differences of foreign subsidiaries.

**ASC 740-30-25-18:**
As indicated in paragraph 740-10-25-3, a deferred tax liability shall not be recognized for either of the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration

b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992. A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.
This exception to ASC 740’s comprehensive model for recognition of temporary differences essentially requires a positive assertion of management’s intent to indefinitely reinvest its foreign undistributed earnings. That is, management must have the ability and the intent to indefinitely prevent the outside basis difference of a foreign subsidiary from reversing with a tax consequence.

When the indefinite reversal exception is used to avoid a provision for deferred taxes on outside basis differences, a new judgment regarding the indefinite reversal criteria is required as of each balance sheet date with respect to each subsidiary. Generally, the total outside basis difference of a foreign subsidiary (i.e., the excess of net assets of the subsidiary reflected in consolidation over the parent’s tax basis in the stock of the subsidiary) and the pre-1993 undistributed earnings of a domestic subsidiary will need to be considered. However, the prospect of a tax-free liquidation may make it possible to conclude that the entire outside basis difference of a domestic subsidiary, including unremitted earnings, is not a taxable temporary difference. Similar judgment will be required for the excess book-over-tax basis of a foreign corporate joint venture that is permanent in duration.

11.1.5.3 Partial Reinvestment Assertion

ASC 740 extends the indefinite reversal exception for foreign unremitted earnings to include any excess outside book-over-tax basis in a foreign subsidiary or in a foreign corporate joint venture that is essentially permanent in duration. A number of questions arise. For example, can an entity have a deferred tax liability that reflects an intention to remit a portion, but not all, of the unremitted earnings? Furthermore, can an entity have a deferred tax liability that reflects an intention to remit unremitted earnings, but no amount corresponding to other factors underlying an outside basis difference?

The answer is this: An entity can maintain a deferred tax liability on some, but not all, of the outside basis difference (whether or not such difference is caused by unremitted earnings or other factors) if its assertion is justified by the “evidence” and “plans” described in ASC 740-30-25-17. However, it should be clear that, if an entity makes a partial reinvestment assertion, the entity cannot change its assertion from year-to-year in a manner that would suggest that the entity is managing its income. If partial deferred taxes are provided, the amount should be based on the tax liability that would be triggered by repatriation of the amount that is not invested indefinitely.

11.1.5.4 Evidence Required

ASC 740-30-25-17 requires management to compile evidence to support its assertion that the foreign unremitted earnings are indefinitely reinvested in order to qualify for the indefinite reversal exception. A mere history of not distributing foreign earnings does not serve as a replacement for specific reinvestment plans. The following matters, among others, should be considered in evaluating specific plans:

• The forecasts and budgets of the parent and subsidiary for both the long and short term.
• The financial requirements of both the parent and subsidiary for the long and short term, including:
  1. Projected working capital and other capital needs in locations where the earnings are generated; and
2. Reasons why any excess earnings are not needed by the parent or another subsidiary somewhere else in the chain.

- Past history of dividend actions.
- Tax consequences of a decision to remit or reinvest.
- Remittance restrictions in a loan agreement of a subsidiary.
- Remittance restrictions imposed by foreign governments that result in forced reinvestment in the country.
- Any U.S. government programs designed to influence remittances.

The specific plans for reinvestment must be documented and maintained. They must support the assertion that the reversal of the outside basis difference can and will be postponed indefinitely.

Section TX 11.1.5.9 discusses the National Professional Services Group consultation requirement when engagement teams have performed extended going concern procedures (regardless of whether a going concern opinion is ultimately rendered) and management asserts indefinite reinvestment.

11.1.5.5 Effect of Distributions Out of Current-Year Earnings on an Indefinite Reversal Assertion

An entity can make a distribution from current-year GAAP earnings and still not have a change in assertion about undistributed earnings existing as of the end of its prior fiscal year.

Example 11-5: Effect of Current-Year Distributions on a Company's Assertion Regarding Indefinite Reversal of Undistributed Earnings

**Background/Facts:**
Assume that, based on asserting and meeting the ASC 740-30-25-18 indefinite reversal criteria, a company has not historically recognized a deferred tax liability on its excess book-over-tax basis for its investment in a foreign subsidiary. This outside basis results from undistributed earnings of the foreign subsidiary totaling $400,000. The company anticipates that its foreign subsidiary will generate earnings in excess of $100,000 per year for the foreseeable future. As a result, management decides to initiate future annual dividend payments of $100,000 from the foreign subsidiary. These dividends would be limited to future earnings, and therefore would be reduced to the extent that the level of future earnings is not met.

**Question:**
Does management’s plan call into question the indefinite reversal assertion, which would require the company to record a deferred tax liability with respect to the higher outside book basis?

**Analysis/Conclusion:**
Not necessarily. In the above situation, management intends to include only future earnings in distributions and to reduce or eliminate the dividend in the event of any shortfall. Therefore, the indefinite reversal assertion remains sustainable with respect to the existing outside basis difference, although management must still be able to provide sufficient evidence that the outside basis will continue to meet the indefinite reversal criteria, including specific plans for reinvesting the funds.

(continued)
If, however, management's intentions were to repatriate $100,000 a year, regardless of the foreign subsidiary's earnings, a change in circumstances would be deemed to have occurred with respect to its prior assertion. Recognition of a deferred tax liability and a corresponding charge to continuing operations in the period of change would be required. This is consistent with ASC 740-30-25-19, which indicates that the tax effect of undistributed earnings of a subsidiary should be charged to expense in the period during which the circumstances change. The tax effect of undistributed earnings of a subsidiary should not be classified as an extraordinary item.

11.1.5.6 Effect of Change in an Indefinite Reversal Assertion

Excerpt from ASC 740

ASC 740-30-25-19:
If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings shall not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent entity shall adjust income tax expense of the current period; such adjustment of income tax expense shall not be accounted for as an extraordinary item.

If it becomes apparent that some or all of the unremitted earnings of the foreign subsidiary will be remitted in the foreseeable future and if the entity has not provided deferred taxes on that amount, the parent entity should adjust income tax expense of the current period and make the disclosures required by ASC 740-10-50-2.

The impact of current-year movement in the cumulative translation adjustments (CTA) account on the expected tax liability on the repatriation should generally be allocated to CTA, consistent with the intraperiod allocation provisions of ASC 740-20-45-11(b). See Section TX 11.5.3 and Section TX 12.2.3.2.1. ASC 740-20-45-11(b) states that the tax effects of gains and losses included in comprehensive income, but excluded from net income, that occur during the year are charged or credited directly to related components of shareholders’ equity. Thus, the tax expense or benefit for the related current-year CTA movement would be recorded through other comprehensive income. However, because the beginning-of-year CTA account balance did not arise during the year, but rather in prior years, ASC 740-10-45-11(b) does not apply and the tax effects associated with the beginning-of-year balance should be recorded to continuing operations, and not backwards traced to CTA, when there is a change in the indefinite reversal assertion.

11.1.5.7 Inside Basis Differences That Meet the Indefinite Reversal Criteria

A question arises as to whether the indefinite reversal exception can be used so that an entity does not need to recognize temporary differences that exist within foreign subsidiaries (i.e., inside basis temporary differences) that may not reverse in the foreseeable future. ASC 740-30-25-17 specifically prohibits an extension of the
outside-basis indefinite reversal exception to inside basis temporary differences of a foreign subsidiary.

For example, consider inside basis differences of an Italian subsidiary of a U.S. parent where the local currency is the functional currency. Under an Italian law that is no longer applicable, fixed assets were occasionally restated for tax purposes to compensate for the effects of inflation. The amount that offsets the increase in the tax basis of fixed assets was described as a credit to revaluation surplus, which some viewed as a component of equity for tax purposes. That amount became taxable in certain situations, such as in the event of a liquidation of the Italian subsidiary or if the earnings associated with the revaluation surplus were distributed. Under this former Italian law, no mechanisms were available to avoid eventual treatment of the revaluation surplus as taxable income. Faced with a similar tax law, a parent company of a foreign subsidiary should not apply the indefinite reversal criteria to inside basis differences of a foreign subsidiary such as a revaluation surplus (ASC 740-30-25-17).

Therefore, the indefinite reversal criteria of ASC 740-30-25-17 should not be applied to inside basis differences of foreign subsidiaries and a deferred tax liability should be provided on the amount of the inside basis difference (e.g., a revaluation surplus temporary difference), even though such amounts may not be expected to reverse in the foreseeable future.

**PwC Observation:** On this topic, ASC 740-30-15-4 restates the prohibition in ASC 740-30-25-17: “There are other exceptions to the comprehensive recognition of deferred income taxes on temporary differences specifically addressed in other Subtopics. However, the provisions of this Subtopic shall not be applied to analogous types of temporary differences.”

### 11.1.5.8 Indefinite Reversal Exception and Purchase Accounting

In a business combination, the acquirer must make its own determination regarding indefinite reversal (or lack thereof) in connection with outside basis differences of the target. If the acquirer does not meet or does not assert the indefinite reversal criteria at the time of the acquisition with respect to the outside basis difference related to an acquired foreign subsidiary or joint venture that is permanent in nature, deferred taxes should be recognized in purchase accounting, regardless of the prior owner’s assertion (see Section TX 10.4.3 for more details).

**PwC Observation:** It may be tempting for a company to take the position that it cannot support an indefinite reversal assertion on a newly acquired foreign subsidiary because taxes on the outside basis difference would be recorded in purchase accounting, rather than through earnings. However, the reasons for any subsequent change in assertion with respect to future earnings must be reconcilable with the position taken in purchase accounting. Accordingly, a company should carefully consider any decision to provide deferred taxes in purchase accounting if it intends to make the assertion with respect to future earnings.

An acquisition may also impact the acquirer’s intention and ability to delay reversal of taxable temporary difference related to subsidiaries it owned prior to the acquisition. As discussed in Section TX 10.4.3, the tax effects of the change in assertion related
to the acquirer’s previously owned subsidiaries would generally be recorded in the income statement.

### 11.1.5.9  Going-Concern Uncertainty

The existence of a going-concern uncertainty may suggest that management is no longer able to control the decision to indefinite reinvest unremitted foreign earnings. In fact, the financial uncertainty that often exists in these cases may create a presumption that unremitted foreign earnings will be needed to meet existing obligations and keep the business afloat. In this regard, the facts and circumstances of each individual going-concern situation should be evaluated to understand whether maintaining an indefinite reinvestment assertion is still possible or whether a deferred tax liability is needed.

When we have performed extended going concern procedures (regardless of whether a going concern opinion is ultimately rendered) and the company continues to assert indefinite reinvestment for its outside basis difference in a foreign subsidiary under ASC 740-30-25, PwC engagement teams are required to consult with the Accounting Services Group within PwC’s National Professional Services Group.

### 11.1.6  Foreign Corporate Joint Ventures That Are Not Permanent in Duration

Most investments in corporate joint ventures are accounted for by the equity method for financial reporting purposes and by the cost method for tax purposes. The book and tax carrying amounts of any investment may differ due to undistributed earnings, translation adjustments, changes in interest, and differences between the book and tax bases of the assets and liabilities contributed. The difference between the book basis and tax basis of the investment in a foreign joint venture that is not permanent in duration is a temporary difference for which a deferred tax liability or asset should be recorded.

### 11.1.7  Measuring the Tax Effect of Outside Basis Differences on Subsidiaries and Equity Investees (Domestic and Foreign)

With respect to measuring the tax effect of a book-over-tax outside basis difference, ASC 740-10-55-23 provides:

> The tax rate that is used to measure deferred tax liabilities and deferred tax assets is the enacted tax rate(s) 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.
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.

Thus, in order to calculate or measure the tax effects of a book-over-tax outside basis difference, a realistic and reasonable expectation as to the time and manner in which such a difference is expected to be recovered must be determined.

The appropriate amount of tax that should be recorded for the outside basis differences of domestic subsidiaries will need to be identified if the tax-free recovery assertion in ASC 740-30-25-7 cannot be made.

When unremitted earnings of foreign subsidiaries do not meet the indefinite reversal criteria and when foreign equity investees exist, the effects of reversal on the parent company’s deferred tax computations include the potential gross-up and related credit for foreign taxes that are deemed paid. The effects of reversal also include any foreign withholding taxes and the related parent company’s tax deduction or credit when repatriation is expected by dividends. Differences between tax accumulated earnings and profits (E&P) and U.S. GAAP unremitted earnings may merit consideration, as these differences would affect the measurement of taxes due upon remittance. For example, E&P may include earnings of a purchased subsidiary prior to its acquisition, and would therefore affect the amount of any potential distribution that would be considered a taxable dividend (as opposed to a return of capital or a distribution in excess of the parent’s tax basis in the subsidiary).

Moreover, in estimating whether foreign taxes will be deducted or credited in the reversal years, it may be necessary to project the following: (1) foreign taxes that will be paid on branch income or subpart F income, resulting either from reversals or from future taxable income other than reversals; (2) dividends that will be received from future earnings of the same or other foreign subsidiaries; (3) the related deemed-paid credits that would be available; (4) the source of the income (i.e., whether it is sourced in the United States or a foreign country) and its effects on the foreign tax credit computations; and (5) whether the proximate years available for carryback and carryforward will be “excess credit” or “excess limitation” years.

In addition, some jurisdictions apply a different tax rate to distributed earnings than they do to undistributed earnings. As a result, the applicable tax rate will depend on whether the indefinite reversal criteria have been asserted and met and whether it will affect the related foreign tax credit calculations. (See ASC 740-10-25-39 through 25-41 and Section TX 4.2.4.2.)

Foreign tax credit calculations can be extremely complex. Taxes provided must reflect the expected form of repatriation (e.g., dividend, sale or liquidation, or loan to the parent), the particular tax characterization that the expected form of repatriation will attract (ordinary versus capital gain), and the extent to which deemed-paid foreign tax credits are available. As a result, the amount of the deferred tax liability...
can vary considerably, depending on the repatriation scenario. Considerations similar to those discussed in the final paragraphs of this section may be appropriate with respect to nonsubsidiary investees. All estimates and calculations must be reflected in the applicable rate that is applied to the taxable temporary difference.

In addition, deferred taxes must be provided with respect to unremitted earnings of nonsubsidiary and non-joint venture investees that are carried on the equity method (for further discussion on equity method investees, see Section TX 11.1.10.5). In fact, the entire outside basis difference in such an investee is included in the deferred tax computation. The deferred tax, when provided for such reversals, is generally the estimated incremental effect on future taxes payable (except when graduated rates are a significant factor). For the unremitted earnings of an equity-method investee, the pattern and type of future taxable income should be based on the expected method of realization (i.e., dividends or sale). If the dividend assumption is inappropriate, the investor may have to assume ultimate realization through sale of the investment. When measuring the related deferred taxes, consideration will need to be given to the expected character of the gain or loss on disposal. This may result in deductible temporary differences and loss carryforwards of a capital nature that are not realizable without sufficient sources of capital gain income. For further discussion regarding the factors to be considered in assessing the expected method of realization, refer to Example 11-6.

Whether the investor has control of the investee must also be considered. For example, a tax-planning action may exist that could be employed to achieve a lower tax. However, such an action may be limited because the investor does not control the investee.

In any analysis of the form of realization, consideration should be given to whether the investor’s recorded share of investee earnings represents accumulated earnings and profits of the investee for tax purposes (and which, if remitted, would be treated as dividends for tax purposes) or amortization of the investor’s cost difference. The dividend rate would be appropriate only in relation to the underlying E&P of the investee (this could include E&P accumulated prior to the investor’s purchase), adjusted to accommodate investee timing differences for changes in E&P that will result from reversals of the timing differences prior to the distributions. If there is a difference between investor’s cost and underlying equity, this difference will be amortized by the investor. To the extent that such amortization represents eventual capital gain, investor taxes should be provided, assuming capital gain treatment. To the extent that amortization represents an ultimate reduction in capital gain or an increase in capital loss, it is possible that a benefit should be recognized. If investor taxes are being provided on underlying earnings, assuming capital gain treatment, reduction of such taxes to reflect accumulated amortization of excess investor cost would be appropriate. Recognition of the benefits of capital loss is appropriate only if offset against capital gains meets the more-likely-than-not criterion. Circumstances could arise in which it is appropriate to apply the dividend rate to the entire amount of underlying earnings, without recognizing any tax benefit on amortization of excess investor cost, because application of the dividend rate would result in capital loss, the tax benefit of which is more-likely-than-not to expire unused.
Example 11-6: Measurement of a Deferred Tax Liability Related to the Excess Book-Over-Tax Outside Basis in an Equity Method Investment

Background/Facts:
Company A owns 30 percent of the outstanding stock of Company B and accounts for the investment under the equity method. Company A and B are in the same country. Company A’s investment in Company B has an excess book-over-tax basis that is attributable to unremitted earnings.

In the jurisdiction in which Company A and B operate, dividends can be distributed tax-free to a corporate investor that has more than 25 percent ownership. However, a capital gains tax is levied upon disposal of stock investments.

Because Company B is an integral part of Company A’s overall business by supporting its supply chain, Company A has no plan to sell its stock investment in Company B in the foreseeable future. Although Company A has the ability to exercise significant influence over operating and financial policies of Company B, it does not have the ability to require Company B to pay dividends.

Question:
Should Company A measure the deferred tax liability related to the excess book-over-tax outside basis in Company B based on a disposal or a dividend assumption? Can the assumption change as circumstances change?

Analysis/Conclusion:
ASC 740-10-55-24 states that deferred taxes should be measured using the 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. It also indicates that 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. That is, the temporary difference reversal assumption should be based upon a neutral assessment of the relevant facts and expectations rather than on an accounting policy presumption. The assumption should be based upon the most likely manner of recovery at each reporting period and may change (with resulting remeasurement of current or deferred taxes) as circumstances change.

In addition to other situation-specific factors, in assessing the facts and expectations, consideration should generally be given to:

- Investee’s history of paying dividends (from accumulated earnings)
- Investor’s (and/or investee’s) ability to control or influence dividend payments
- Investor’s intentions for the investment and any history of disposing of comparable investments
- Other significant shareholders with an ability or influence to either force a disposal of the investment or dividend payments
- Investee’s (and/or investor’s) liquidity and capital requirements
- Legal considerations and the availability of market disposal options
- Tax planning opportunities that would influence the disposal structure/consequences
- Whether the investment represents an integral component of the investor’s overall business or long-term strategic plans

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For example, if Company B has paid dividends in excess of current year earnings in the past and that practice is expected to continue in the future, it may be appropriate to assume that the basis difference will reverse through dividend distributions. Accordingly, it may be appropriate for Company A not to record a deferred tax liability as dividends would be tax-free in the jurisdiction in which it operates.

However, if Company B has not paid dividends, or has always paid dividends only from current year earnings, and there is no indication that the practice will change in the future, it may be appropriate to assume that the basis difference will reverse through a disposal. In that case, Company A would measure the deferred tax liability at the capital gains rate even though it has no intention of disposing the Company B stock in the foreseeable future.

As facts and expectations change, evidence may accumulate over time supporting a shift from a dividend to disposal assumption or vice-versa. Disclosure of the reversal assumption along with the possibility of near-term changes which could have a significant accounting or liquidity impact may be appropriate.

11.1.8 Potential Deferred Tax Assets on Subsidiaries, Corporate Joint Ventures, and Equity Investees (Foreign and Domestic)

11.1.8.1 In General

Where outside tax basis exceeds outside book basis in an investment in a subsidiary or corporate joint venture that is essentially permanent in duration, there may be a deductible temporary difference that justifies the recognition of a deferred tax asset. Under ASC 740-30-25-9, the future tax benefit is recognized “only if it is apparent that the temporary difference will reverse in the foreseeable future.” The “foreseeable future” as used in ASC 740-30-25-9, contradicts the indefinite reversal criteria of ASC 740-30-25-17, because the reversal of the excess outside tax basis would be definitely planned, and not indefinitely deferred.

Note that ASC 740-30-25-9 does not apply to foreign or domestic unconsolidated investees (except for corporate joint ventures). Therefore, the outside tax-over-book basis for such an investment should generally result in a deferred tax asset (which is subject to a valuation allowance assessment). Based on ASC 740-10-55-24, measurement would depend on expectations of how the investment will ultimately be realized (e.g., through sale or liquidation). If an entity expects to ultimately realize the investment through sale at a loss, the deferred tax asset should be measured based on capital loss rates. If, however, an entity expects to recognize the investment through sale at a gain (but a higher book than tax gain because of the excess outside tax basis), measurement at ordinary rates is appropriate. The expectation must be reasonable and supportable.

Realization of the excess outside tax basis may be predicated upon sale of the subsidiary. But, as confirmed by ASC 740-30-25-10, there could be circumstances in which the tax benefit can be recognized prior to meeting the criteria of ASC 360-10-45-9 as “held for sale.” The held-for-sale date is the date on which the pretax gain or loss from disposal should be estimated and a component should be reclassified as a discontinued operation. We believe that, in most cases, the held-for-sale date will be the date on which it becomes apparent that disposition will occur in the foreseeable future. Certain assets to be disposed of do not qualify as a component under ASC 360. If the disposal of such assets involves the realization of a higher outside tax basis, we believe that, in most cases, the tax benefit of the higher outside basis should be recognized when the “held for sale” conditions of ASC 360-10-45-9, are met.
PwC Observation: Although ASC 740 does not explicitly define “foreseeable future,” we believe that generally, within the context of a potential sale of a subsidiary, the term means sometime within the next year. To record a deferred tax asset in this circumstance, management should be fully committed to the plan to reverse the temporary difference, and not just exploring it as a possibility.

If there is a change in intention or fact that would cause a deferred tax asset to be recorded under ASC 740-30-25-9, such an asset should be treated as a discrete item in the interim period during which the change in intention or circumstances occurs.

It should be noted that the generation of future profits does not constitute “reversal” of an excess tax outside basis difference. ASC 740-1-25-20 defines a deductible temporary difference as a temporary difference that results in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. Thus, “reversal” of a deductible temporary difference provides a tax deduction when the related asset is recovered. Future earnings will neither recover the related asset (i.e., the investment in the subsidiary or corporate joint venture that is essentially permanent in duration) nor result in a tax deduction or benefit in the parent’s tax return; rather, the book basis of parent’s investment in the subsidiary or corporate joint venture will increase and the tax basis in the investment will remain unchanged.

Example 11-7: When to Recognize a Tax Benefit for a Worthless Stock Deduction

Background/Facts:
Company A, a U.S. corporation, has a wholly-owned foreign subsidiary (FS). At December 31, 20X1, Company A had zero book basis in FS due to significant prior year losses and $100 million tax basis in the FS stock. During Q4 of 20X1, there have been ongoing discussions about the viability of FS’s continued business plans leading to a decision to cease operations and liquidate FS. It was expected that the liquidation of FS would be consummated within the next year. In Q1 20X2, Company A made a “Check-the-Box” (CTB) election to treat FS as a disregarded entity retroactively effective on the last day of its 20X1 tax return. The CTB election resulted in a deemed liquidation of FS for U.S. federal income tax purposes, leading Company A to claim its $100 million tax basis in FS as a worthless stock deduction on the 20X1 tax return. The CTB election has no other U.S. or foreign tax implications and FS has no inside basis temporary differences. At December 31, 20X1, management concluded that without the CTB election (or other process of liquidation), Company A would not have met the more-likely-than-not recognition threshold to record the tax benefit from the worthless stock deduction.

Question:
When should Company A recognize the tax benefit from the worthless stock deduction (i.e., Q4 20X1 or Q1 20X2)?

Analysis/Conclusion:
The tax effects of an excess tax-over-book basis in the stock of a subsidiary should be recognized when it becomes apparent that the temporary difference will reverse in the foreseeable future. In the context of a worthless stock deduction, this criterion would generally be met in the earliest period in which the investment is considered “worthless” for federal income tax purposes. There are various measures used to

(continued)
make this determination and there are certain identifying events that confirm stock worthlessness including a bankruptcy, court-appointed receiver, and liquidation. As a result, if such an identifiable event is required in order to recognize a tax benefit under ASC 740-10-25-6, the ability of the company to control the occurrence of that event must be considered. The relevant question is therefore whether Company A would have concluded that, based on available information as of December 31, 20X1, the FS stock was otherwise considered worthless and they could presume completion of the “confirming” event. If the stock was otherwise considered worthless as of December 31, 20X1, the mere fact that the CTB election was filed in a subsequent period should not change the timing of when the benefit is recognized. Absent regulatory or/and contractual restrictions, the liquidation of FS via a CTB election would be considered primarily within Company A’s control.

The filing date of the CTB election and the selected effective date are not determinative if the stock was otherwise considered worthless as of December 31, 20X1, and the company expected to complete all relevant administrative procedures shortly thereafter. If the company had selected an effective date in 20X2, it would still not change the fact that as of December 31, 20X1, it was apparent that the excess tax basis would reverse (i.e., become deductible) within the next year.

Note: The tax effect of a worthless stock deduction should be accounted for discretely in the interim reporting period when it becomes apparent that the temporary difference will reverse in the foreseeable future. There might also be other accounting consequences in these circumstances, such as deferred tax effects resulting from the change in tax status.

11.1.8.2 Recognition of Deferred Tax Assets on Foreign Tax Credits Prior to Meeting the Establishing Criteria under Tax Law

In general, we believe that ASC 740 supports recognition of foreign tax credits (FTCs) as deferred tax assets only when such tax attributes have been generated and can be claimed on a U.S. tax return (i.e., the related carryforward provisions have begun). In other words, a deferred tax asset should not be recognized for FTCs that currently do not exist, but will be generated by the reversal of a taxable temporary difference (often referred to as “unborn FTCs”). One exception to this concept is with regard to FTCs that can be recognized as deferred tax assets if all of the conditions except for the actual repatriation of cash have been met to create the credits. Even in this case, we believe that an entity must be able to assert that it has met the condition for apparent reversal in the foreseeable future prior to its recognition, as stipulated in ASC 740-30-25-9 (e.g., the entity is committed to making the repatriation in the near term). Only then should an entity record and analyze for realizability the deferred tax asset related to the entire FTC, including any portion of the FTC that has been carried forward and could be utilized in future years, as long as its future realization is not dependent on past or future items (e.g., undistributed earnings) for which a deferred tax liability has not been or will not be recorded.

In certain jurisdictions such as the United States, a dividend from a foreign subsidiary may carry with it a deemed-paid foreign tax credit that, in general, is only available if the subsidiary has accumulated earnings and profits from which it can pay a dividend. This leads to a common question: Can a deferred tax asset be recorded by the parent company for foreign taxes that have already been paid by the foreign subsidiary but, because of a current deficit in accumulated earnings and profits, would not give rise to a deemed-paid foreign tax credit unless (or until) the foreign subsidiary generates future earnings and profits in excess of the current deficit and makes a distribution? In this circumstance, we believe that a deferred tax asset
should not be recorded until a distribution from the subsidiary would represent the repatriation of accumulated E&P (i.e., the point at which a distribution, if made, would qualify for the deemed-paid credit).

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**Example 11-8: Recognition of Deferred Tax Assets on Foreign Tax Credits Before the Establishing Criteria under Tax Law Have Been Met**

**Background/Facts:**
At the end of year 1, a recently acquired subsidiary has taxable profits for local tax purposes, but a deficit in earnings and profits (E&P) for U.S. income tax purposes. This deficit is due primarily to amortizable goodwill for U.S. tax purposes; however, no such goodwill exists for local tax purposes and the subsidiary has paid foreign taxes. The parent believes that the subsidiary will most likely continue to be profitable on a local tax basis and that, over the next few years, the E&P will turn positive and foreign tax credits (FTCs) will be able to be generated in the parent company's U.S. tax return. However, thus far, the cash distributions from the subsidiary to the parent have been deemed a return of capital, and not dividends, because of the deficit in E&P.

Assume that the following facts are true:

<table>
<thead>
<tr>
<th>Local Taxes</th>
<th>Earnings &amp; Profits (E&amp;P)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year 1</strong></td>
<td></td>
</tr>
<tr>
<td>Pretax income</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Section 197 amortization</td>
<td>—</td>
</tr>
<tr>
<td>Foreign taxes (30%)</td>
<td>(600)</td>
</tr>
<tr>
<td>Cash distribution</td>
<td>1,400</td>
</tr>
<tr>
<td><strong>Year 2</strong></td>
<td></td>
</tr>
<tr>
<td>Pretax income</td>
<td>4,000</td>
</tr>
<tr>
<td>Section 197 amortization</td>
<td>—</td>
</tr>
<tr>
<td>Foreign taxes (30%)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Carryforward E&amp;P deficit</td>
<td>2,800</td>
</tr>
<tr>
<td>Cumulative E&amp;P</td>
<td>$ 1,200</td>
</tr>
<tr>
<td>Year 2 cash distribution</td>
<td>$(2,800)</td>
</tr>
</tbody>
</table>

1. The entire amount would be considered a return of capital.
2. Of the $2,800 cash distribution, $1,500 would be considered a return of capital and $1,300 would be considered a dividend because current E&P in Year 2 is $1,300. The $1,300 dividend brings with it FTCs of $1,800 ($600 + $1,200).

**Question:**
Can a deferred tax asset be recorded at the end of year 1 for future FTCs ($600 in this example) if it is probable that the deficit in E&P will reverse and that the FTCs will eventually be generated when future dividends are paid?

**Analysis/Conclusion:**
No. The deferred tax asset should not be recorded until at least one dollar of potential cash distributions represents repatriation of cumulative E&P (i.e., until potential cash distributions are dividends and not return of capital). Because the U.S.
outside basis differences and other special areas

11.1.9  Partnerships and Other Flow-Through Entities

We believe that deferred taxes related to an investment in a foreign or domestic partnership (and other flow-through entities that are taxed as partnerships, such as multi-member LLCs) should be measured based on the difference between the financial statement amount of the investment and its tax basis (i.e., its outside basis difference). Deferred taxes are not based on book/tax-basis differences within the partnership because those differences are inherent in the outside basis difference. This is the case regardless of whether the book investment in the partnership is accounted for using the cost, or equity method, consolidated or pro-rata consolidated. The deferred taxes should be based on the tax consequences associated with the partner’s expected method of recovering its book investment in the partnership. Furthermore, if an entity is treated as a partnership or other pass-through entity by its parent for tax purposes, the parent cannot utilize the indefinite reversal exception in ASC 740-30-25-17 to avoid recording a deferred tax liability on the outside basis difference. (As discussed in Section TX 11.6.1, however, the parent can have an accounting policy that permits an indefinite reversal assertion to be made with respect to a foreign branch CTA account in cases where taxation of foreign currency gains or losses occur only upon repatriation).

We are aware, however, that certain exceptions to the general guidance have been made in practice. Specifically, different views exist regarding if and when deferred taxes should be provided on the portion of an outside basis difference attributable to nondeductible goodwill. For example, assume that an entity contributes to a partnership the net assets of one of its subsidiaries and that those assets include nondeductible goodwill. Some believe that deferred taxes should be recognized on the entire outside basis difference, including the portion attributable to nondeductible goodwill inherent to the underlying investment, while others believe that the portion of the outside basis attributable to nondeductible goodwill should be excluded from the outside basis difference for which a deferred tax liability is recorded. Still others believe that the exception should be limited to situations in which the investment in a
tax benefit from the foreign taxes is predicated on future events (i.e., the creation of positive E&P from future profits), it does not meet the general criteria of an asset under CON 6, par. 25 and 26.

Rather, in this example, the U.S. tax benefit related to the foreign tax paid can be reflected in year 2 once the subsidiary has generated positive E&P and the parent plans to repatriate the excess cash from the subsidiary. Assuming that there is no other foreign-source income in year 2, the FTC calculation in the U.S. tax return will result in excess FTCs, which can be used to offset U.S. tax on other foreign-source income in future years. The piece of the FTC that has been carried forward should be calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividend</td>
<td>$1,300</td>
</tr>
<tr>
<td>Foreign tax gross up</td>
<td>1,800</td>
</tr>
<tr>
<td>Total taxable income</td>
<td>3,100</td>
</tr>
<tr>
<td>U.S. tax at 35%</td>
<td>1,085</td>
</tr>
<tr>
<td>FTC available</td>
<td>1,800</td>
</tr>
<tr>
<td>Excess FTC benefit</td>
<td>715</td>
</tr>
</tbody>
</table>

The excess FTC benefit would constitute a deferred tax asset at the end of year 2 and would be evaluated for realization under ASC 740 at that time.
partnership is controlled and therefore consolidated by the investor entity. We would not object to any of these practices provided that, whichever one is chosen, the entity follows it consistently for all partnership investments.

Moreover, an examination of outside basis through its component parts should not be limited to nondeductible goodwill alone. There are other exceptions to the comprehensive model of recognition such as the indefinite reversal exception in ASC 740-30-25-17 that might be applied with regard to a foreign subsidiary owned by the partnership. We believe that an entity must adopt a consistent policy to (1) look through the outside basis of the partnership and exclude it from the computation of deferred taxes on all underlying items for which ASC 740 provides an exception to its comprehensive model of recognition or (2) not look through the outside basis of the partnership and record deferred taxes based on the entire difference between the book and tax bases of its investment. As noted above, we do not object to either practice. However, we expect entities to choose one practice and apply that practice consistently to all flow-through entities.

Example 11-9: Establishing Deferred Taxes on a Partnership Investment for Which Part of the Outside Basis Difference Is Attributable to Nondeductible Goodwill

Background/Facts:
Suppose Company X effectively owns 100 percent of a domestic partnership, Partnership P, which is a flow-through entity for tax purposes. Partnership P is also a reporting unit to which the company allocated nondeductible goodwill pursuant to ASC 350, Intangibles-Goodwill and Other. The allocation of nondeductible goodwill increases Company X’s investment in Partnership P for book but not for tax purposes and creates an outside basis difference.

It is Company X’s policy not to provide deferred taxes on the portion of outside basis difference attributable to nondeductible goodwill. Company X intends to dispose of its investment in Partnership P and classifies it as held for sale. Company X anticipates that the sale will result in a taxable gain in excess of the book gain, due largely to the nondeductible goodwill that is inherent in the outside basis difference.

Question:
Should Company X provide deferred taxes on the outside basis difference attributable to the nondeductible goodwill when it first decides to dispose of Partnership P, or should Company X allow the disproportionate tax effect of not recording the deferred taxes on the full outside basis to be reflected at the time of the actual disposition?

Analysis/Conclusion:
We believe that, because Company X adopted a policy to look through its outside basis difference in a partnership and not provide deferred taxes on the portion related to nondeductible goodwill, Company X should not provide taxes on the outside basis difference and should reflect a disproportionate tax effect in the period of the actual disposal. It should be noted that, if deferred taxes had not been recorded on portions of the outside basis difference of Partnership P for other reasons (e.g., the indefinite reversal exception under ASC 740-30-25-17 related to the partnership’s investment in a foreign subsidiary), Company X would be required to provide deferred taxes once the relevant assertion could no longer be relied upon (e.g., at the held-for-sale date).
With respect to potential deferred tax assets in outside basis differences associated with a partnership, questions will arise as to whether the guidance in ASC 740-30-25-9, should be applied. This guidance prohibits the recognition of a deferred tax asset for an investment in a subsidiary or corporate joint venture, unless it is apparent that the temporary difference will reverse in the foreseeable future.

Because partnerships are not taxable entities and their tax consequences “flow-through” to the investors, the guidance in ASC 740-30-25-9 does not directly apply. However, in situations where the investor entity has control, it may be appropriate to consider this guidance by analogy.

For example, if all or a portion of the outside excess tax basis in the partnership is expected to be realized only through sale of the investment, it may not be appropriate to recognize the related deferred tax asset until a sale is contemplated in the foreseeable future. In addition, when assessing the realizability of a deferred tax asset related to an investment in a partnership, it is important to remember that the deferred tax asset represents a tax loss that is often capital in nature. Under existing U.S. tax law, future taxable income of a similar nature (i.e., capital gains) will be necessary to realize the capital loss that underlies the deferred tax asset.

**11.1.10 Other Issues Related to Accounting for Outside Basis Differences**

**11.1.10.1 Considerations Related to Variable Interest Entities**

The impact of a consolidated variable interest entity (VIE) under ASC 810 on the accounting for income taxes must be evaluated in each individual circumstance. The ASC Master Glossary defines subsidiary as “an entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.) [ARB 51, paragraph B1].” Hence, we believe that the income tax accounting guidance for subsidiaries applies to consolidated VIEs.

In assessing the accounting for outside basis differences of a consolidated VIE, we believe that control will be a significant factor in the analysis. Control as used in this context implies the right to control distributions or other transactions that would otherwise cause a taxable event to occur. When considering whether a deferred tax liability is required under either ASC 740-30-25-18 or ASC 740-30-25-7, we believe that an entity must be able to control distributions or other transactions that would otherwise cause a taxable event to occur in order to assert indefinite reversal. This is based on our belief that the underlying rationale for the indefinite reversal exception in ASC 740-30-25-17 is an entity's ability and intent to control the timing of the events that cause basis differences to reverse and result in taxable amounts in future years.

Further, we understand that the restriction in ASC 740-30-25-9 regarding the recognition of deferred tax assets was included to bring some form of parity to the exceptions provided in ASC 740-30-25-18(a) and ASC 740-30-25-7 for recognition of deferred tax liabilities. Therefore, we believe it is appropriate to apply a similar thought process when considering whether the exception to recognizing deferred tax assets in ASC 740-30-25-9 applies (i.e., the entity must have the ability to control the timing of the events that cause the temporary difference to reverse in a taxable manner).
11.1.10.2 Changes from Investee to Subsidiary and from Subsidiary to Investee

Excerpts from ASC 740

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

ASC 740-30-25-16: 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.

Because deferred tax assets and liabilities must be recorded for outside basis differences of investees and often will not be provided for outside basis differences of subsidiaries, determining whether a change in an investment from an investee to a subsidiary (or vice versa) will give rise to an adjustment to deferred tax assets and liabilities generally depends on whether the outside basis difference relates to a foreign or domestic entity. The change from investee to subsidiary (or vice versa) can result from the investor/parent’s purchase or sale of stock held by other investors, as well as the investee/subsidiary’s transactions in its own shares.

Guidance for investments in foreign entities is provided in ASC 740-30-25-15 through 25-16.
Change from investee to foreign subsidiary

In general, ASC 740-30-25-16 requires that the deferred tax liability provided for unremitted earnings of a prior investee that becomes a foreign subsidiary is frozen, regardless of whether the investment currently meets the indefinite reversal criteria. The frozen deferred tax liability would not be reversed until (1) dividends from the subsidiary exceed the parent’s share of the subsidiary’s earnings subsequent to the date on which it became a subsidiary or (2) the parent disposed of its interest in the subsidiary.

When an investee becomes a foreign subsidiary in a business combination achieved in stages, the acquirer's previously held equity interest is remeasured to fair value at the date the controlling interest is acquired and a gain or loss is recognized in the income statement (ASC 805-10-25-10). The requirement to record the previously held equity interest at fair value may increase the outside basis difference. A question arises whether the additional temporary difference need also be frozen, consistent with ASC 740-30-25-16. Because of the lack of clarity in the guidance, we believe there is more than one acceptable view. One view is that the deferred tax liability for the entire outside basis difference (refer to Section TX 11.1.5.1 for meaning of “entire outside basis difference”) should be frozen until the temporary difference reverses. Alternatively, the parent investor may elect to freeze only the portion of the deferred tax liability that relates to undistributed earnings of the investee as of the date control is obtained. The approach selected is an accounting policy election that should be applied consistently from acquisition to acquisition (for further discussion, see Section TX 10.5.7).

When a deferred tax asset was previously recognized for an equity method investment, we believe the deferred tax asset should be written off unless the temporary difference is expected to reverse in the foreseeable future. If the deferred tax asset is written off, the charge should be recorded in income from continuing operations, except for any portion related to current year activity that is recorded in other comprehensive income.

Change from foreign subsidiary to investee

If a foreign subsidiary becomes an investee, ASC 740-30-25-15 indicates that the amount of outside basis difference of the foreign subsidiary for which deferred taxes were not provided on the basis of the indefinite reversal exception is effectively frozen until the indefinite reversal criteria are no longer met.

Change from domestic subsidiary to investee

We believe that ASC 740-30-25-16 is applicable only to outside basis differences to which the indefinite reversal exception applies and, therefore, is generally not available to outside basis differences in domestic entities. Thus, if deferred taxes were not provided on the taxable outside basis difference of a prior domestic subsidiary on the basis of the scenario suggested by ASC 740-30-25-7, deferred taxes generally would need to be provided on the subsidiary’s change in status to investee. We believe that the charge to recognize the deferred tax liability in these cases would be recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation). It is also important to remember that the charge would occur when the entity's intentions changed and it no longer anticipated that it would be able to recover the investment tax-free. An entity may determine this well before the change in status from subsidiary to investee actually occurs.
Change from investee to domestic subsidiary

The requirement to record a pre-existing interest at fair value also applies when an investee becomes a domestic subsidiary. The effect of reversing a deferred tax asset or liability recorded by the acquirer prior to the investee becoming a domestic subsidiary of the acquirer should be reflected in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation). Therefore, when an investee becomes a domestic subsidiary through a combination achieved in stages and a deferred tax liability can be released (based on the ability to recover the investment in a tax-free manner (see Section TX 11.1.4.5.1)), the corresponding credit should go to income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

If a deferred tax asset has been established for the excess outside tax basis of an investee and the investee subsequently becomes a domestic subsidiary through a combination achieved in stages, it is likely that the deferred tax asset will no longer qualify for recognition (i.e., if the temporary difference will not reverse in the foreseeable future as required in ASC 740-30-25-9). In this case, the deferred tax asset should be derecognized with the charge recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

Sometimes the scenario suggested in ASC 740-30-25-7 does not apply and the acquirer cannot release a deferred tax liability for an excess book outside basis difference in its investment in a domestic subsidiary acquired through a combination achieved in stages. In such cases, the tax effect of the corresponding change in outside-basis difference caused by the requirement to record the pre-existing equity interest at fair value should also be recorded in income from continuing operations (except for the portion related to current year activity, which is subject to intraperiod allocation).

11.1.10.3 Changes in a Parent's Equity in the Net Assets of a Subsidiary Resulting from Transactions with the Non-Controlling Shareholders

A parent's ownership interest in a subsidiary can change while its controlling financial interest in the subsidiary is retained. For example, the parent might buy additional interests or sell interests in the subsidiary and/or the subsidiary might reacquire some of its ownership interest or issue additional ownership interest. Under ASC 810-10-65-1, these events are considered equity transactions. Accordingly, the difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted is recognized in equity attributable to the parent. A further discussion on these transactions and the tax accounting consequences is included in Section TX 10.8.

11.1.10.4 Tax-to-Tax (Inside Versus Outside) Tax Basis Differences

In addition to the outside basis differences and inside basis differences discussed above, differences may exist between the tax basis of the capital stock of a subsidiary (i.e., the parent's tax basis in the shares of the subsidiary) and the subsidiary’s tax basis in the underlying individual net assets. These differences are generally referred to as “tax-to-tax differences” or “inside versus outside tax-basis
differences.” Such differences are not discussed in ASC 740.¹ Temporary differences are differences between an asset or liability’s tax basis and the reported amount in the financial statements. Consequently, tax-to-tax differences are not temporary differences as defined by ASC 740, and recognition of a deferred tax asset for an outside tax-basis difference over an inside tax-basis difference is prohibited.

11.1.10.5 Equity Method Investees

Investments accounted for under the equity method for financial reporting purposes, pursuant to ASC 323, *The Equity Method of Accounting for Investments in Common Stock*, are generally accounted for under the cost method for tax purposes. As a result, a temporary difference arises related to the outside basis difference in the investment. Deferred taxes should be provided for this outside basis temporary difference as discussed in Section TX 11.1.4.4, Section 11.1.7 and Section TX 11.1.8.

The outside basis difference is calculated by comparing the tax basis of the stock to the book basis of the investment. While determining the tax basis (i.e., cost) of the stock is generally straightforward, complexities often arise when applying the equity method to determine the book basis. Under the equity method, the investor is required to allocate its cost of the investment to the individual assets and liabilities of the investee, similar to the purchase price allocation process required for business combinations. This allocation process includes consideration of incremental deferred tax assets and liabilities (on the investee’s books) for differences between the allocated values (that reflect the investor’s cost) and the carrying amounts in the investee’s financial statements. ARM 1163.441 provides further guidance on this allocation process and determining the underlying equity in the net assets of the investee.

11.2 Certain Bad Debt Reserves for U.S. S&L Associations

Excerpt from ASC 942

ASC 942-740-25-1:
As described in paragraph 740-10-25-3, a deferred tax liability shall not be recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. 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 (that is, the base-year amount).

(continued)

¹ The FASB staff addressed tax-to-tax differences in an announcement at the March 1993 EITF meeting. The staff indicated that recognition of deferred tax assets is only permitted for deductible temporary differences and carryforward amounts.
However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction shall be accrued as tax expense of the current period; the accrual of those income taxes shall not be accounted for as an extraordinary item.

ASC 942-740-25-2:
Paragraph 740-30-25-52 requires that a deferred tax liability be recognized for the following types of taxable temporary differences:

a. Bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

Prior to ASC 740, a deferred tax liability was not recognized for bad debt reserves for U.S. S&L associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (i.e., the base-year amount). ASC 740 continues the exception for this taxable temporary difference (ASC 740-10-25-3(a) (3)), but prospectively requires a deferred tax liability for amounts arising in tax years beginning after December 31, 1987 (ASC 942-740-25-1 through 25-3).

There are two key tax-related questions on this topic: (1) What is the base-year bad debt reserve of U.S. S&L associations (and other qualified thrift lenders)? (2) How are deferred taxes calculated for amounts that are in excess of the base-year amount?

The base-year tax reserve is the bad debt reserve for income tax purposes that arose in tax years beginning before 1988. The base-year tax reserve includes the balances of the nonqualifying, qualifying, and supplemental bad debt reserves as of the end of the tax year beginning before 1988. The excess at the balance sheet date of a tax bad debt reserve over the base-year reserve is a taxable temporary difference for which a deferred tax liability must be provided. If the tax bad debt reserve falls below the base-year reserve, the amount of that reduction constitutes taxable income, and the entity would need to increase its current taxes payable for the tax effect of that amount. Subsequent increases in the reserve, up to the base-year amount, are not taxable temporary differences (to the extent that such restorations of the base-year amount are permitted under the tax law).

The entire balance of the bad debt reserves for financial reporting purposes are considered future deductible temporary differences for which deferred tax assets are recognized, subject to an assessment of the need for a valuation allowance. The tax benefit of the deductible temporary difference (i.e., the entire book bad debt reserve) would be subject to a realization test, as would any other deferred tax asset.

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2 As of the issuance date of this guide the FASB was in the process of reviewing codification for accuracy, as such this reference is subject to change.
Example 11-10: Accounting for Income Tax Benefits from Bad Debts of a Savings and Loan Association

Assume that the following information is true as of December 31, 20X7:

<table>
<thead>
<tr>
<th></th>
<th>Deductible Temporary Difference</th>
<th>Taxable Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book bad debt reserve</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>Tax bad debt reserve</td>
<td></td>
<td>$3,000</td>
</tr>
<tr>
<td>Base-year reserve</td>
<td></td>
<td>$2,000</td>
</tr>
</tbody>
</table>

At December 31, 20X7, the taxable temporary difference would be $1,000 (a tax bad debt reserve of $3,000 less a base-year reserve of $2,000).

If, as of December 31, 20X8, the tax bad debt reserve were to fall to $2,000, there would be no remaining taxable temporary difference because the tax bad debt reserve would equal the base-year reserve.

If, as of December 31, 20X9, the tax bad debt reserve were to fall further to $1,500, the current tax liability (payable) would increase, but there would be no deferred tax liability because the tax bad debt reserve would be less than the base-year reserve.

11.3 Policyholders’ Surplus Account of Stock Life Insurance Companies

Excerpts from ASC 944

ASC 944-740-25-2:
Except as noted in the following paragraph, a deferred tax liability or asset shall be recognized for the deferred tax consequences of temporary differences in accordance with Topic 740.

ASC 944-740-25-3:
As described in Topic 740, a life insurance entity shall not provide deferred taxes on taxable temporary differences related to policyholders’ surplus that arose in fiscal years beginning on or before December 15, 1992. However, if circumstances indicate that the insurance entity is likely to pay income taxes, either currently or in later years, because of a known or expected reduction in policyholders’ surplus, income taxes attributable to that reduction shall be accrued as a tax expense of the current period; the accrual of those income taxes shall not be accounted for as an extraordinary item.

The Life Insurance Company Tax Act of 1959 allowed stock life insurance companies to defer a portion of their income in a tax-memorandum account called the Policyholders’ Surplus Account (PSA). The accumulated deferred income was subject to tax only if the amounts were deemed to be distributed from the PSA or if certain stipulated maximums were exceeded. The Deficit Reduction Act of 1984 repealed the provisions that allowed the deferral of income, but left intact the provisions that subjected deductions from the PSA to income tax.
In general, amounts in the PSA are subject to income tax in the following circumstances:

- Distributions to shareholders are deemed to come from the PSA.
- Amounts are subtracted from the PSA pursuant to a special election by the taxpayer.
- The balance in the PSA exceeds a prescribed limit.
- The entity ceases activity as an insurance entity for one year or as a life insurance entity for two consecutive years.

The American Jobs Creation Act of 2004 suspended the rules imposing tax on distributions to shareholders from the PSA. The Act also changed the order in which distributions are deemed to have occurred: Distributions are first paid out from the PSA, then from the shareholders’ surplus account (SSA), and finally from other accounts. These changes apply to tax years beginning in 2005 and 2006 only.

Pursuant to ASC 740-10-25-3(a)(4), deferred taxes do not need to be provided on the PSA balance unless it becomes apparent that those temporary differences will reverse in the foreseeable future.

**11.4 Deposits in Statutory Reserve Funds by U.S. Steamship Entities**

ASC 995-740 provides that specific taxable temporary differences related to U.S. steamship entities may be exempted from the requirement for recognition of deferred income taxes on all temporary differences. Specifically, ASC 995-740-25-2 prescribes the treatment under ASC 740 of temporary differences related to deposits in statutory reserve funds of U.S. steamship entities that were not previously tax-effected. ASC 995-740-25-2 states, “The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship entities that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse.”

**11.5 Tax Effects of Changes in Foreign Exchange Rate**

**11.5.1 Translation of Foreign Deferred Taxes**

Deferred foreign income taxes are translated at current rates under ASC 830, *Foreign Currency Matters*, regardless of an entity’s functional currency.

**11.5.2 Transaction Gains and Losses**

Gains and losses from foreign currency transactions will generally be taxable (deductible), either in the U.S. or in a foreign country. If these gains and losses are included in taxable income in a period that differs from the one in which they are included in income for financial reporting purposes, ASC 830-20-05-3, requires deferred tax accounting in accordance with ASC 740.

**11.5.3 Translation Adjustments on Outside Basis Differences**

Translation adjustments for subsidiaries are part of the outside basis temporary difference related to the parent’s investment in the subsidiary. These adjustments, in general, reflect the gains and losses associated with the translation of a foreign subsidiary’s financial statements from its functional currency into the reporting currency. ASC 830-30-45-21, states that deferred taxes shall not be provided on
translation adjustments when deferred taxes are not provided on unremitted earnings under the indefinite reversal exception discussed in ASC 740-30-25-17. However, if deferred taxes are not provided on unremitted earnings because it is expected that their repatriation will result in no additional U.S. tax because of foreign tax credits, it may still be necessary to provide for deferred tax on translation adjustments if the indefinite reversal criteria are not met and if realization would not constitute foreign source income or would not generate foreign tax credits.

When determining whether to tax effect translation adjustments, the following points should be considered:

1. The need for tax-effecting is first determined on a foreign-operation-by-foreign-operation basis. Hence, it may be appropriate to tax-effect translation adjustments of only certain foreign operations. (Note that while the need is determined on an operation-by-operation basis, operations will often be aggregated by tax jurisdiction for tax-planning and computational purposes.)

2. Even though all local currency net assets (represented by total capital and retained earnings) affect the translation adjustment, the portion of the translation adjustment tax-effected within an operation identified in consideration 1 above should be directly related to the portion of equity (including capital and retained earnings) that is expected to be remitted. For example, if return of capital is not expected, but all retained earnings will be remitted, it may be appropriate to tax-effect only the portion of the translation adjustment related to retained earnings. If a return of both capital and retained earnings is contemplated, it may be appropriate to consider whether the capital portion is likely to be taxed as a capital gain and will not trigger any foreign tax credits as no local taxes would typically have been paid with respect to the currency effects.

3. It is necessary to consider whether the translation adjustments will result in ordinary or capital gain or loss. Different tax rates may apply, and the assessment of whether realization is more-likely-than-not may be affected. Further, the extent to which foreign tax credits can be applied in the calculation will need to be considered.

4. For a discussion on the treatment of translation adjustments related to branches see Section TX 11.6.1.

11.5.4 Hedging

11.5.4.1 Hedging an Investment in a Foreign Subsidiary

A parent company may enter into a transaction that qualifies as a hedge of its net investment in a foreign subsidiary. Any gains or losses associated with this hedge are recognized in the cumulative translation adjustments (CTA) account. Consistent with the treatment of gains and losses associated with the hedging transaction, the tax effects of temporary differences created by this hedging transaction generally are credited or charged to CTA under ASC 830-30-45-21 and ASC 740-20-45-11(b). If the indefinite reversal exception in ASC 740-30-25-17 applies, the parent would not need to provide for deferred taxes related to CTA. However, in such instances, the entity should provide for the tax effects of any temporary differences resulting from the hedging transaction because the associated tax consequences are not indefinitely deferred (i.e., the instrument used to hedge will have tax consequences upon its settlement). In such situations, a deferred tax asset or liability would be recognized on any gains or losses associated with the hedge, with corresponding entries for CTA. Upon settlement of the hedge, the deferred taxes would be reversed.
to offset the current taxes associated with the settlement. The net tax effects of the hedge would remain in CTA until the investment in the foreign entity was sold or completely, or substantially, liquidated.

11.5.4.2 Hedging a Deferred Tax Balance

An entity may have a foreign subsidiary that hedges the foreign currency risks associated with a deferred tax asset or liability and whose functional currency is the reporting currency. Since gains and losses on the remeasurement of the deferred tax asset or liability are recorded in the income statement, gains or losses from the hedging instrument designated as a fair value hedge of foreign currency should also be recorded in the income statement. (See ASC 815, Derivatives and Hedging, for entities that designate these hedges as cash flow hedges of foreign currency.) Within the income statement, the hedging gains or losses should be reported on the same line as the foreign currency gains or losses so that the gains or losses on the hedged item are offset by the losses or gains on the hedging instrument.

11.5.5 U.S. Dollar Functional Currency

11.5.5.1 Nonmonetary Assets and Liabilities

ASC 740’s asset and liability method determines the deferred taxes that are implicit in the balance sheet based on the assumption that assets will be recovered and liabilities will be settled at their carrying amounts. When a foreign operation uses the U.S. dollar as its functional currency, the carrying amounts of nonmonetary assets and liabilities (e.g., fixed assets) are based on U.S. dollar amounts that are derived by using historical exchange rates.

The foreign tax basis of the asset would have been initially established when the asset was acquired. That tax basis equaled the amount of foreign currency paid to acquire the asset, which was the same amount translated at the exchange rate then in effect when the asset was acquired (i.e., the historical rate) and used to arrive at the U.S. dollar carrying amount before depreciation. The foreign tax basis, especially in hyperinflationary countries, may be subject to indexing under the foreign tax law.

For any nonmonetary asset, the temporary difference for foreign tax purposes includes the following three components:

1. The difference between the foreign tax basis before any adjustment for indexing and the carrying amount in the pre-remeasurement, foreign-currency financial statements (i.e., after adjustment to U.S. accounting principles and before remeasurement into U.S. dollars)

2. The changes in tax basis, if any, resulting from indexing provisions of the foreign tax law

3. The difference arising in remeasurement (i.e., the difference between the historical-rate and current-rate translations of the U.S. dollar carrying amount)
Typically, in hyperinflationary countries, the second component listed above would partially offset the impact of the third component.

A strict application of ASC 740’s asset and liability method would require that deferred foreign taxes be provided for all three components, but ASC 740-10-25-3(f) precludes deferred taxes for the second and third components. While the effects of indexing on the tax bases are recognized in computing deferred taxes in situations where the foreign currency is the functional currency, they are not recognized for differences related to assets and liabilities that under, ASC 830-10, are remeasured from the local currency into the functional currency using historical exchange rates.

Thus, for fixed assets, when the U.S. dollar is the functional currency, deferred taxes should be computed in the foreign currency by comparing the historical book and tax bases in the foreign currency after the respective depreciation, but before any indexing for book or tax purposes. The foreign currency deferred tax is then remeasured into U.S. dollars using the current exchange rate. Any additional tax depreciation on the current return that results from indexing will reduce the current tax provision.

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**Example 11-11: Foreign Subsidiary with a U.S. Dollar Functional Currency**

**Background/Facts:**
A foreign subsidiary with a U.S. dollar functional currency purchased an item of plant and equipment for 5,000 foreign currency (FC) at the start of year 1, when the exchange rate was FC5 to $1. The asset is depreciated on the straight-line basis over ten years for financial reporting purposes and over five years for tax purposes. The foreign tax law does not include indexing. The exchange rate increases to FC7 to $1 in year 3.

**Question:**
What portion of the temporary difference gives rise to deferred taxes?

**Analysis/Conclusion:**
Deferred taxes should only be provided on the difference between the FC tax basis and the FC equivalent of the U.S. dollar book basis (i.e., the FC carrying amount in U.S. GAAP before remeasurement) translated at the historical exchange rate. Consistent with ASC 740-10-25-3(f), deferred taxes should not be provided on the remaining difference that is attributable to changes in the exchange rate since the time of the asset’s acquisition (i.e., the difference between the current spot rate and the historical exchange rate at the date of the asset’s acquisition). The calculation of (continued)
these temporary differences and the portion of the temporary difference that gives rise to deferred taxes is shown below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Exchange rate: FC5 = $1</th>
<th>Exchange rate: FC7 = $1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cost FC5,000</td>
<td>Cost FC5,000</td>
</tr>
<tr>
<td></td>
<td>Accumulated depreciation (1,000)</td>
<td>Accumulated depreciation (3,000)</td>
</tr>
<tr>
<td></td>
<td>Tax/book basis FC4,000</td>
<td>Tax/book basis FC2,000</td>
</tr>
<tr>
<td></td>
<td>Temporary difference FC</td>
<td>Temporary difference FC</td>
</tr>
<tr>
<td></td>
<td>Recognized under ASC 740</td>
<td>Recognized under ASC 740</td>
</tr>
<tr>
<td></td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td></td>
<td>(500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td></td>
<td>FC4,500</td>
<td>FC3,500</td>
</tr>
<tr>
<td></td>
<td>$900</td>
<td>$700</td>
</tr>
<tr>
<td></td>
<td>FC4,500</td>
<td>FC4,900</td>
</tr>
<tr>
<td></td>
<td>FC 500</td>
<td>FC1,500</td>
</tr>
</tbody>
</table>

The temporary differences recognized under ASC 740 would be tax-effected at the applicable foreign tax rate and remeasured into the functional currency at the current exchange rate.

In year 3 above, there is a total temporary difference of FC2,900. This is the difference between the tax basis of the asset and the future foreign currency revenues at the current exchange rate, which is needed to recover the functional currency book basis. The temporary difference has arisen from two sources:

- The difference between U.S. GAAP depreciation in the foreign currency before remeasurement and tax depreciation. This element, which is a temporary difference of FC1,500, is recognized under ASC 740.
- The change in the exchange rate that changes the foreign currency equivalent of the functional currency book basis, using the current exchange rate. In this example, it increases the temporary difference by FC1,400, (FC4,900 vs. FC3,500). This element is not recognized in the financial statements under ASC 740-10-25-3(f).

It is important to note, however, that foreign private issuers located in countries with highly inflationary economies that prepare financial statements restated for general
price-level changes would record deferred taxes for temporary differences between
the indexed tax-basis amount of the asset or liability and the related price-level
restated amount reported in the financial statements (ASC 830-740-25-5 and ASC
830-740-30-1).

11.5.5.2 Monetary Assets and Liabilities

An entity, located and taxed in a foreign jurisdiction, and having the U.S. dollar as
its functional currency, may have monetary assets and liabilities denominated in the
local currency, which would likely be the currency used to prepare the income tax
return in the foreign jurisdiction. While the effects of changes in the exchange rate
would give rise to transaction gains or losses in the functional currency financial
statements under ASC 830, the resulting change in the functional currency financial
statement carrying amounts, however, generally will not result in the recognition of
either current or deferred taxes in the foreign jurisdiction. This is because in such
circumstances, changes in foreign exchange rates do not have tax consequences
in the foreign jurisdiction and do not create basis differences between the local
currency financial statement carrying amounts and the local currency tax basis.

However, such entity may have monetary assets and liabilities that are denominated
in currencies other than the local currency. Perhaps the most common example
would be a foreign subsidiary’s intercompany payables, denominated in U.S.
dollars. If the entity will be taxed on the difference between the foreign currency
amount at which the asset or liability is originally incurred and the amount at which
it is ultimately settled, the temporary difference for the monetary asset or liability
would be computed by comparing the book basis in the currency of the country of
domicile—the carrying amount in U.S. dollars in the remeasured financial statements
translated at the current exchange rate—with the tax basis in that currency. After
application of the applicable rate to the temporary difference, the deferred tax so
computed in the foreign currency would be translated at the current exchange rate
into U.S. dollars for inclusion in the remeasured financial statements. (A deferred tax
asset would, of course, be assessed as to the need for a valuation allowance.)

This procedure will cause a deferred tax asset or liability to be recognized as
the exchange rate changes. When the monetary asset or liability is denominated
in U.S. dollars, changes in the exchange rate between the U.S. dollar and the
foreign currency will give rise to a deferred tax effect, even though there is no
pretax exchange-rate gain or loss in the remeasured financial statements. In some
jurisdictions, changes in the exchange rate would have current tax consequences, as
illustrated in the following example.

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Example 11-12: Foreign Subsidiary with a U.S. Dollar Functional Currency and
Unrealized Foreign Exchange Gains/Losses on Intercompany Loans

Background/Facts:
Company P is a multinational company domiciled in the U.S. with a wholly owned
subsidiary (“Sub”) in Country B. Company P prepares U.S. GAAP consolidated
financial statements. The reporting currency (RC) is the U.S. dollar (“USD”). Sub has
concluded that its functional currency (FC) is also the USD, pursuant to ASC 830,
Foreign Currency Matters. Since Sub maintains its books and records in USD, there
is no remeasurement from local currency into USD for financial statement purposes.

(continued)
Under the provisions of the tax law in Country B, Sub must file its tax return in local currency (LC), the Euro. Sub has a USD-denominated intercompany payable to P in the amount of $30.0 million.

The tax law of Country B requires that Sub’s unrealized foreign exchange (“FX”) gains/losses be included in taxable income in the period in which they arise. It is determined that this law applies with respect to the intercompany loan. Since the intercompany loan is denominated in USD, there is no pre-tax accounting under ASC 830 for unrealized translation gains/losses at each reporting date. However, for purposes of Sub’s tax filing in LC, unrealized FX gains/losses are reported on the tax return as they occur.

**Question:**
Do the unrealized FX gains/losses, which are currently taxable and created upon translation of the USD-denominated intercompany loan to local currency for tax reporting purposes, result in a temporary difference under ASC 740?

**Analysis/Conclusion:**
No. In this fact pattern, the unrealized FX gains/losses that are currently taxable will not reverse either on a future tax return or when the liability is settled. Therefore, unrealized FX gains/losses that arise upon translation of the intercompany loan to local currency for tax reporting purposes should not be treated as a temporary difference. Rather, the effects on taxable income should be accounted for in the periods in which they arise. In addition, such tax effects should generally be included within income tax expense in continuing operations, and not as part of the cumulative translation adjustments (CTA) account in other comprehensive income (OCI). To the extent the tax effects resulting from unrealized FX gains/losses are significant, additional explanation may be needed in connection with the company’s tax rate reconciliation disclosures.

A careful understanding of the applicable tax law in the relevant jurisdiction is important in determining the accounting for the income tax effects of the unrealized FX gains/losses. In this particular fact pattern, the tax law of Country B requires that unrealized FX gains/losses be included in taxable income in the period in which they arise. In many jurisdictions, however, the law instead would require taxation of the unrealized FX gains/losses when the liability is settled. In those circumstances, a temporary difference would exist and a deferred tax asset/liability would be required for the future tax consequence of the accumulated unrealized FX effects as of each balance sheet.

**11.5.6 Indexed NOLs in Highly Inflationary Economies**

**11.5.6.1 Switching to a Highly Inflationary Economy**

In accordance with ASC 830-10-45-16, when the functional currency is the reporting currency, ASC 740-10-25-3(f) prohibits recognition of deferred tax benefits that result from indexing for tax purposes assets and liabilities that are remeasured into the reporting currency using historical exchange rates. Thus, deferred tax benefits attributable to any such indexing that occurs after the change in functional currency to the reporting currency are 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. Prospectively, deferred tax assets should not be recorded for future indexation consistent with the prohibition in ASC 740-10-25-3(f).
In many instances, net operating loss (NOL) carryforwards in these jurisdictions are also indexed for inflation. The staff announcement did not explicitly address how such indexed NOLs should be treated. Should the tax benefit resulting from the indexation of existing NOLs be recorded or should it be precluded from recognition in accordance with ASC 740-10-25-3(f)? This leads to another question: Because a foreign entity’s tax return will use indexed tax bases for nonmonetary assets to calculate tax deductions that may increase the NOL upon which a deferred tax asset is reported, should the portion of the current-period loss attributable to indexing be segregated and not recognized in accordance with ASC 740-10-25-3(f)?

ASC 830-10-45-18 no longer regards deferred tax assets and liabilities as items that must be translated using historical exchange rates. Accordingly, we believe that the prohibition in ASC 740-10-25-3(f) which relates solely to assets and liabilities translated using historical exchange rates, does not apply and that the impact of indexing the NOL amount should be recognized. Further, the tax loss reported on the tax return should be used to calculate the NOL upon which a deferred tax asset is reported because the prohibition in ASC 740-10-25-3(f) relates to the direct book/tax differences, and not to the impact of indexing on the deductions used in the tax return. Also, we do not believe that it is practicable to determine the portion of prior tax losses that are attributable to indexing nonmonetary assets.

Thus, the entire amount of the indexed foreign currency NOL should be recognized as a deferred tax asset and translated using current exchange rates. Such deferred tax assets should then be evaluated for realization as required by ASC 740.

11.5.6.2 Economies That Are No Longer Highly Inflationary

When the reporting currency is the functional currency, ASC 740 does not permit the recording of deferred taxes for portions of the temporary differences that result from the remeasurement of nonmonetary items and from tax indexing. However, once ASC 830-10-45-15 has been applied, these portions become part of the temporary differences between the new functional currency book bases of nonmonetary items and their tax bases adjusted for any indexing. The temporary differences for nonmonetary items are not changed, but the ASC 740 exception for portions of the differences no longer applies. Thus, while there is no effect of the change in functional currency on the consolidated carrying amount of nonmonetary items, there is likely to be an effect on deferred taxes. ASC 830-740-45-2 requires that deferred taxes be reflected in the cumulative translation adjustments component of other comprehensive income in shareholders’ equity.

11.5.7 Intraperiod Allocation as It Applies to the CTA Account

Some transaction gains and losses (ASC 830-20-35-3) and all translation adjustments are recorded directly in the cumulative translation adjustments (CTA) account. ASC 830-30-45-21 requires the tax effects of these items to be allocated to the CTA account.

Allocation to the CTA account is clearly required for current and deferred taxes on transaction gains and losses recorded in the CTA account and for deferred taxes on translation adjustments. With respect to deferred taxes provided by a parent or investor for the outside basis temporary difference, the method of allocating deferred taxes between continuing operations and other items must be considered. (As indicated in ASC 740-20-45-14, the allocation of tax effects to two or more items other than continuing operations must follow certain procedures under ASC 740.) Although several alternatives exist, one logical method of allocation is set forth...
below. For simplicity of discussion, it should be assumed that (1) the only sources of change in the outside basis difference during the year are continuing operations and translation adjustments for the year, and (2) no remittance or other recovery of the parent’s investment has occurred during the year.

1. Compute the total deferred tax provision for the year. This would be the difference between (a) the required year-end deferred tax liability at enacted tax rates and current exchange rates, utilizing available credits and tax-planning alternatives, and (b) the beginning-of-year deferred tax liability.

2. Compute the charge to continuing operations. This consists of the following components:
   a. The deferred taxes related to the current year’s continuing operations at average translation rates for the year (i.e., the rate used in translating the income statement).
   b. The change in the deferred tax liability resulting from changes in tax rates, tax-planning actions, and the portion of a change in the valuation allowance that results from a change in judgment about the realizability of the related deferred tax asset in future years. Note that in absence of a basis for allocation, it may be appropriate to prorate the effects of changes in tax-planning actions between continuing operations and the CTA account.

3. The differential (1 less 2 above) represents (in the absence of any other items except continuing operations) the charge (or credit) to the CTA account, which should include the following components:
   a. The capital gain or loss effect of revaluation of contributed capital.
   b. The effect of exchange rate changes on beginning-of-year deferred taxes provided on unremitted earnings.
   c. The effect of exchange-rate changes on the deferred tax liability provided on current-year continuing operations (2 above) at year-end, and not average, exchange rates.
   d. The effects of changes in the valuation allowance and changes in tax-planning actions that are not appropriately allocated to continuing operations.

This computation will require appropriate consideration of foreign withholding taxes and limitations on utilization of foreign tax credits.

Chapter TX 12 offers a comprehensive discussion of intraperiod allocation.

11.5.8 Deferred Taxes on Intercompany Loans with Foreign Subsidiaries

Often, parent entities have intercompany loans with their foreign subsidiaries that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future as discussed in ASC 830-20-35-3(b)). Typically, these loans are either denominated in the functional currency of the parent or the functional currency of the subsidiary. Because of the difference between the functional currencies and the denomination of the loan, foreign currency translation adjustments arise. As a result, one needs to consider whether deferred taxes should be recorded on these translation adjustments, particularly in light of any assertion of indefinite reversal under ASC 740-30-25-17. Consider the following example:
Example 11-13: Whether Deferred Taxes Should Be Provided on the Foreign Currency Gains and Losses Reported in OCI

Background/Facts:
Company X is a U.S. multinational corporation and has several outstanding intercompany loans with one of its wholly owned foreign subsidiaries, Subsidiary Y. The functional currency of Subsidiary Y is the local currency. Company X has asserted that the loans are of a long-term investment nature. Therefore, gains and losses are reported in other comprehensive income (“OCI”) under ASC 830-30-45-21.

The intercompany loans can be divided into the following two categories:

- Loans denominated in the functional currency of the parent for which Subsidiary Y bears the currency risk.
- Loans denominated in the functional currency of Subsidiary Y for which the parent bears the currency risk.

Company X asserts and meets the indefinite reversal criteria under ASC 740-30-25-17 for its investment in Subsidiary Y.

Question:
Should deferred taxes be provided on the foreign currency gains and losses reported in OCI?

Analysis/Conclusion:
ASC 830-30-45-21 states that translation adjustments should be accounted for in the same way that temporary differences are accounted for under the provisions of ASC 740, except for translation adjustments related to foreign subsidiaries where deferred taxes are not provided on unremitted earnings under the indefinite reversal exception in ASC 740-30-25-17.

Loans denominated in the functional currency of Subsidiary Y

The intercompany loans and the related gains and losses on the loans denominated in the functional currency of Subsidiary Y should be viewed as a part of Company X’s net investment in Subsidiary Y (i.e., outside basis difference). The tax effects should be evaluated under the governing principles of the indefinite reversal criteria in ASC 740-30-25-17. Accordingly, a deferred tax liability should be recorded for a book-over-tax-outside basis difference unless an assertion of indefinite reversal is made under ASC 740-30-25-17.

Loans denominated in the functional currency of the parent

The gains and losses on intercompany loans denominated in the functional currency of the parent create a difference between the book basis and tax basis of the intercompany payable or receivable on Subsidiary Y’s books (i.e., inside basis difference). Deferred taxes should generally be provided on these types of temporary differences, and the tax benefit or expense should generally be recorded in other comprehensive income, subject to the intraperiod allocation rules of ASC 740-20. However, if the parent is asserting indefinite reversal of its outside basis difference in Subsidiary Y under ASC 740-30-25-17, it may be appropriate to extend the principles of the indefinite reversal exception to the temporary differences related to the intercompany loans. This latter approach would only be appropriate if the ultimate taxation of the foreign currency effects of a loan only occur upon repayment and if settlement is not planned or anticipated in the foreseeable future.

(continued)
In cases where the indefinite reversal criteria is asserted and met, we believe that a second assessment must also be performed with respect to the intercompany loans to determine whether a deferred tax liability should be provided. If events other than a cash remittance or repatriation event could cause that portion of the temporary difference to become taxable, Company X would need to consider whether the taxable event can, in fact, be deferred indefinitely. For example, under the IRS’s “significant modification” rules, many common business decisions (e.g., changing the interest rate on a loan, recapitalizing a portion of the loan, etc.) could result in a significant modification to the terms of the loan and cause a taxable event, even if repayment or settlement does not occur. In other words, even though Company X asserts the loans are of a long-term investment nature and asserts that it will indefinitely reinvest the earnings of Subsidiary Y, if Company X is unwilling or unable to assert that a taxable event can be deferred indefinitely because certain business decisions may cause a taxable event, a deferred tax liability should be established, with the related tax expense recorded in OCI.

In addition to the second evaluation above, any temporary difference resulting from an excess of tax-over-book outside basis difference would need to be evaluated under ASC 740-30-25-9. Under that guidance, a deferred tax asset is recorded only if it is apparent that the temporary difference will reverse in the foreseeable future.

In evaluating the appropriate foreign currency and deferred tax implications of intercompany loans, it is also important to ensure that management’s assertions used to determine the appropriate book accounting under GAAP are consistent with management’s assertions submitted to the relevant taxing authorities, which form the basis for determining the appropriate tax return treatment.

11.6 Accounting for Branch Operations and Subpart F Income

11.6.1 Branch Operations

A branch operation generally represents the operations of an entity conducted in a country that is different from the country in which the entity is incorporated. Accordingly, for a U.S. entity, a branch represents the portion of the U.S. entity’s operations that are located in and taxed by a foreign jurisdiction. For U.S. entities, a branch can also take the form of a wholly-owned foreign corporation that has elected for tax purposes to be treated as a disregarded entity of its immediate parent corporation.

Branch operations are often subject to tax in two jurisdictions: the foreign country in which the branch operates and the entity’s home country. Accordingly, we would expect the entity to have two sets of temporary differences that give rise to deferred tax assets and liabilities: one for the foreign jurisdiction in which the branch operates and one for the entity’s home jurisdiction. The temporary differences in the foreign jurisdiction will be based on the differences between the book basis and the related foreign tax basis of each related asset and liability. The temporary differences in the home country jurisdiction will be based on differences between the book basis and the home country tax basis in each related asset and liability.

In addition, the entity should record deferred taxes in its home country for the tax effects of foreign deferred tax assets and liabilities because each would be expected to constitute a temporary difference in the home country deferred tax computation. Specifically, when a deferred foreign tax liability is settled, it increases foreign taxes
paid, which decreases the home country taxes paid as a result of additional foreign tax credits or deductions for the additional foreign taxes paid. Conversely, when a deferred foreign tax asset in the foreign jurisdiction is recovered, it reduces foreign taxes paid, which increases the home country taxes as a result of lower foreign tax credits or deductions for foreign taxes paid. (See ASC 740-10-55-20 which describes a similar concept within the context of deductible state income taxes.)

In considering the amount of deferred taxes to record in the home country as they relate to the foreign deferred tax assets and liabilities recorded, an entity must consider how those foreign deferred taxes, when paid, will interact with the tax computations in the home country tax return. In the United States, for example, a taxpayer makes an annual election to deduct foreign taxes paid or to take them as a credit against its U.S. tax liability. (Although the deduction of foreign taxes paid is obviously less beneficial than claiming a credit, there are limitations on the use of foreign tax credits, and unutilized foreign tax credits have a limited carryforward period.) Also, in deciding whether to deduct or credit foreign taxes paid, a taxpayer will need to consider the interaction of the income and taxes of the foreign branch with the income and taxes of the entity’s other branches and foreign corporations, which, in turn, will affect the decision to take a deduction or a credit for foreign tax.

If the taxpayer expects to take a credit for the foreign taxes to be paid, it should record, before considering any related credit limitations, a home country deferred tax asset (liability) for each related foreign deferred tax liability (asset) at a rate of 100 percent for the amount of the foreign deferred taxes that are expected to be creditable. If the foreign taxes that will be paid as the deferred taxes reverse are not expected to be fully creditable (e.g., in situations where the foreign tax rate exceeds the home country tax rate), unique considerations will arise. As a result, it may be appropriate to record home country deferred taxes on foreign country deferred taxes at a rate of less than 100 percent of the foreign deferred tax asset or liability, or it may be appropriate to record such taxes at a rate of 100 percent with a valuation allowance for the portion of any net foreign deferred taxes that, when paid, are expected to expire unutilized.

If the entity expects to deduct (rather than take a credit for) foreign taxes paid, it should establish in the home country jurisdiction deferred taxes on the foreign deferred tax assets and liabilities at the home country enacted rate that is expected to apply in the period during which the foreign deferred taxes reverse.

If there is no net deferred tax asset in the foreign jurisdiction due to a full valuation allowance, a corresponding deferred tax liability in the home country jurisdiction would generally be inappropriate.

While deferred taxes must be recorded for branch earnings, another area that must be considered when looking at the accounting for branches is the accounting for any cumulative translation adjustments (“CTA”) account for the operations of the branch. In circumstances when the temporary differences associated with the CTA of the foreign branch will not be taxed in the U.S. until there is a remittance of cash, a question arises as to whether or not a company can apply an indefinite reversal assertion to the CTA of the foreign branch.

We believe the answer depends upon which of two acceptable views the Company applies in its interpretation of the accounting literature. View 1 is that an indefinite reversal assertion is not available for a branch and View 2 allows for the application
of an indefinite reversal assertion (when facts and circumstances permit). The views are summarized as follows:

View 1—ACS 740-30-25-17, which is an exception to comprehensive recognition of deferred taxes, only applies to outside basis taxable temporary differences related to investments in foreign subsidiaries and certain foreign corporate joint ventures. Because branch income is directly taxable to the owner or parent, there is technically no outside basis difference in the branch and therefore the exception in ASC 740-30-25-17 is not applicable. Furthermore, ASC 740-30-15-4 prohibits applying the indefinite reversal criterion to analogous types of temporary differences.

View 2—In deliberating ASC 740, the FASB indicated that the underlying rationale for the exception in ASC 740-30-25-17 is based on the inherent complexity and hypothetical nature of the calculation. However, application of the exception depends on a company's ability and intent to control the timing of the events that cause temporary differences to reverse and result in taxable amounts in future years. In particular, the exception focuses on the expectation of owner or parent taxation in the home jurisdiction. If taxation of the CTA occurs only upon a remittance of cash from the branch, the timing of taxation can be controlled by the owner or parent. On that basis, an indefinite reversal assertion could be applied to the CTA of a foreign branch (even though the assertion could not apply to the periodic earnings of the branch since they pass through to the parent). This is not an “analogous” temporary difference which would be prohibited by ASC 740-30-15-4; rather, it is in the scope of ASC 740-30-25-17. That is because such amount relates to a foreign operation and carries with it the same measurement complexities as any other foreign outside basis difference.

The view taken is an accounting policy which should be applied consistently. Accordingly, if View 1 is adopted, it would be applied to all of the Company’s foreign branches. If View 2 is adopted, indefinite reversal could be asserted for any branch for which the criteria are supportable by specific plans relating to the unremitted branch earnings. As a result, under View 2, an indefinite reversal assertion could be made and supported for one branch while not being make for another.

For a company applying View 2, other points to note are as follows:

- Note that View 2 is analogous to the conclusion reached in Section TX 11.6.2.3 with respect to previously taxed income of a foreign subsidiary. As noted in Section TX 11.6.2.3, the fact that earnings have already been taxed can make the assertion difficult when there is a possibility of repatriation from foreign operations.

- When an overall translation loss exists in the CTA, it is necessary to demonstrate that the temporary difference will reverse in the foreseeable future before recognizing a deferred tax asset under ASC 740-30-25-9.

- In the event that an indefinite reversal assertion changes, the deferred taxes attributable to current year CTA movement are recorded to other comprehensive income in accordance with ASC 740-20-45-11(b). However, because the beginning-of-year CTA balance did not arise during the year, but rather in prior years, ASC 740-20-45-11(b) does not apply and the tax effects associated with these prior-year cumulative balances should be recorded to continuing operations.

The effects of translating the home country's temporary differences related to the foreign branch should be recorded in CTA (for further discussion, see Example 11-14).
Example 11-14: Recording Foreign Currency Fluctuation Impacts on Deferred Income Taxes Related to Foreign Branches

Background/Facts:
Company A is a U.S. corporation with a wholly owned subsidiary in Germany. The subsidiary is treated as a branch for U.S. tax purposes (i.e., a “check-the-box” election has been made). The functional currency of the German subsidiary is the local currency, the euro. In the current year, the subsidiary records an operating expense of €1 million and a corresponding accrual for an obligation payable in euros. The expense is deductible in the U.S. only when paid; therefore, a U.S. deferred tax asset is recorded on the deductible temporary difference. At that time, the exchange rate is 1.5 to 1, resulting in a deductible temporary difference of $1.5 million. At the end of the subsequent reporting period, the exchange rate is 2 to 1. Assuming no other change in the operating expense accrual, the U.S. deductible temporary difference would increase from $1.5 million to $2 million.

Question:
How should Company A record the income tax benefit related to the $.5 million increase in the deductible temporary difference?

Analysis/Conclusion:
The benefit should be recorded as part of the cumulative translation adjustment (CTA) in other comprehensive income (OCI). ASC 740-20-45-11(b) states that tax effects of gains and losses included in comprehensive income but excluded from net income shall also be charged or credited to OCI. In this case, the increase in the deductible temporary difference is caused by the change in the exchange rate. The effect of translating the accrual from euros to dollars in consolidation would be recorded in CTA, and the related tax effect should therefore also be recorded in CTA.

The example above is based on a simple fact pattern meant to highlight the requirement to allocate tax effects from translation adjustments to CTA. In most circumstances, changes in deferred tax assets and liabilities are caused by a number of reasons in addition to exchange rate changes (e.g., actual movements in the underlying accounts, changes in tax rates or laws, valuation allowance, etc.). In those circumstances, it may be more challenging to determine proper intraperiod allocation of the overall tax provision among the various components of comprehensive income.

Example 11-15: Deferred Tax Accounting on Inside Basis Difference in a Foreign Branch

Background/Facts:
• Company P has a branch in Country X where the statutory tax rate is 25 percent.
• In the current year, the branch has pretax income of $10,000. For Country X and U.S. tax purposes, the branch has excess tax-over-book depreciation of $5,000 and nondeductible inventory reserves of $3,000.
• For U.S. purposes, the branch is taxed at 40 percent.
• Taxes paid to Country X will be claimed as a foreign tax credit.

(continued)
**Question:**
How and in which jurisdictions should deferred taxes be recorded on the depreciation and nondeductible reserves temporary differences?

**Analysis/Conclusion:**
Because the branch is taxed in both Country X and the United States, the taxable and deductible temporary differences in each jurisdiction must be computed. A net deferred tax asset (DTA) for the U.S. tax effects of the foreign deferred tax liability (DTL) associated with the depreciable property, as well as a DTL for the U.S. tax effects of the foreign DTA associated with the reserves, would be included in the deferred tax balance because both the foreign DTL and DTA have a book basis but no tax basis. For U.S. tax purposes, this will reduce foreign taxes paid when the foreign DTA is recovered, and will increase foreign taxes paid when the foreign DTL is settled. Consequently, the effect of these foreign deferred taxes on the foreign taxes paid will, in turn, affect the U.S. tax liability as a result of the impact on future U.S. credits or deductions for foreign taxes paid.

This concept is illustrated below:

<table>
<thead>
<tr>
<th></th>
<th>Country X</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nondeductible reserves</td>
<td>750 ($3,000 x 25%)</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>(1,250) ($5,000 x 25%)</td>
<td></td>
</tr>
<tr>
<td>Branch DTL, Net</td>
<td>(500)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nondeductible reserves</td>
<td>1,200 ($3,000 x 40%)</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>(2,000) ($5,000 x 40%)</td>
<td></td>
</tr>
<tr>
<td>DTA on Branch DTL, Net</td>
<td>500 ($500 x 100%)*</td>
<td></td>
</tr>
<tr>
<td>U.S. DTL, Net</td>
<td>(300)</td>
<td></td>
</tr>
<tr>
<td>Total DTA/(DTL)</td>
<td>(800)</td>
<td></td>
</tr>
</tbody>
</table>

* It should be noted that a 100 percent U.S. tax rate is applied to the branch net DTL and results in a corresponding U.S. DTA for the same amount. This rate assumes that, when paid, the foreign taxes will be fully creditable in the United States. Any limitation that would affect Company P’s ability to take a full foreign tax credit in the United States would either affect the rate that should be applied to the branch net DTL or require the establishment of a valuation allowance on the U.S. net DTA established on the branch deferred taxes.

Furthermore, in some fact patterns, scheduling the reversal of the foreign deferred taxes may be required if the company’s foreign tax credit posture would be affected by the timing of these reversals, when considered in connection with the other foreign activities of the company or the tax consolidated group. Thus, if reversals of the foreign DTAs and DTLs are expected to occur in periods in which the company expects to claim a deduction (rather than credits) for foreign taxes paid, a 40 percent rate should be applied to the branch deferred taxes, rather than a 100 percent rate.

When the foreign branch incurs a loss, a deferred tax asset would arise in the foreign jurisdiction for that loss if it can be carried forward to offset future foreign taxable income and no valuation allowance is required. Generally, a foreign-branch loss would also be deductible under current U.S. tax law. If that were the case, should a “double” tax benefit (i.e., current U.S. deduction and foreign deferred tax asset) be recognized?

No, we believe that a deferred tax liability should be reported in the U.S. jurisdiction because the future foreign taxable income necessary for the realization of the foreign deferred tax asset will also be reported as U.S. income in future years, with no
foreign tax credits available to offset the U.S. tax in the year during which the foreign income is earned. As discussed above, the tax liability for this taxable temporary difference would generally be based on the foregone foreign tax credits that would otherwise have been available to the company had cash taxes been paid.

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**Example 11-16: Foreign Branches**

**Single Branch**

Assume that a U.S. entity has a foreign branch that incurs a $100 loss and records a deferred tax asset (DTA) of $20 related to a foreign NOL carryover (20 percent foreign tax rate) with no valuation allowance. Assuming that the U.S. entity is profitable, the $100 foreign loss that is included in the U.S. tax return would reduce the current U.S. taxes payable by $40.

To realize the foreign DTA of $20, the foreign branch will need $100 of foreign taxable income in the future, and this $100 will also need to be reported in future U.S. tax returns. As a result, a $20 U.S. deferred tax liability (DTL) should be recognized for the foreign DTA.

When the foreign branch earns $100 of income in the future, the $20 foreign DTA that is related to the foreign NOL will be utilized. Additionally, the $100 will be included in the U.S. tax return, creating $40 in current U.S. taxes payable and causing the $20 in deferred U.S. tax liability to reverse. The net effect will be a $40 tax provision for the $100 of branch income that is reported in the U.S. tax jurisdiction.

**Multiple Branches**

If more than one branch in more than one jurisdiction exists, the accounting increases in complexity. Assume that there are no temporary differences in a given year, that the tax rate is 40 percent in both the United States and foreign jurisdiction A, and that the tax rate is 20 percent in foreign jurisdiction B. The company takes U.S. foreign tax credits for its foreign taxes paid. There is no carryback potential, but both loss and credit carryforwards are allowed in each jurisdiction.

<table>
<thead>
<tr>
<th>U.S. domestic income</th>
<th>$ 800</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Branch A income</td>
<td>300</td>
</tr>
<tr>
<td>Foreign Branch B loss</td>
<td>(100)</td>
</tr>
<tr>
<td>Total entity income</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S. federal tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>U.S. federal tax prior to FTC</td>
<td>$400</td>
</tr>
</tbody>
</table>

The following illustrates the calculation of FTC availability:

<table>
<thead>
<tr>
<th>Net Income</th>
<th>Tax Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch A</td>
<td>$300</td>
</tr>
<tr>
<td></td>
<td>$120</td>
</tr>
<tr>
<td>Branch B</td>
<td>(100)</td>
</tr>
<tr>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$200</td>
</tr>
<tr>
<td></td>
<td>$120</td>
</tr>
<tr>
<td>Total entity income</td>
<td>$1,000</td>
</tr>
<tr>
<td>FTC limitation (200 / 1,000)</td>
<td>20%</td>
</tr>
<tr>
<td>U.S. Federal tax</td>
<td>$400</td>
</tr>
<tr>
<td>FTC limitation</td>
<td>20%</td>
</tr>
<tr>
<td>FTC limitation</td>
<td>$80—Utilization of $80 of FTC with $40 carried forward.</td>
</tr>
</tbody>
</table>

(continued)
In this example, although $120 of foreign taxes were paid, only $80 can be claimed as a tax credit in the current year’s return. The remaining $40 would be carried forward. Given that excess foreign tax credits have limited carryforward potential in the United States, these carryovers need to be assessed for realizability. If, for example, losses are anticipated in jurisdiction B through the U.S. foreign tax credit carryforward period, a valuation allowance may be appropriate on the $40 of excess foreign tax credits.

Also, with respect to the DTA of $20 that is related to the $100 of NOL generated in jurisdiction B, the company will need to consider whether a valuation allowance should be established. If a valuation allowance is not recorded, a corresponding DTL of $20 should be recorded in the United States. On the other hand, if a valuation allowance is recorded against the NOL-related DTA in jurisdiction B, a corresponding DTL in the U.S. jurisdiction would be inappropriate because there is no net DTA in the foreign jurisdiction.

### 11.6.2 U.S. Subpart F Income: Income from Foreign Subsidiaries That Cannot Be Deferred

#### 11.6.2.1 In General

If a U.S. corporation conducts business through a foreign subsidiary that has not elected to be taxed as a disregarded entity or partnership, there is normally no U.S. taxation unless earnings are distributed to the subsidiary’s parent. The exceptions to this general deferral rule are contained within subpart F of the Internal Revenue Code. Subpart F was enacted to discourage U.S. companies from forming a foreign subsidiary to defer the U.S. taxation of certain types of foreign earnings. Under the subpart F regime, certain types of income are currently taxable to the extent of the foreign subsidiary’s current earnings and profits (current E&P). Subpart F income, when taxable, is treated as a deemed dividend, followed by an immediate reconstitution of the deemed dividend to the foreign subsidiary. This reconstitution increases the U.S. parent’s tax basis in the foreign subsidiary. If a subsequent distribution is actually made from the foreign subsidiary, the amounts that have already been subjected to subpart F can be repatriated without further taxation (other than potential withholding taxes and any tax consequences applicable to foreign currency gains or losses). However, the distribution would serve to reduce the U.S. parent’s tax basis in the subsidiary.

In some circumstances the entire income of the foreign subsidiary may be subject to subpart F. Foreign subsidiaries whose subpart F income represents more than 70 percent of the entity’s gross income are considered “full inclusion” subsidiaries (meaning, their entire income is considered subpart F income). There are also instances where foreign subsidiaries engaged in certain financing activities may be subject to current U.S. taxation on their entire income in the absence of a statutory exception for “active” financing activities. In those circumstances, recognition of U.S. deferred taxes would be required for temporary differences of that subsidiary since it is effectively the tax equivalent of a branch.

Similar to the discussion in Section TX 11.6.1 for foreign branches, foreign entities subject to subpart F may have U.S. tax consequences that arise upon the reversal of temporary differences which, upon reversal, will represent subpart F income. Foreign temporary differences, both deductible and taxable, that will impact subpart F income (and thus U.S. taxes) when they reverse may give rise to U.S. deferred taxes (in a manner that is similar to that discussed in Section TX 11.6.1 for a foreign branch).
Additionally, subpart F income may sometimes be deferred for U.S. tax purposes because the foreign subsidiary has no current E&P. Deferred subpart F income is recognized in taxable income when the foreign subsidiary generates current E&P. We believe the accounting consequences from subpart F income, **whether the income is (1) unrealized or (2) realized but deferred for U.S. tax purposes**, should follow either one of the following acceptable views:

**View A (an inside-basis unit of account):** Under this view, deferred taxes would be recorded regardless of whether an outside basis difference exists and regardless of whether the outside basis is in a book-over-tax- or tax-over-book position. Unrealized income recognized in book earnings will create subpart F income when the underlying asset is recovered. Therefore, the equivalent of an inside basis U.S. taxable temporary difference exists for which a U.S. deferred tax liability is recognized. Similarly, even deferred subpart F income would create the equivalent of an inside basis U.S. taxable temporary difference. This is because deferred subpart F income is comparable to other book income permitted by U.S. tax law to be deferred (but not permanently avoided). Therefore, under ASC 740-10-55-63, a temporary difference exists for deferred subpart F income as it would for other deferred taxable income. While anticipation of future losses at the foreign subsidiary could further delay the taxation of subpart F income, the concepts underpinning ASC 740 do not allow the recognition of a deferred tax liability to be avoided by consideration of anticipated future losses.

**View B (an outside-basis unit of account):** Subpart F income (both unrealized and realized but deferred for U.S. tax purposes), as a component of the subsidiary’s book earnings, is encompassed in the outside basis of the parent’s investment. Therefore, outside basis would be the unit of account for purposes of determining the relevant temporary difference. However, unlike other portions of the outside basis difference for which the U.S. parent may be able to control the timing of taxation simply by avoiding repatriations of cash, as it relates to subpart F income there may not be an ability to delay taxation. Therefore, under this view, deferred taxes are recorded when subpart F income is recognized in book income (both unrealized and realized but deferred for U.S. tax purposes), but only with respect to the amount of subpart F income that does not exceed the parent’s book-tax outside basis difference. If the U.S. parent asserts indefinite reinvestment, deferred taxes recorded are limited to the hypothetical deferred tax amount that cannot be avoided as a result of its indefinite reinvestment assertion.

The selection of one of these views is an accounting policy choice that must be consistently applied. Further, it should be noted that neither view is applicable in a case where the company already recognizes deferred taxes on its outside basis difference. This is because such amounts are inherent in the outside basis difference and thus already reflected in the deferred taxes recorded on the balance sheet.

**Example 11-17: Foreign Temporary Differences That Give Rise to Subpart F Income in the Future**

**Background/Facts:**
Assume that a foreign subsidiary holds an appreciated available-for-sale security that is accounted for under ASC 320, *Investments—Debt and Equity Securities*. When sold, the gain on the sale of this security would constitute subpart F income in the United States. The U.S. parent company has a significant book-over-tax outside basis difference in the foreign subsidiary; however, it has asserted indefinite reversal as it does not intend to repatriate any of the subsidiary’s undistributed earnings.
Question:
Should U.S. deferred taxes be recorded on the potential subpart F income resulting from the appreciated equity security?

Analysis/Conclusion:
Yes. To the extent that the company is not able to avoid the triggering of subpart F income on the reversal of the temporary difference associated with this investment, U.S. deferred taxes should be provided in a circumstance where the company has otherwise made an assertion of indefinite reversal related to its overall outside basis difference under ASC 740-30-25-17. This would be the case whether the company was following a recognition and measurement approach consistent with either View A, an inside-basis unit of account, or View B, an outside-basis unit of account.

11.6.2.2 Indefinite Reversal Exception and Potential Future Subpart F Income

To utilize the indefinite reversal exception in ASC 740-30-25-17, the immediate parent must have the ability and intent to indefinitely defer the reversal of the temporary difference with a tax consequence. To the extent that activities occurring at the controlled foreign corporation (CFC) level or below will cause the recognition of subpart F income by the CFC’s U.S. parent, the underlying facts and circumstances must be examined to determine whether recording U.S. deferred taxes can be avoided for the item that may become subject to U.S. tax. The following example discusses the indefinite reinvestment consequence from a CFC’s equity method investment:

Example 11-18: Subpart F Income and Indefinite Reversal

Background/Facts:
Company A operates in the United States and owns 100 percent of U.K. Subsidiary B, which is a CFC. Subsidiary B owns 30 percent of the outstanding stock of Irish Investee C, but does not have the ability to exercise control over Investee C. Accordingly, Subsidiary B carries Investee C on its books using the equity method of accounting.
The following assumptions are true for this example:

- Dividends remitted by Investee C to Subsidiary B will be taxable to Company A under U.S. subpart F rules. In other words, even if the cash from the dividend payment were to remain with Subsidiary B, the income would be immediately taxable in the United States.³

- Company A has asserted its intention to indefinitely reinvest all of the accumulated unremitted earnings of Subsidiary B.

- The entire difference between Company A’s book and tax bases in Subsidiary B relates to unremitted earnings.

- Investee C has not had a history of making distributions.

**Question:**
As Company A intends to indefinitely reinvest all of Subsidiary B’s accumulated unremitted earnings, can Company A rely on the indefinite reversal exception in ASC 740-30-25-17 to not record deferred taxes on the portion of Subsidiary B’s unremitted earnings that relate to Investee C?

**Analysis/Conclusion:**
No. For Company A to invoke the exception in ASC 740-30-25-17, it must not only have the intent, but also the ability to control the reversal of the portion of the outside basis difference for which deferred taxes are not recorded. To the extent that activities of a CFC constitute subpart F income for tax purposes, the subpart F includable amounts are treated as a deemed distribution, followed by a subsequent reinvestment of the proceeds back to the CFC. This reinvestment of proceeds results in an increase in the U.S. parent’s tax basis in the CFC and a consequential reduction in the outside basis difference at a tax cost. This result is squarely inconsistent with an indefinite reversal assertion under ASC 740-30-25-17.

Because Subsidiary B does not control Investee C, and because a dividend or certain other transactions involving Investee C will be taxable in the United States to Company A as subpart F income, Company A does not have the ability to assert the exception in ASC 740-30-25-17 on the portion of Subsidiary B’s unremitted earnings that relate to Investee C. In effect, the existence of the subpart F provisions makes Company A’s indirect ownership in the Investee C (through Subsidiary B) analogous to Company A having direct ownership in Investee C. Accordingly, ownership of Investee C indirectly through Subsidiary B does not change the accounting—even if Investee C does not have a history of making distributions.

11.6.2.3 **Subpart F Qualified Deficit**

When the subsidiary has a current-year E&P deficit (i.e., a loss measured under applicable tax law), subpart F taxation is deferred until it has current-year E&P (Section TX 11.6.2.1). A qualified subpart F deficit is the amount of a current-year E&P deficit attributable to activities which, when profitable, give rise to certain types of subpart F income. The qualified deficit is available to reduce income from sales activities in the future that would otherwise be taxable under the subpart F rules. The question is, should a U.S. deferred tax asset be recorded for the subpart F qualified deficit?

³ The Internal Revenue Code’s subpart F rules are complex and contain various exceptions. Accordingly, an analysis of how subpart F would apply to a particular fact pattern is essential.
Consistent with our view on the accounting for subpart F gains (Section TX 11.6.2.1), we believe a policy choice, applied on a consistent basis, should be made to determine whether deferred taxes relating to subpart F taxation are recognized and measured on an inside- or outside-basis unit of account. Depending on a company's accounting policy, as discussed below, it may be appropriate to recognize a deferred tax asset for a subpart F qualified deficit:

View A (inside-basis unit of account): Under this view, a qualified deficit creates an inside basis difference for which a deferred tax asset would be recorded. This view considers a qualified deficit to be a tax attribute akin to a carryforward or a deferred stream of tax deductions which can reduce income of the same category in the future that would otherwise be taxable under the subpart F rules.

View B (outside-basis unit of account): Under this view, a qualified deficit is considered a component of the subsidiary’s book earnings, and therefore inherent in the outside basis of the parent’s investment. Accordingly, the recognition requirement applicable to a deductible outside basis difference would apply. A deferred tax asset is recorded only if it is apparent that reversal of the qualified deficit is anticipated to occur in the foreseeable future (ASC 740-30-25-9) and only to the extent of the parent’s tax-over-book outside basis difference. If subpart F income is anticipated in future periods and the qualified deficit is expected to eliminate the associated U.S. tax cost (cash or utilization of a loss or credit carryforward), a deferred tax asset would be recognized based upon the amount of subpart F loss that does not exceed the parent’s tax-over-book outside basis difference.

Importantly, under either View A or View B, a valuation allowance may be required if it is more-likely-than-not that some portion or all of the recognized deferred tax asset will not be realized.

### 11.6.2.4 Indefinite Reversal and Subpart F’s Previously Taxed Income

This question is often asked: How should previously taxed income (PTI) be considered when applying the indefinite reversal criteria?

A U.S. parent can generally distribute PTI without subjecting itself to further U.S. income tax except for the tax consequences applicable to any foreign currency gain or loss as well as the tax costs associated with foreign withholding taxes that may be offset by a U.S. foreign tax credit. Therefore, management must still declare its intentions as to whether that PTI is indefinitely reinvested if that repatriation will result in additional taxes (such as foreign withholding taxes net of U.S. foreign tax credits or U.S. taxes on foreign currency gains or losses associated with remittances). Section TX 11.6.1 on branch operations discusses the rationale for an indefinite reversal assertion related to PTI. When a company analyzes its intentions under ASC 740-30-25-17, which will often include the tax consequences of remitting undistributed earnings, it may be more difficult to overcome the presumption that the undistributed earnings that underlies the PTI are indefinitely reinvested because the earnings have already been taxed and the incremental tax may be relatively minimal (e.g., foreign withholding taxes and translation effects).
Chapter 12: Intraperiod Tax Allocation
Chapter Summary

ASC 740 provides rules for allocating the total tax expense (or benefit) for the year among the various financial statement components, including components of net income (e.g., continuing operations, discontinued operations, and extraordinary items), components of comprehensive income that are excluded from net income, and other items reflected directly in contributed capital or retained earnings. This process of allocation is referred to in ASC 740 as “intraperiod allocation.” In this chapter, we discuss the accounting model for intraperiod allocation and some of the intricacies in the model's application.
Excerpts from ASC 740

Allocation of Income Tax Expense or Benefit for the Year

ASC 740-20-45-1:
This guidance addresses the requirements to allocate total income tax expense or benefit. Subtopic 740-10 defines the requirements for computing total income tax expense or benefit for an entity. As defined by those requirements, total income tax expense or benefit includes current and deferred income taxes. After determining total income tax expense or benefit under those requirements, the intraperiod tax allocation guidance is used to allocate total income tax expense or benefit to different components of comprehensive income and shareholders’ equity.

ASC 740-20-45-2:
Income tax expense or benefit for the year shall be allocated among:

a. Continuing operations
b. Discontinued operations
c. Extraordinary items
d. Other comprehensive income
e. Items charged or credited directly to shareholders’ equity.

ASC 740-20-45-3:
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).

(continued)
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.

See Section 740-20-55 for examples of the allocation of total tax expense or benefit to continuing operations, the effect of a tax credit carryforward, and an allocation to other comprehensive income.

This guidance addresses the allocation methodology for allocating total income tax expense or benefit to continuing operations. The amount of income tax expense or benefit allocated to continuing operations may include multiple components. The tax effect of pretax income or loss from current year continuing operations is always one component of the amount allocated to continuing operations.

The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. The exception to that incremental approach is that all items (for example, extraordinary items, discontinued operations, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations. That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the realizability of deferred tax assets. Application of this modification makes it appropriate to consider an extraordinary gain in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations.

(continued)
ASC 740-20-45-8:
The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of:

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 (except as set forth in paragraph 740-20-45-11(e) for dividends paid on unallocated shares held by an employee stock ownership plan or any other stock compensation arrangement).

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

ASC 740-20-45-9:
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

ASC 740-20-45-10:
This guidance identifies specific items outside of continuing operations that require an allocation of income tax expense or benefit. It also establishes the methodology for allocation. That methodology differs depending on whether there is only one item other than continuing operations or whether there are multiple items other than continuing operations.

ASC 740-20-45-11:
The tax effects of the following items occurring during the year shall be charged or credited directly to other comprehensive income or to related components of shareholders’ equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error. Paragraph 250-10-45-8 addresses the effects of a change in accounting principle, including any related income tax effects.

(continued)
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. Expenses for employee stock options recognized differently for financial reporting and tax purposes as required by Subtopic 718-740. An employee stock ownership plan and a stock option plan are analogous. Both are compensatory arrangements and both sometimes result in tax deductions for amounts that are not presently recognized as compensation expense in the financial statements under existing generally accepted accounting principles (GAAP). The tax benefits of both are reported as a credit to shareholders' equity.

e. Dividends that are paid on unallocated shares held by an employee stock ownership plan and that are charged to retained earnings. This is different from a tax deduction received for the payment of dividends on allocated shares held by an employee stock ownership plan that represents, in substance, an exemption from taxation of an equivalent amount of earnings for which the tax benefit shall be recognized as a reduction of tax expense and shall not be allocated directly to shareholders' equity.

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

ASC 740-20-45-12:
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.

ASC 740-20-45-13:
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.

(continued)
Multiple Items of Allocation Other than Continuing Operations

ASC 740-20-45-14:
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.

12.1 Level of Application

While ASC 740 does not explicitly state the level of application of the intraperiod allocation rules, implicitly those allocation rules should be applied at the jurisdictional level when only one return is filed within a jurisdiction, and at the tax-return level when more than one tax return is filed within a jurisdiction (e.g., where a consolidated tax return is not filed).

PwC Observation: Applying the intraperiod allocation rules at the proper level requires a significant amount of attention for multi-jurisdictional entities—especially when a valuation allowance is increased or decreased during the year within a jurisdiction.

12.2 The Basic Model

Although ASC 740 outlines the basic model for intraperiod allocation in only a few paragraphs (primarily ASC 740-20-45-1 through 45-14), application of the guidance can be complex and counterintuitive. When ASC 740 does not specifically allocate all or a portion of the total tax expense to a specific financial statement component or components, it allocates taxes based on what often is referred to as the “with-and-without” or “incremental” approach. This basic approach can be summarized in the following three steps:

Step 1: Compute the total tax expense or benefit (both current and deferred) for the period.
Step 2: Compute the tax effect of pretax income or loss from continuing operations, without consideration of the current-year pretax income from other financial statement components, plus or minus the tax effects of the items (as listed in Section TX 12.2.2.2) that ASC 740 specifically allocates to continuing operations.

Step 3: Allocate among the other financial statement components, in accordance with the guidance in ASC 740-20-45-12 through 45-14, the portion of total tax that remains after allocation of tax to continuing operations (the difference between the total tax expense (computed in Step 1) and the amount allocated to continuing operations (computed in Step 2)).

12.2.1 Step 1: Compute Total Tax Expense or Benefit

The first step in the intraperiod allocation process is to compute the total tax expense or benefit (both current and deferred) recognized in the financial statements. This includes the tax effects of all sources of income (or loss)—that is, the tax effects attributable to continuing operations, discontinued operations, extraordinary items, items of other comprehensive income, certain changes in accounting principles, and the effects of valuation allowance changes. The only exceptions relate to (1) certain changes within the measurement period for a business combination that affect recognition of acquired tax benefits (ASC 805-740-45-2), (2) tax effects allocated to additional paid-in capital when applying the exception to the basic approach to allocating a change in valuation allowance that is outlined in ASC 740-20-45-3, and (3) the additional exception related to certain quasi reorganizations articulated in ASC 852-740-45-3.

12.2.2 Step 2: Compute Tax Attributable to Continuing Operations

12.2.2.1 Tax Effect of Current-Year Income from Pretax Continuing Operations

Computing the tax effects to be allocated to continuing operations begins with the quantification of the tax effect for the year for continuing operations without consideration of the tax effects (both current and deferred) of current-year income from all other financial statement components.

Some examples of computing the tax effect of current-year income from pretax continuing operations using the basic model for intraperiod allocation appear below:

Example 12-1: ASC 740-20-55-14

ASC 740-20-45-7 discusses allocation to continuing operations and ASC 740-20-55-14 provides an example of the with-and-without or incremental approach. The facts from that example and some additional discussion follow.

Background/Facts:
Assume that in 20X6 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

(continued)

1 If there is more than one financial statement component other than continuing operations, the allocation is made on a pro rata basis in accordance with each component's incremental tax effects. See Section TX 12.2.3 for a discussion of the application of ASC 740-20-45-14.
Intraperiod Tax Allocation / 12 - 9

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.

**Question:**
How should the tax provision for 20X6 be allocated between continuing operations and discontinued operations?

**Analysis/Conclusion:**
In this instance, no tax expense would be allocated to continuing operations because of the availability of the loss carryforward at the beginning of the year. The tax effect on pretax continuing operations is computed before the tax effects of other financial statement components (in this case, before consideration of the loss from discontinued operations). Because a carryforward loss from the prior year was available for utilization, and there was income from continuing operations available to realize that carryforward, income from continuing operations is considered to “realize” the previously unrecognized net operating loss carryforward.

This result was arrived at in the following manner:

**Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>1,000</td>
</tr>
<tr>
<td>20X6 Pretax Income / (Loss) – Discontinued Operations</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Pretax Income/(Loss)</td>
<td>—</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance</td>
<td>—</td>
</tr>
<tr>
<td>Change in Valuation Allowance</td>
<td>—</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit)</td>
<td>—</td>
</tr>
</tbody>
</table>

**Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>1,000</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance</td>
<td>400</td>
</tr>
<tr>
<td>Change in Valuation Allowance†</td>
<td>(400)</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit)</td>
<td>—</td>
</tr>
</tbody>
</table>

† ASC 740’s intraperiod allocation rules require that the amount of tax attributable to the current-year income from continuing operations be determined by a computation that does not consider the tax effects of items that are excluded from income from continuing operations. Without the current-year loss from discontinued operations of $1,000, continuing operations would have benefited from the net operating loss carryforward that existed at December 31, 20X5 (which at the time had a valuation allowance recorded against it).

**Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

**Step 3: Tax to be Allocated to Discontinued Operations**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Tax Provision/(Benefit) (Step 1)</td>
<td>—</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Allocated to Continuing Operations (Step 2)</td>
<td>—</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Allocated to Discontinued Operations</td>
<td>—</td>
</tr>
</tbody>
</table>

(continued)
As can be seen in the example above, the intraperiod allocation rules cause the entity to allocate tax effects as if $1,000 of NOL carryforward was utilized against the income from continuing operations rather than offsetting the taxable income from continuing operations with the current-year loss from discontinued operations. As a result, the loss from discontinued operations is treated as restoring the NOL carryforward. But, because the entity maintains a full valuation allowance, no tax benefit is recorded in discontinued operations for the loss carryforward.

Example 12-2: ASC 740-20-55-14 Fact Pattern Without NOL Carryforward

Background/Facts:
Assume the same facts as those in Example 12-1, above, except that there is no NOL carryforward.

Analysis/Conclusion:
Intraperiod allocation would be performed in the following manner:

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components

| Pretax Income / (Loss) – Continuing Operations | 1,000 |
| Pretax Income / (Loss) – Discontinued Operations | (1,000) |
| Tax Rate | 40% |
| Expected Tax Provision/(Benefit) Before Valuation Allowance | — |
| Change in Valuation Allowance | — |
| 20X6 Total Tax Provision/(Benefit) | — |

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components (continued)

Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations

| Pretax Income / (Loss) – Continuing Operations | 1,000 |
| Tax Rate | 40% |
| Expected Tax Provision/(Benefit) Before Valuation Allowance | 400 |
| Change in Valuation Allowance | — |
| 20X6 Total Tax Provision/(Benefit) | 400 |

Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations (continued)

Step 3: Tax to be Allocated to Discontinued Operations

| Total Tax Provision/(Benefit) (Step 1) | — |
| Tax Provision/(Benefit) Allocated to Continuing Operations (Step 2) | 400 |
| Tax Provision/(Benefit) Allocated to Discontinued Operations | (400) |

Step 3: Tax to be Allocated to Discontinued Operations (continued)
As a result of the application of the incremental approach, tax of $400 was allocated to continuing operations (the tax on the $1,000 of income) even though the $1,000 current-year loss from discontinued operations would serve to offset the $1,000 of income from continuing operations. The difference between the total tax expense of zero and the tax expense of $400 attributable to continuing operations is a $400 tax benefit. This $400 tax benefit is allocated to discontinued operations.

**PwC Observation:** Items included in continuing operations generally are considered to enter into tax computations before items included in other financial statement components. Some refer to this concept as the “primacy of continuing operations.” As a result, in situations where a company records a valuation allowance on beginning-of-year tax attributes such as net operating losses, capital loss carryforwards, or other deferred tax assets (DTAs) that can be realized in the current year by income from continuing operations, the benefit of this realization generally is allocated to continuing operations rather than to the financial statement component that gave rise to the attribute in the earlier year. It is important to note that there are exceptions to the general rule, which are discussed in more detail later in this chapter.

The tax effect of current-year income from pretax continuing operations should consider all of the information available at the end of the reporting period, adjusted to ignore the tax effects (both balance sheet and income statement) of the current-period income or loss from financial statement components other than continuing operations. Thus, to the extent that pretax income or loss from financial statement components other than continuing operations causes a change in a deferred tax balance or in taxes payable for the current period, these effects should be disregarded when determining the amount to be allocated to continuing operations. Example 12-3 illustrates one instance of how this would be applied.

**Example 12-3: Computing the Tax Effect Attributable to Pretax Continuing Operations**

**Assume the following:**

- Company A, a calendar-year company, in recent years has recognized unrealized losses for “other than temporary impairments” (OTTI) of available-for-sale (AFS) securities within its investment portfolio. Because these unrealized losses are not currently deductible, the current-year, mark-to-market adjustment (recorded as a current-year pretax loss in income from continuing operations) has created a deductible temporary difference (DTD) that happens to be capital in character. In the United States, capital losses can be used to offset only capital gain income. Excess capital losses may be carried back three years and forward five years. Company A has evaluated the positive and negative evidence related to investments of a capital nature within its portfolio and concluded that it cannot consider projections of future capital gains that could support the realization of those DTAs.

- The pretax result from continuing operations was breakeven in 20X6 except for a current-year loss of $150,000 attributable to additional OTTI recorded in 20X6. In addition, as a result of a worsening economy during the year, $250,000 of unrealized gains on other AFS securities held by Company A lost all of their prior...
net appreciation. This market value decline was considered to be temporary and, as a result, the $250,000 pretax loss was recognized in other comprehensive income.

• At both December 31, 20X5 and 20X6, Company A has $200,000 of capital gains available in the carryback period. Based on the facts and circumstances, Company A would be willing to sell its OTTI securities in order to support the recognition of the deductible temporary differences that are capital in nature.

• At December 31, 20X5, Company A has a deductible temporary difference of $275,000 related to OTTI and a taxable temporary difference (TTD) of $250,000 related to appreciated AFS securities. The deferred tax components for 20X5 and 20X6 appear below:

<table>
<thead>
<tr>
<th>In ('000s)</th>
<th>12/31/X5</th>
<th>Change</th>
<th>12/31/X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTD Attributable to OTTI</td>
<td>275,000</td>
<td>150,000</td>
<td>425,000</td>
</tr>
<tr>
<td>TTD Attributable to Unrealized (Gains)/Losses</td>
<td>(250,000)</td>
<td>250,000</td>
<td>—</td>
</tr>
<tr>
<td>Net</td>
<td>25,000</td>
<td>400,000</td>
<td>425,000</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>DTA/(DTL) Before Valuation Allowance</td>
<td>10,000</td>
<td>160,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>—</td>
<td>(90,000)</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Net DTA</td>
<td>10,000</td>
<td>70,000</td>
<td>80,000</td>
</tr>
</tbody>
</table>

• At December 31, 20X5, no valuation allowance was recorded because Company A has sufficient capital gain income of $450,000 (available from the sale of appreciated AFS securities of $250,000 plus capital gains available in the carryback period of $200,000) to allow for the realization of the DTD attributable to OTTI of $275,000. At December 31, 20X6, however, only the $200,000 of carryback potential is available. Thus, $225,000 of DTDs (or $90,000 tax-effected at 40 percent) will need a valuation allowance.

Intraperiod allocation would be performed as follows:

**Step 1: 20X6 Tax Expense/(Benefit) With All Financial Statement Components:**

20X6 Pretax Income / (Loss) – Continuing Operations  
(150,000)

20X6 Pretax Income / (Loss) – Other Comprehensive Income  
(250,000)

Pretax Income/(Loss)  
(400,000)

Tax Rate  
40%

Expected Tax Expense/(Benefit) Before Valuation Allowance  
(160,000)

Increase/(Decrease) in Valuation Allowance  
90,000

20X6 Total Tax Provision/(Benefit)  
(70,000)

**Step 1: 20X6 Tax Expense/(Benefit) With All Financial Statement Components**  
(70,000)

(continued)
**Step 2:** Compute the Tax Effect of Pretax Income/(Loss) From Continuing Operations Without Consideration of the Current-Year Pretax Income from Other Financial Statement Components.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Increase/(Decrease) in Valuation Allowance†</td>
<td>—</td>
</tr>
<tr>
<td>20X6 Total Tax Expense/(Benefit)</td>
<td>(60,000)</td>
</tr>
</tbody>
</table>

† The current-year loss in continuing operations is fully benefited because, in this fact pattern, absent the 20X6 loss reported in other comprehensive income, no valuation allowance would have been required.

**Step 2:** 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations (60,000)

**Step 3:** The Residual Between the Total Expense/(Benefit) (Computed in Step 1 Above) and the Amount Allocated Among the Other Components of the Financial Statements.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Tax Expense/(Benefit)</td>
<td>(70,000)</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Allocated to Continuing Operations</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Tax Expense/(Benefit) Allocated to Other Comprehensive Income</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>

**Step 3:** 20X6 Tax Expense/(Benefit) Allocated to Other Comprehensive Income (10,000)

Following the incremental approach, the entire $90,000 valuation allowance recorded during the year was allocated to other comprehensive income (OCI) because, absent the current-year pretax loss on the AFS securities reported in OCI, no valuation allowance would have been required (that is, the DTDs associated with the $150,000 OTTI loss recognized in 20X6 would have been fully recoverable based on continuing operations, if there had been no change in the pretax carrying value of AFS securities). In this example, the valuation allowance was required because the pretax loss in AFS securities during the year was responsible for the reversal of the taxable temporary difference that existed at the beginning of the year and that served as a source of income for the realization of the existing deferred tax asset.
12.2.2 Other Items Specifically Allocated to Continuing Operations

In addition to the tax effect of the current-year income from pretax continuing operations, ASC 740 specifically requires certain components of total income tax expense or benefit for the year to be included in the tax provision/(benefit) from continuing operations. Such components include:

<table>
<thead>
<tr>
<th>Description</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax effects of changes in tax laws or rates (Section TX 12.2.2.2.1)</td>
<td>ASC 740-10-45-15, and ASC 740-20-45-8(b)</td>
</tr>
<tr>
<td>Tax effects of changes in tax status (Section TX 12.2.2.2.1)</td>
<td>ASC 740-10-45-19 and ASC 740-20-45-8(c)</td>
</tr>
<tr>
<td>The effect of a changed assessment about the realizability of deferred tax assets that existed at the beginning of the year because of a change in the expectation of taxable income available in future years that does not relate to source-of-loss items (Section TX 12.2.2.2.3.3)</td>
<td>ASC 740-10-45-20</td>
</tr>
<tr>
<td>Tax-deductible dividends paid to shareholders (except for amounts paid on unallocated shares held by an ESOP that are charged to retained earnings)</td>
<td>ASC 740-20-45-8(d)</td>
</tr>
<tr>
<td>Tax effects of change in assertion related to prior years’ unremitting earnings of foreign subsidiaries (Section TX 12.2.2.2.2)¹a</td>
<td>ASC 740-30-25-19</td>
</tr>
<tr>
<td>Tax effects of changes in unrecognized tax benefits for which backward tracing is not required nor elected (Section TX 16.9.1)</td>
<td></td>
</tr>
<tr>
<td>Clearing of disproportionate tax effects lodged in OCI (Section TX 12.2.3.2.2.3)</td>
<td></td>
</tr>
</tbody>
</table>

¹a Refer to Section TX 12.2.3.2.4.2 for guidance related to outside basis differences in a discontinued operation.

12.2.2.2.1 Changes in Tax Laws or an Entity’s Tax Status

Adjustments to deferred tax balances are necessary when tax laws or rates change (ASC 740-10-35-4) or an entity’s tax status changes (ASC 740-10-25-32 and ASC 740-10-40-6). All such deferred tax adjustments, including those elements of deferred tax that relate to items originally reported in other financial statement components (such as OCI), are required to be reflected entirely in continuing operations.

When a change in tax law is enacted with retroactive effect, ASC 740-10-25-48 and ASC 740-10-45-16 specify that the tax effects (current as well as deferred) of items excluded from income from continuing operations arising during the current year, but prior to the date of enactment, should be adjusted to reflect the rate change as of the enactment date, with the adjustment also reflected in income from continuing operations.

For a more detailed discussion on these topics, see Chapter TX 7 for changes in tax laws or rates and Chapter TX 8 for changes in tax status.

12.2.2.2 Change in Indefinite Reversal Assertion for Foreign Subsidiary

The tax effects that result from a change in an entity’s assertion about its intent to indefinitely reinvest prior undistributed earnings of foreign subsidiaries or foreign
corporate joint ventures that are permanent in duration should be reported in continuing operations in the period in which the change in assertion occurs. Thus, if a company concluded that it could no longer assert that it would indefinitely reinvest its prior-years’ undistributed foreign earnings, it would not be appropriate to “backwards trace” the accrual of the tax consequences of the previously accumulated foreign currency translation adjustments within OCI—even if that is where the amounts would have been allocated if the company had never asserted indefinite reinvestment of those earnings in those prior periods. It should be noted, however, that the tax effects on currency translation adjustments (CTA) arising in the current year are subject to the rules of ASC 740-20-45-11(b). That paragraph states that the tax effects of gains and losses included in OCI, but excluded from net income, that occur during the year should be charged or credited directly to OCI. As a result, it is important to distinguish the tax effects of the change in assertion between current-year and prior-years’ items.

**Example 12-4: Change in Indefinite Reinvestment Assertion**

**Background/Facts:**
Company Y has a profitable foreign subsidiary, Subsidiary S, with $900 of outside basis difference (i.e., book net assets of Subsidiary S in Company Y’s consolidation over Company Y’s tax basis in its shares of Subsidiary S) as of December 31, 20X5, that meets the indefinite reinvestment criteria of ASC 740-30-25-17. Accordingly, as of that date, Company Y had not recorded a deferred tax liability related to the potential reversal (e.g., repatriation of unremitted earnings) of this difference. Subsidiary S’s functional currency is its local currency; thus, translation adjustments that result from translating Subsidiary S’s financial statements into Company Y’s reporting currency (U.S. dollars) are reported in OCI. At December 31, 20X5, $180 of the $900 outside basis difference arose from cumulative net CTA gains reported in OCI.

During the second quarter of 20X6, because of increased liquidity needs in the United States, Company Y no longer intends to indefinitely reinvest its accumulated foreign earnings. As a result of this change in circumstances, the exemption in ASC 740-30-25-17 from providing deferred taxes is no longer available with respect to Company Y’s book-over-tax basis difference in Subsidiary S.

During the first six months of 20X6, pretax income from continuing operations is zero, and exchange rate movements result in a pretax gain of $120 reported in OCI. As a result, the accumulated CTA balance at June 30, 20X6, prior to recording any deferred tax liability, is a credit of $300.

**Analysis/Conclusion:**
During the second quarter of 20X6, Company Y should record an income tax liability on the entire $1,020 outside basis difference at June 30, 20X6. Of this amount, the tax liability associated with the portion of the outside basis difference that arose in prior years, $900 in this case, would be allocated to continuing operations as a current-period expense, and the tax liability associated with current-year-to-date CTA movement of $120 would be allocated to OCI.
12.2.2.3 Changes in the Valuation Allowance

12.2.2.3.1 General Rules

ASC 740-10-45-20 discusses the proper intraperiod allocation for changes in valuation allowances. In addition, ASC 740-20-45-3, and ASC 740-10-55-38 set forth various rules for allocation of the benefits of previously-unrecognized losses and loss carryforwards.\(^2\)

Under these rules, the intraperiod allocation depends on whether the benefit of the loss or deduction is recognized or realized in the year in which it is generated and whether the income to allow for the realization of the loss relates to the current year or future years.

These rules can be summarized as follows:

- When there is an increase or decrease in the valuation allowance applicable to beginning-of-year deferred tax assets that results from changes in circumstances which cause the assessment of the likelihood of realization of these assets by income in future years to change, the effect is reflected in continuing operations. This is true except for the initial recognition of source-of-loss items, as discussed in Section TX 12.2.2.2.3.2.

- When income in the current year allows for the release of a valuation allowance, the resulting benefit is allocated to the current-year component of income that allows for its recognition (except for the initial recognition of source-of-loss items).

- When the tax benefit of a loss in the current year is recognized, it is allocated to the component that generated the loss regardless of the financial statement source of the taxable income that allows for its recognition. This principle is the same whether the source of income is (a) taxable income in the current year, (b) taxable income in a prior year to which the current-year loss can be carried back, or (c) taxable income that is expected to occur in future years.

A question may arise with respect to the allocation of a previously unrecognized tax benefit that could be recognized in the current year based on either (1) changes in estimates about future taxable income (which would allocate the benefit to continuing operations) or (2) a component of income in the current year other than continuing operations. Because the determination of tax allocated to continuing operations is made first (“primacy of continuing operations”) and because we generally would regard all income from projections of taxable income in future years to be attributed to continuing operations, valuation allowance changes usually are recorded in continuing operations. In making this determination, we believe that changes in judgment regarding the projections of future-year income should be attributed to continuing operations, even when the change in estimate about the future is affected by another financial statement component.

Some examples of these general rules for the recording of changes in valuation allowance follow.

\(^2\) We believe that those rules also apply to deductible temporary differences for which tax benefit has not yet been recognized (i.e., in cases where a valuation allowance has been provided against the related deferred tax asset from its inception).
Example 12-5: Change in Valuation Allowance on Beginning-of-Year DTAs Resulting from Changes in Projections of Income in Future Years

Background/Facts:
In 20X6 an entity has $1,000 of pretax income from continuing operations and $500 of pretax income from discontinued operations. At the beginning of the year, the entity has a $2,000 net operating loss carryforward (which was generated in prior years by what are now discontinued operations) that has been reflected as a deferred tax asset of $800 less a valuation allowance of $800 (i.e., no net DTA has been recognized). At year-end 20X6, based on the weight of available evidence, management concludes that the ending DTA is realizable based on projections of future taxable income in excess of $1,000. The statutory tax rate for all years is 40 percent.

Question:
How should the tax provision for 20X6 be allocated between continuing operations and discontinued operations?

Analysis/Conclusion:
Intraperiod allocation would be performed in the following manner:

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>1,000</td>
</tr>
<tr>
<td>20X6 Pretax Income / (Loss) – Discontinued Operations</td>
<td>500</td>
</tr>
<tr>
<td>Pretax Income/(Loss)</td>
<td>1,500</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Release</td>
<td>600</td>
</tr>
<tr>
<td>Valuation Allowance Release</td>
<td>(800)</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit)</td>
<td>(200)</td>
</tr>
</tbody>
</table>

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components: (200)

Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>1,000</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Release</td>
<td>400</td>
</tr>
<tr>
<td>Change in Valuation Allowance†</td>
<td>(400)</td>
</tr>
<tr>
<td>Resulting from current year income</td>
<td></td>
</tr>
<tr>
<td>Resulting from projections of future year income</td>
<td>(400)</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit) Attributable to Continuing Operations</td>
<td>(400)</td>
</tr>
</tbody>
</table>

† ASC 740’s intraperiod allocation rules require that the amount of tax attributable to the current-year income from continuing operations be determined by a computation that generally does not consider the tax effects of items that are excluded from continuing operations. Without consideration of the current-year income from discontinued operations of $500, continuing operations would have realized a $400 DTA relating to net operating loss carryforwards that had a valuation allowance recorded against them at 12/31/X5. In addition, the valuation allowance relating to the $400 DTA relating to the remaining carryforward would have been realized through the projection of future pretax income from continuing operations (which in the fact pattern provided was in excess of $1,000). ASC 740-10-45-20 indicates that the release of the valuation based on income expected in future years should be allocated to continuing operations despite the fact that the losses previously had been generated from what are now the discontinued operations.

Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations (400)

(continued)
Step: 3: Tax to be Allocated to Discontinued Operations

| Total Tax Provision/(Benefit) (Step 1) | 200 |
| Tax Provision/(Benefit) Allocated to Continuing Operations (Step 2) | 400 |
| Tax Provision/(Benefit) Allocated to Discontinued Operations | 200 |

Step: 3: Tax to be Allocated to Discontinued Operations

Because the entire deferred tax asset could be supported by the current-year income from continuing operations and by projections of future income, none of the valuation allowance release has been allocated to discontinued operations.

Example 12-6: Example of Decreases in Valuation Allowance Resulting from Current-Year Income

Background/Facts:
At December 31, 20X6, Company A has a net deferred tax asset (DTA) of $1,000 including a DTA for net operating loss carryforwards of $1,200 and a deferred tax liability (DTL) for the excess of book basis over tax basis in fixed assets of $200. Because of the existence of significant negative evidence at December 31, 20X6, and the lack of positive evidence of sufficient quality and quantity to overcome the negative evidence, a full valuation allowance was recorded against this $1,000 net DTA. During 20X7, Company A generated pretax income from continuing operations of $100 and pretax income from discontinued operations of $800. Assume a tax rate of 40 percent. At December 31, 20X7, based on the weight of available evidence, a full valuation allowance on the existing deferred tax asset of $640 [$1,000 of beginning-of-year DTA less $360 (40% of the sum of pretax income from both continuing and discontinued operations of $900)] was still required.

Question:
What is the intraperiod allocation of the valuation allowance release of $360 that resulted from the current-year realization of net deferred tax assets?

Analysis/Conclusion:
Intraperiod allocation would be performed in the following manner:

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components:

| Pretax Income/(Loss) – Continuing Operations | 100 |
| Pretax Income/(Loss) – Discontinued Operations | 800 |

| Tax Rate | 40% |

| Expected Tax Provision/(Benefit) Before Valuation Allowance Release | 360 |
| Valuation Allowance Release | (360) |

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components:

(continued)
Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>100</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Release</td>
<td>40</td>
</tr>
<tr>
<td>Valuation Allowance Release</td>
<td>(40)</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit) Attributable to Continuing Operations</td>
<td>—</td>
</tr>
</tbody>
</table>

Note: Absent effects of the income from discontinued operations, the provision for continuing operations would be zero, comprising tax of $40 on the $100 of pretax income offset by the $40 benefit from the reversal of the valuation allowance on the DTA related to the net operating losses that would have been utilized.

Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations —

Step: 3: Tax to be Allocated to Discontinued Operations

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Tax Provision/(Benefit) (Step 1)</td>
<td>—</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Related to Continuing Operations (Step 2)</td>
<td>—</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Allocated to Discontinued Operations</td>
<td>—</td>
</tr>
</tbody>
</table>

Step: 3: Tax to be Allocated to Discontinued Operations —

Example 12-7: Example of a Current-Year Loss That Is Recognized in the Year It Was Generated

Background/Facts:
Company A has pretax income from continuing operations of $10,000 and a pretax loss of $20,000 from discontinued operations for the year-ended December 31, 20X6. Company A historically has been profitable and has $5,000 of taxable income available in prior periods to which current-year losses could be carried back. Company A has concluded that no valuation allowance is required at December 31, 20X6, based on projections of future taxable income. The tax rate is 40% for all years.

Question:
How should the current-year tax benefit of $4,000 ($10,000 loss x 40%) be allocated between continuing operations and discontinued operations?

Analysis/Conclusion:
Intraperiod allocation would be performed as follows:

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>10,000</td>
</tr>
<tr>
<td>20X6 Pretax Income / (Loss) – Discontinued Operations</td>
<td>20,000</td>
</tr>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Changes</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Valuation Allowance Change</td>
<td>—</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit)</td>
<td>(4,000)</td>
</tr>
</tbody>
</table>

Step 1: 20X6 Tax Provision/(Benefit) With All Financial Statement Components: (continued)
**Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6 Pretax Income / (Loss) – Continuing Operations</td>
<td>10,000</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Change</td>
<td>4,000</td>
</tr>
<tr>
<td>Change in Valuation Allowance</td>
<td>—</td>
</tr>
<tr>
<td>20X6 Total Tax Provision/(Benefit) Attributable to Continuing Operations</td>
<td>4,000</td>
</tr>
</tbody>
</table>

**Step 2: 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations**

4,000

**Step 3: Tax to be Allocated to Discontinued Operations**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Tax Provision/(Benefit) (Step 1)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Allocated to Continuing Operations (Step 2)</td>
<td>4,000</td>
</tr>
<tr>
<td>Tax Provision/(Benefit) Allocated to Discontinued Operations</td>
<td>(8,000)</td>
</tr>
</tbody>
</table>

**Step 3: Tax to be Allocated to Discontinued Operations**

(8,000)

Note: Of the $8,000 tax benefit recorded in discontinued operations, $2,000 is realizable through a carryback of current-year losses to prior years ($5,000 of carryback capacity at a 40 percent tax rate), $4,000 is realized by current-year income from continuing operations ($10,000 at 40 percent), and a $2,000 deferred tax asset relating to net operating loss carryforwards ($5,000 at 40 percent) is supported by projections of future taxable income. Because no valuation allowance is required (and thus the entire benefit of the current-year loss is recognized in the year it was generated), the benefit of the loss is allocated to the component that gave rise to the loss which, in this case, is discontinued operations.

### 12.2.2.3.2 Source-of-Loss Items

The initial recognition, regardless of when it occurs, of the tax benefits of certain deductible differences and carryforwards is classified on the basis of the source of loss that generates them rather than on the basis of the source of income that utilizes, or is expected to utilize them.

**PwC Observation:** This aspect of intraperiod allocation sometimes is referred to as “backwards tracing.” ASC 740-20-45-3 prohibits backwards tracing except for these specific items.

The initial recognition of tax benefits for the items listed below should be allocated directly to the related components of shareholders’ equity regardless of the source of income that allows for their realization:

- Increases or decreases to contributed capital
- Certain deductions for employee stock options recognized differently for financial reporting and tax purposes (see further discussion of the treatment of stock-based compensation in Chapter TX18). We also believe that the tax effects of favorable and unfavorable adjustments relating to such deductions resulting from changes in assessments of uncertain tax positions should be recorded in equity (see Section TX 16.9 for a discussion on intraperiod allocation and liabilities for unrecognized tax benefits)
• Tax-deductible dividends on unallocated shares held by an ESOP (such dividends are charged to retained earnings)

• Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization

PwC Observation: The treatment as source-of-loss items runs only to initial recognition of the tax benefit. If the benefit of a loss carryforward attributable to a tax deduction received for deductible expenditures incurred in connection with issuing capital stock is recognized in equity, but a valuation allowance is recorded subsequently against that item, it would lose its identity as a source-of-loss item. Accordingly, the subsequent re-recognition of the benefit of the carryforward would be recorded based on the “normal” intraperiod allocation process. That is, the benefit would be allocated based on the general rules for changes in valuation allowances, as noted at Section TX 12.2.2.2.3.1.

Example 12-8: Application of the Source-of-Loss Rule

Background/Facts:
Assume that in 20X6 an entity has $1,000 of income from continuing operations. The applicable tax rate is 40 percent. The entity has a net operating loss carryforward of $1,250 relating to deductible expenditures reported in contributed capital, resulting in a beginning-of-year deferred tax asset of $500 ($1,250 x 40%). This $500 deferred tax asset (DTA) has a full valuation allowance recorded against it that was established at the date of a capital-raising transaction and was not subsequently reduced (making the acquired DTA a source-of-loss item). It is concluded that a full valuation allowance also is required at year-end. There are no permanent or temporary differences (either current year or cumulative) other than the net operating loss carryforward noted above.

Question:
How should tax expense/benefit be allocated?

Analysis/Conclusion:
Given the facts, the total tax expense would be zero (the tax effect of the $1,000 pretax income at a 40 percent statutory tax rate would be offset by the reversal of $400 of the $500 valuation allowance that had been recorded on the carryforward DTA). Because the tax benefit was initially recognized after the period in which it was generated (by means of utilizing $1,000 of the carryforward to offset the pretax income of $1,000), the reversal of the valuation allowance should be backward traced to equity, consistent with ASC 740-10-45-3 and ASC 740-20-45-11(c).

As a result, the entry to allocate tax for the year would be as follows:

Dr Deferred Tax Provision – Continuing Operations $400
Dr Valuation Allowance $400
Cr Deferred Tax Asset $400
Cr Equity $400

3 A quasi reorganization is a voluntary accounting procedure by which a company with an accumulated retained earnings deficit adjusts its accounts to obtain a “fresh start.”
12.2.2.3.3 Determining Which Deferred Tax Asset Was Realized in Order to Source the Release of a Valuation Allowance

The general rules for allocating the effects of changes in valuation allowances discussed at Section TX 12.2.2.3.1 apply to most changes in valuation allowances. However, because of the source-of-loss exceptions for the initial recognition of certain tax benefits and because a deductible temporary difference may reverse and be utilized on a tax return but be replaced with another deductible temporary difference within the same year (thus not realizing a tax benefit), the determination of which carryforward or deductible temporary difference produced a realized tax benefit during the year may become important when applying the intraperiod allocation rules. This subsection explores the ordering rules that should be applied when addressing the question, “Which deferred tax asset produced a recognizable tax benefit?”

Recognition of a Tax Benefit for Carryforwards and Other Deductible Temporary Differences (ASC 740-10-55-37)

When there are both DTAs at the beginning of the year and DTAs arising in the current year from sources other than continuing operations, a change in the valuation allowance must be “sourced” to the assets that gave rise to the change.

In determining whether the reversal of a particular deductible temporary difference or carryforward provided a benefit, one must consider the interaction of originating temporary differences with loss and other carryforwards. Just because a net operating loss carryforward was utilized (used on the tax return), it does not mean that a benefit was realized (provided incremental cash tax savings). ASC 740-10-55-37 indicates that the reversal of a DTD as a deduction or through the use of a carryforward does not constitute realization when reversal or utilization resulted because of the origination of a new DTD. This is because the DTA that has been utilized has simply been replaced by the originating DTA without providing for realization. Accordingly, ASC 740-10-55-37 indicates that the “source” of the benefit of the originating DTD would not be the component of income in which the originating DTD arose; rather, it would take on the source of the deduction or carryforward that it replaced.

The specific example in ASC 740-10-55-37 refers only to deferred revenue, but the reference to ASC 740-20-45-3 makes it clear that the same rationale applies when an origination or increase of a DTD during the year allows for the utilization of a deduction or carryforward which originated in equity (e.g., the tax benefit and related valuation allowance recorded in equity, consistent with ASC 740-20-45-11(c) through (f)).
Example 12-9: Application of ASC 740-10-55-37

On December 31, 20X5, Company X raised new capital from its investors. Company X has recorded a deferred tax asset related to a $2,000 loss carryforward arising from a large expenditure related to the capital-raising transaction, for which a full valuation allowance was also recognized and recorded in equity. In 20X6, Company X generated a pretax loss from continuing operations of $1,000. Included in this $1,000 loss was $3,000 of warranty reserve expense that is not deductible until paid for income tax purposes.

<table>
<thead>
<tr>
<th>Source of Loss</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Loss From Continuing Operations</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Originating Deductible Temporary Differences</td>
<td>3,000</td>
</tr>
<tr>
<td>Usage of Loss Carryforward recorded in equity</td>
<td>(2,000)</td>
</tr>
</tbody>
</table>

Even though the $2,000 net operating loss carryforward was utilized during the year, no realization of deferred tax assets occurred because the loss from pretax continuing operations only served to increase the net deferred tax asset (and related valuation allowance). As a result, while the $2,000 net operating loss carryforward was consumed on the tax return, it was not realized; rather, it was merely transformed into the deductible temporary difference for the warranty reserve. If Company X changed its assessment about the realizability of its deferred tax assets in 20X7 (assuming no originating or reversing temporary differences in 20X7), $2,000 of the $3,000 release would be allocated to equity in accordance with ASC 740-20-45-3 through 45-4.

Example 12-10: Effect of ASC 740-10-55-37 on Ordering

Deductible temporary differences that reverse and manifest themselves into an originating temporary difference (or an NOL carryforward) have not been realized. Instead, that portion of the originating temporary difference takes on the character of the reversing DTA. The following example demonstrates how ASC 740-10-55-37 can affect the ordering in intraperiod allocation.

Background/Facts:
Assume that an entity has the following taxable income:

<table>
<thead>
<tr>
<th>Source of Income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income/(Loss) from Continuing Operations</td>
<td>1,000</td>
</tr>
<tr>
<td>Income/(Loss) from Discontinued Operations</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Reversing—DTDs recorded in equity</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Net Operating Loss</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

Also Assume:
- Coming into the year, there are no available carryforwards or income available in carryback years.
- The DTD that is reversing was originally established in equity with a full valuation allowance of $1,000 against it. This valuation allowance has not been reduced subsequently.

(continued)
• The DTA at the end of the current year requires a full valuation allowance.
• The statutory tax rate is 40 percent.

**Analysis/Conclusion:**
The total tax expense for the year is zero because there was no pretax income for the year ($1,000 income from continuing operations less $1,000 loss from discontinued operations), and the reversing equity-related DTDs created a taxable loss of $1,000 for which the related DTA requires a full valuation allowance.

ASC 740's intraperiod allocation rules would allocate a tax expense of $400 to continuing operations and a tax benefit of $400 to discontinued operations. Even though the ordering rules generally would consider the reversal of the equity-related DTDs before the current-year loss from discontinued operations, no tax benefit is allocated to the reversing equity-related DTDs because the DTA that arose in equity has merely been transformed into a DTA relating to an NOL carryforward. Said another way, while the equity-related DTDs reversed, they did not provide for incremental cash tax savings and thus were not realized.

Had the loss from discontinued operations in this example been $300, then $700 of the reversing equity-related DTDs would have been realized (resulting in incremental cash tax savings). As a result, the total tax expense of zero would be allocated as follows:

<table>
<thead>
<tr>
<th>Tax Expense/(Benefit) Allocated to Continuing Operations</th>
<th>400 = [1,000 x 40%]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Expense/(Benefit) Allocated to Discontinued Operations</td>
<td>(120) = [300 x 40%]</td>
</tr>
<tr>
<td>Tax Expense/(Benefit) Allocated to equity in accordance with ASC 740-20-45-3</td>
<td>(280) = [700 x 40%]</td>
</tr>
</tbody>
</table>

**Applying the Intraperiod Allocation General Rule for Ordering to Stock-based Compensation**

Under the general rule for ordering tax benefits, items included in continuing operations generally are considered to enter into tax computations before items included in other components. The tax deduction that corresponds to the recognized book compensation cost is accounted for in continuing operations under ASC 740. Complexities arise when considering the windfall tax benefit recorded in additional paid-in capital (APIC).

ASC 718-20-55-20 provides that the tax benefit and credit to APIC for a windfall tax benefit should not be recorded until the deduction reduces income taxes payable. In some cases, an entity may have current-year windfall tax benefits and NOL (or tax credit) carryforwards from earlier years, both of which are available to offset taxable income in the current year. In the U.S., the current-year stock compensation deduction (which would encompass the windfall tax benefit) would be used to offset taxable income before the NOL carryforwards because all current-year deductions take priority over NOL carryforwards in the tax return. For this situation, the ASC 718 Resource Group agreed that either of the following two approaches would be acceptable to determine the order in which tax attributes should be considered:

• **With-and-without approach:** Follow the with-and-without intraperiod tax allocation approach as described in ASC 740-20-45-7, which would result in windfall tax benefits being utilized last. That is, a windfall benefit would be recognized in APIC only if an incremental benefit was provided after considering all other tax attributes presently available to the entity.
• **Tax law ordering approach:** Apply the tax law. That is, allocate the benefit based on provisions in the tax law that identify the sequence in which those amounts are utilized for tax purposes.

An entity should treat its decision to adopt either approach as an accounting policy decision, which should be followed consistently. The table below provides a simplified illustration of the differences between the with-and-without and tax law ordering approaches for an entity with no valuation allowance (Company A) and an entity with a full valuation allowance (Company B).

---

**Example 12-11: With-and-Without and Tax Law Ordering Approaches**

**Background/Facts:**
- The applicable tax rate is 40 percent in all periods.
- Income taxes payable are zero at the beginning of the period.
- Taxable income before the excess tax deduction for stock-based compensation is $700,000.
- Current-year excess tax deduction for stock-based compensation is $200,000.
- NOL carryforward from prior years' operating losses is $1,000,000 (deferred tax asset of $400,000).

**Analysis/Conclusion:**

**Company A: No Valuation Allowance**

- Following the with-and-without approach, windfall tax benefits are the last item to be utilized to offset taxable income. The NOL carryforward generated from operations in prior years is sufficient to offset current-year taxable income before consideration of windfall tax benefits. Therefore, the excess tax deduction for stock-based compensation does not reduce taxes payable, and Company A would not record a windfall tax benefit to APIC. The deferred tax asset would be reduced by $280,000 (the $700,000 of taxable income assumed to be offset by NOL carryforwards multiplied by the 40 percent tax rate). The windfall tax benefit of $80,000 ($200,000 excess tax deduction multiplied by the 40 percent tax rate) would not be recognized until such time as that deduction was deemed to produce a reduction in taxes payable. At this point, while the NOL carryforward has been reduced to $300,000 for book purposes, $500,000 of NOL carryforward remains on the return (on the tax return, the $200,000 stock-based compensation deduction reduces taxable income to $500,000 and only $500,000 of the NOL carryforward is used). The $200,000 difference must be tracked “off balance sheet” and, when it is utilized in subsequent periods, the reduction in taxes payable is credited to APIC.

- Following the tax law ordering approach, the current-year excess tax deduction for stock-based compensation would be used to offset taxable income before utilization of the NOL carryforward. The excess tax deduction of $200,000 would reduce taxable income, and Company A would record the windfall tax benefit of $80,000 to APIC. In addition, the deferred tax asset would be reduced by $200,000 ($500,000 of NOL carryforward utilized to offset remaining taxable income multiplied by the 40 percent tax rate).

(continued)
The differences between the with-and-without approach and the tax law ordering approach for Company A can be summarized as follows:

<table>
<thead>
<tr>
<th>Company A</th>
<th>With-and-Without</th>
<th>Tax Law Ordering</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes payable before reduction for NOL carryforward and excess tax deductions for stock-based compensation ($700,000 x 40%)</td>
<td>$280,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>Less: Utilization of NOL carryforward deferred tax asset</td>
<td>(280,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Less: Windfall tax benefit recorded in APIC</td>
<td>—</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Income tax expense ($700,000 x 40%)</td>
<td>$280,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>Remaining NOL carryforward deferred tax asset</td>
<td>$120,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

**Company B: Full Valuation Allowance**

The same assumptions apply to Company B, except that Company B has a full valuation allowance recorded against its deferred tax assets.

Following the with-and-without approach, Company B would record the same entries as Company A except that Company B also would release $280,000 of the valuation allowance related to the NOL carryforward that was utilized. The release of valuation allowance would reduce income tax expense to zero in the current period. The windfall tax benefit of $80,000 ($200,000 excess tax deduction multiplied by the 40 percent tax rate) would not be recognized until such time as that deduction was deemed to produce a reduction in taxes payable. As in the “no valuation allowance” scenario, the $200,000 difference between the NOL carryforward for book and tax purposes must be tracked “off balance sheet” and, when it is utilized in subsequent periods, the reduction in taxes payable is credited to APIC.

Following the tax law ordering approach, Company B would record the same entries as Company A except that Company B would release only $200,000 of the valuation allowance related to the NOL carryforward that was utilized. In this scenario, Company B’s financial statements would reflect $80,000 of income tax expense in the current period (income tax expense of $280,000 less release of the valuation allowance of $200,000).

The differences between the with-and-without approach and the tax law ordering approach for Company B can be summarized as follows:

<table>
<thead>
<tr>
<th>Company B</th>
<th>With-and-Without</th>
<th>Tax Law Ordering</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes payable before reduction for NOL carryforward and excess tax deductions for stock-based compensation ($700,000 x 40%)</td>
<td>$280,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>Less: Utilization of NOL carryforward deferred tax asset</td>
<td>(280,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Less: Windfall tax benefit recorded in APIC</td>
<td>—</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Income tax expense before release of valuation allowance ($700,000 x 40%)</td>
<td>$280,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>Less: Release of valuation allowance</td>
<td>(280,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>—</td>
<td>$80,000</td>
</tr>
<tr>
<td>Remaining NOL carryforward deferred tax asset, net of valuation allowance</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>
PwC Observation: A policy decision to account for utilization of windfall tax benefits based on tax law ordering should be less complex than following the with-and-without intraperiod allocation approach. Following the tax law ordering approach should reduce the need to track differences between the treatment of NOL carryforwards for book purposes as compared with the treatment of NOL carryforwards for tax return purposes. Using the amounts in the illustrative example, a with-and-without accounting policy would necessitate tracking the $200,000 of NOL carryforward considered to be “off balance sheet” stock option deductions for book purposes.

Even in cases where the tax law ordering approach is followed, there will be occasions when only a portion of an NOL carryforward attributed to a given tax year is utilized. In these cases, a convention will need to be adopted for purposes of determining how much, if any, of the NOL carryforward that was utilized should be deemed to relate to windfall tax benefits. We believe that it is generally appropriate in this scenario to consider the windfall tax benefit to be the last portion of the NOL carryforward utilized consistent with the incremental approach, whereby items relating to other components of income enter into intraperiod allocation last. For example, assume an entity had an NOL carryforward from the prior year of $1,000,000 that resulted from operating losses of $600,000 and excess tax deductions of $400,000, the latter of which was not reflected as a deferred tax asset in light of the requirements of ASC 718-20-55-20 (which would prohibit the recording of a deferred tax asset on net operating loss carryforwards created by windfall tax benefits). In the current year, the entity generated taxable income of $700,000. Following an approach of utilizing windfall tax benefits last, the entity would be deemed to have utilized all of the available NOL carryforward from operations and would recognize a windfall tax benefit in APIC related to only $100,000 of the total available excess deductions of $400,000.

The determination of whether a windfall tax benefit has been realized is not only affected by NOL carryforwards but also by other carryforwards (e.g., foreign tax credit and R&D credit carryforwards). Determination of whether a windfall benefit has been realized when there are credit carryforwards is influenced by whether the tax law ordering or the with-and-without approach is being followed. The logic in Example 12-11 that was used to determine whether a windfall tax benefit was realized when the windfall interacted with an NOL carryforward may also be used to determine whether a windfall tax benefit is realized when the windfall interacts with these other carryforwards.

For example, a windfall tax deduction might reduce taxable income on the tax return, and therefore limit utilization of R&D credits that were generated during the year, thereby creating an R&D credit carryforward. If the tax law ordering approach is followed, the windfall tax deductions are considered to be used before the R&D credits, in which case the stock option windfall deduction would be recorded in the financial statements through APIC and a deferred tax asset is recorded for the R&D credit carryforward. If the with-and-without approach is followed, the R&D credits are considered to be used before the windfall tax deductions and no benefit is recognized in APIC. As in Example 12-11 above, the R&D credit carryforward on the tax return must be tracked “off-balance sheet” and, when it is utilized in subsequent periods, the reduction in taxes payable is credited to APIC.
For discussion of other intraperiod allocation complexities relating to ASC 718, such as the acceptable methods of accounting for the indirect effects of windfall deductions, and ASC 718’s interaction with the U.S. AMT, see Example 12-19.

12.2.3 Step 3: Allocate the Remaining Portion of Tax Expense or Benefit to Other Components

The portion of total tax that remains after allocation of tax to continuing operations (the difference between the total tax expense (computed in Step 1 above) and the amount allocated to continuing operations (computed in Step 2 above) is then allocated among the other financial statement components in accordance with the guidance in ASC 740-20-45-14.

The tax effects excluded from continuing operations will relate to current or deferred taxable income or deductions arising from revenue and expense items recognized in other components in the current year.

ASC 740-20-45-12 states:

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.

ASC 740-20-45-14 states:

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 (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items.

d. Apportion the tax expense determined in (c) ratably to each net gain item.

12.2.3.1 Determining the Individual Effects on Income Tax Expense or Benefit

We believe that the individual effects on income tax expense or benefit of a specific financial statement component represent that component’s incremental tax effect (on a jurisdiction-by-jurisdiction basis) on consolidated tax expense or benefit. Accordingly, we believe that this amount should be quantified by means of comparing the difference between the total tax expense or benefit computed for the year that includes all sources of income and loss and the total tax expense or
benefit for the year computed with all sources of income and loss except for the financial statement component being quantified. While that amount may not be the amount that ultimately is allocated to the respective financial statement component, it represents the individual incremental effect of the item for purposes of applying the allocation procedure outlined in ASC 740-20-45-14. All items (other than continuing operations) should be given equal priority for purposes of intraperiod tax allocation, unless there is specific guidance that provides otherwise.

---

**Example 12-12: Allocation of Tax Expense/Benefit to Financial Statement Components Other Than Continuing Operations**

**Background/Facts:**
Company A is a well-established manufacturing company that has taken a turn for the worse over the past several years. During 20X6, Company A sold one of its nonperforming businesses and, going forward, will focus on its remaining businesses. Although Company A is optimistic about the future, management has concluded that a valuation allowance will be necessary for all net deferred tax assets not supported by either carryback availability or future reversals of existing taxable temporary differences. There are no available tax-planning strategies and no weight can be given to projections of future taxable income from operations.

The Company’s 20X6 statement of net loss and comprehensive loss, before considering the effect of income taxes, is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Sales</td>
<td>(800)</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>200</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>(400)</td>
</tr>
<tr>
<td>Loss from Continuing Operations</td>
<td>(200)</td>
</tr>
<tr>
<td>Discontinued Operations</td>
<td>(400)</td>
</tr>
<tr>
<td>Net Loss</td>
<td>(600)</td>
</tr>
<tr>
<td>OCI–Derivatives—Cash Flow Hedges</td>
<td>25</td>
</tr>
<tr>
<td>OCI–Unrealized Loss on ASC 320 AFS Securities</td>
<td>(45)</td>
</tr>
<tr>
<td>Comprehensive Loss</td>
<td>(620)</td>
</tr>
</tbody>
</table>

**Additional Information:**
- The Company paid $40 in income taxes in 20X5 (representing $100 of taxable income available in the carryback period). Disregard any effects of AMT.
- Included in SG&A are $50 of nondeductible meals and entertainment expenses.
- The loss on discontinued operations in 20X6 consists entirely of losses from operations (there was no gain or loss on disposition).
- Taxable temporary differences related to fixed assets will reverse within the NOL carryforward period and are considered a source of income to support realization of the deferred tax assets.
- Assume that the entire portfolio of AFS securities represents debt securities that are classified as available-for-sale but management has no particular expectation that these debt securities will be sold prior to maturity. Accordingly, management does not expect the unrealized depreciation at 20X5 or 20X6 to result in a realized capital loss.

(continued)
Company A’s temporary differences and tax attributes, and the related deferred tax assets and liabilities, were as follows at December 31, 20X5, and 20X6:

<table>
<thead>
<tr>
<th>12/31/20X5</th>
<th>Temporary Difference</th>
<th>Applicable Tax Rate</th>
<th>Deferred Tax Asset/(Liability)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL Carryforward</td>
<td>—</td>
<td>40%</td>
<td>—</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>100</td>
<td>40%</td>
<td>40</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>75</td>
<td>40%</td>
<td>30</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>40%</td>
<td>10</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(300)</td>
<td>40%</td>
<td>(120)</td>
</tr>
<tr>
<td>Gross Deferred Tax Asset/(Liability)</td>
<td></td>
<td></td>
<td>(40)</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>—</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Net Deferred Tax Asset/(Liability)</td>
<td></td>
<td></td>
<td>(40)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>12/31/20X6</th>
<th>Temporary Difference</th>
<th>Applicable Tax Rate</th>
<th>Deferred Tax Asset/(Liability)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL Carryforward</td>
<td>400</td>
<td>40%</td>
<td>160</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>50</td>
<td>40%</td>
<td>20</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>120</td>
<td>40%</td>
<td>48</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>—</td>
<td>40%</td>
<td>—</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(200)</td>
<td>40%</td>
<td>(80)</td>
</tr>
<tr>
<td>Gross Deferred Tax Asset/(Liability)</td>
<td></td>
<td></td>
<td>148</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>(148)</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Net Deferred Tax Asset/(Liability)</td>
<td></td>
<td></td>
<td>(148)</td>
</tr>
</tbody>
</table>

**Analysis/Conclusion:**

<table>
<thead>
<tr>
<th>Taxable Income by Component</th>
<th>Continuing Operations</th>
<th>Discontinued Operations</th>
<th>AFS Securities</th>
<th>Derivatives</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Book Income</td>
<td>(200)</td>
<td>(400)</td>
<td>(45)</td>
<td>25</td>
<td>(620)</td>
</tr>
<tr>
<td>Schedule M Adjustments</td>
<td>—</td>
<td>—</td>
<td>(45)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>M&amp;E</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>(50)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(50)</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>100</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>100</td>
</tr>
<tr>
<td>ACS 320 AFS Securities</td>
<td>—</td>
<td>—</td>
<td>45</td>
<td>—</td>
<td>45</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td>(100)</td>
<td>(400)</td>
<td>—</td>
<td>—</td>
<td>(500)</td>
</tr>
<tr>
<td>Loss Carried Forward</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>400</td>
</tr>
<tr>
<td>Loss Carried Back—Current Tax Benefit @ 40%</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>100</td>
</tr>
</tbody>
</table>

(continued)
**Step 1:** 20X6 Tax Expense/(Benefit) With All Financial Statement Components:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(620)</td>
</tr>
<tr>
<td>Nondeductible Meals &amp; Entertainment</td>
<td>50</td>
</tr>
<tr>
<td>Taxable Income/(Loss)</td>
<td>(570)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Changes</td>
<td>(228)</td>
</tr>
<tr>
<td>Valuation Allowance Change</td>
<td>148</td>
</tr>
<tr>
<td><strong>20X6 Total Tax Provision/(Benefit)</strong></td>
<td>(80)</td>
</tr>
</tbody>
</table>

**Step 1:** Tax Provision/(Benefit) With All Financial Statement Components: (80)

**Step 2:** 20X6 Tax Provision/(Benefit) Attributable to Continuing Operations (“Without”)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(200) from above</td>
</tr>
<tr>
<td>Nondeductible Meals &amp; Entertainment</td>
<td>50</td>
</tr>
<tr>
<td>Taxable Income/(Loss)</td>
<td>(150)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Increase</td>
<td>(60)</td>
</tr>
<tr>
<td>Valuation Allowance Increase</td>
<td>—</td>
</tr>
<tr>
<td><strong>20X6 Total Tax Provision/(Benefit)</strong></td>
<td>(60)</td>
</tr>
<tr>
<td>Current Tax Provision/(Benefit)</td>
<td>(40)†</td>
</tr>
<tr>
<td>Deferred Tax Provision/Benefit</td>
<td>(20)††</td>
</tr>
<tr>
<td><strong>Total Tax Provision/(Benefit)</strong></td>
<td>(60)</td>
</tr>
</tbody>
</table>

† Loss carryback of $100 taxable loss (from above).
†† Change in deferred tax balance from $40 DTL to $20 (from above).

The Deferred Provision for Continuing Operations on a “Without” Basis Is Computed from the Following:

<table>
<thead>
<tr>
<th>Description</th>
<th>A 12/31/X5 Deferred Taxes</th>
<th>B 12/31/X6 Deferred Taxes</th>
<th>C With/Without Adjustment</th>
<th>B + C 12/31/X6 Deferred “Without” Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL</td>
<td>—</td>
<td>400</td>
<td>(400)</td>
<td>—</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>100</td>
<td>50</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(300)</td>
<td>(200)</td>
<td>—</td>
<td>(200)</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>—</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>75</td>
<td>120</td>
<td>(45)</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>(100)</td>
<td>370</td>
<td>(420)</td>
<td>(50)</td>
</tr>
<tr>
<td></td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
</tbody>
</table>

Because continuing operations, without considering the effects of financial statement components outside of continuing operations, would have had a net DTL of $20 and because, in this fact pattern, it has been assumed that all of the DTLs serve as a source of taxable income available for the recognition of DTAs, no valuation allowance is required on a “without” basis. Thus, none of the valuation allowance increase is allocated to continuing operations.

(continued)
Step 3: Tax to be Allocated to Categories Other than Continuing Operations

Total Tax Expense/(Benefit) (Step 1) (80)
Tax Provision/(Benefit) Allocated to Continuing Operations (Step 2) (60)
Tax to be Allocated to Items Other than Continuing Operations (20)

As a result of performing steps 1 and 2, there is a tax benefit of $20 to be allocated to all components other than continuing operations. If there were only one component other than continuing operations, the $20 would be allocated to that component. Because there is more than one component, the incremental tax effect of each individual component must be computed.

Calculate the Incremental Effects of Discontinued Operations:

<table>
<thead>
<tr>
<th></th>
<th>With</th>
<th>Without†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(620)</td>
<td>(220)</td>
</tr>
<tr>
<td>Nondeductible Meals &amp; Entertainment</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Taxable Income/(Loss)</td>
<td>(570)</td>
<td>(170)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Expense/(Benefit) Before Valuation Allowance Increase</td>
<td>(228)</td>
<td>(68)</td>
</tr>
<tr>
<td>Valuation Allowance Increase</td>
<td>148</td>
<td>—</td>
</tr>
<tr>
<td>Total Tax Expense/(Benefit)</td>
<td>(80)</td>
<td>(68)</td>
</tr>
<tr>
<td>Current Tax Expense/(Benefit)</td>
<td>(40)</td>
<td>(40)TT</td>
</tr>
<tr>
<td>Deferred Tax Expense/(Benefit)</td>
<td>(40)</td>
<td>(28)TT†</td>
</tr>
<tr>
<td><strong>Total Tax Expense/(Benefit)</strong></td>
<td>(80)</td>
<td>(68)</td>
</tr>
</tbody>
</table>

Incremental Effect – Discontinued Operations (12)

† Represents the “with” calculation less amounts attributable to discontinued operations.
TT Loss carryback of $100 taxable loss (from above).
TT† Change in deferred tax balance from $40 DTL to 12 DTL (see below).

The Deferred Provision for Discontinued Operations on a “Without” Basis Is Computed from the Following:

<table>
<thead>
<tr>
<th></th>
<th>A 12/31/X5 Deferred Taxes</th>
<th>B 12/31/X6 Deferred Taxes</th>
<th>C With/Without Adjustment</th>
<th>B + C 12/31/X6 “Without” Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL</td>
<td>—</td>
<td>400</td>
<td>(400)</td>
<td>—</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>100</td>
<td>50</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(300)</td>
<td>(200)</td>
<td>—</td>
<td>(200)</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>75</td>
<td>120</td>
<td>—</td>
<td>120</td>
</tr>
<tr>
<td>(100)</td>
<td>370</td>
<td>(400)</td>
<td>(30)</td>
<td></td>
</tr>
<tr>
<td>DTA/(DTL)</td>
<td>(40)</td>
<td>148</td>
<td>(160)</td>
<td>(12)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Without considering the effects of the current-year loss from discontinued operations of $400, the balance sheet would have reflected a net DTL of $12. Because the company’s deferred tax balance would have been a net DTL and because, in this example, it has been assumed that all of the DTLs serve as a source of taxable income available for the recognition of DTAs, no valuation allowance would be required on a “without discontinued operations” basis.

(continued)
Calculate the Incremental Effects of AFS Securities:

<table>
<thead>
<tr>
<th></th>
<th>With</th>
<th>Without†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(620)</td>
<td>(575)</td>
</tr>
<tr>
<td>Nondeductable Meals &amp; Entertainment</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Taxable Income/(Loss)</td>
<td>(570)</td>
<td>(525)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Provision/(Benefit) Before Valuation Allowance Increase</td>
<td>(228)</td>
<td>(210)</td>
</tr>
<tr>
<td>Valuation Allowance Increase</td>
<td>148</td>
<td>130</td>
</tr>
<tr>
<td>Total Tax Provision/(Benefit)</td>
<td>(80)</td>
<td>(80)</td>
</tr>
</tbody>
</table>

Current Tax Provision/(Benefit) | (40) | (40)††
Deferred Tax Provision/(Benefit) | (40) | (40)†††

Total Tax Provision/(Benefit) | (80) | (80)

Incremental Effect—AFS Securities

† Represents the “with” calculation less the current year result attributable to AFS securities reported in OCI.
†† Loss carryback of $100 taxable loss (from above).
††† Change in deferred tax balance from $40 DTL to a net DTL of $0 (see below).

The Deferred Provision for AFS Securities on a “Without” Basis Is Computed from the Following:

<table>
<thead>
<tr>
<th></th>
<th>A 12/31/X5 Deferred Taxes</th>
<th>B 12/31/X6 Deferred Taxes</th>
<th>C With/ Without Adjustment</th>
<th>B + C 12/31/X6 Deferred “Without” Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL</td>
<td>—</td>
<td>400</td>
<td>—</td>
<td>400</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>100</td>
<td>50</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(300)</td>
<td>(200)</td>
<td>—</td>
<td>(200)</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>75</td>
<td>120</td>
<td>(45)</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>(100)</td>
<td>370</td>
<td>(45)</td>
<td>325</td>
</tr>
<tr>
<td></td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>DTA/(DTL)</td>
<td>(40)</td>
<td>148</td>
<td>(18)</td>
<td>(130)</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net DTA/(DTL)</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Without considering the effects of the current-year loss from AFS securities of $45, the balance sheet would have reflected a net DTA of $130 before consideration of whether a valuation allowance would be required. Because one of the assumed facts is that there are no sources of taxable income other than reversing taxable temporary differences, a valuation allowance would be required for the full $130 net DTA on a “without AFS securities” basis.

(continued)
Calculate the Incremental Effects of OCI from Derivatives—Cash Flow Hedges:

<table>
<thead>
<tr>
<th></th>
<th>With</th>
<th>Without†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(620)</td>
<td>(645)</td>
</tr>
<tr>
<td>Nondeductable Meals &amp; Entertainment</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Taxable Income/(Loss)</td>
<td>(570)</td>
<td>(595)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Expense/(Benefit) Before Valuation Allowance Increase</td>
<td>(228)</td>
<td>(238)</td>
</tr>
<tr>
<td>Valuation Allowance Increase</td>
<td>148</td>
<td>158</td>
</tr>
<tr>
<td>Total Tax Expense/(Benefit)</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Current Tax Expense/(Benefit)</td>
<td>(40)</td>
<td>(40)††</td>
</tr>
<tr>
<td>Deferred Tax Expense/(Benefit)</td>
<td>(40)</td>
<td>(40)†††</td>
</tr>
<tr>
<td><strong>Total Tax Expense/(Benefit)</strong></td>
<td>(80)</td>
<td>(80)</td>
</tr>
</tbody>
</table>

Incremental Effect—OCI From Cash Flow Hedges

† Represents the “with” calculation less the current year result attributable to OCI-Derivatives.
†† Loss carryback of $100 taxable loss (from above).
††† Change in deferred tax balance from $40 DTL to a net DTL of $0 (see below).

The Deferred Tax Benefit for OCI from Derivatives—Cash Flow Hedges on a “Without" Basis Is Computed from the Following:

<table>
<thead>
<tr>
<th></th>
<th>A 12/31/X5 Deferred Taxes</th>
<th>B 12/31/X6 Deferred Taxes</th>
<th>C With/Without Adjustment</th>
<th>B + C 12/31/X6 Deferred “Without&quot; Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL</td>
<td>—</td>
<td>400</td>
<td>—</td>
<td>400</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>100</td>
<td>50</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(300)</td>
<td>(200)</td>
<td>—</td>
<td>(200)</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>—</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>75</td>
<td>120</td>
<td>—</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td>(100)</td>
<td>370</td>
<td>25</td>
<td>395</td>
</tr>
<tr>
<td><strong>DTA/(DTL)</strong></td>
<td>(40)</td>
<td>148</td>
<td>10</td>
<td>158</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Net DTA/(DTL)</strong></td>
<td>(40)</td>
<td>—</td>
<td></td>
<td>(158)</td>
</tr>
</tbody>
</table>

Without considering the effects of the current-year income from derivatives of $25, the balance sheet would have reflected a net DTA of $158, before consideration of whether a valuation allowance would be required. Because one of the assumed facts is that there are no sources of taxable income other than reversing taxable temporary differences, a valuation allowance would be required for the full $158 DTA on a “without OCI-derivatives” basis.

The incremental effects of all components other than continuing operations are as follows:

<table>
<thead>
<tr>
<th>Financial Statement Category</th>
<th>Incremental Tax Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discontinued Operations</td>
<td>(12)</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>—</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>(12)</td>
</tr>
</tbody>
</table>

(continued)
Note: Because the sum of the parts ($12) does not equal the amount left to be allocated ($20), the allocation procedure as outlined in ASC 740-20-45-14 must be performed. The first step in this process is to calculate the incremental effects during the year of all the loss items in the aggregate.

Calculate the Incremental Effects of the Total Net Loss for All Net Loss Items:

<table>
<thead>
<tr>
<th></th>
<th>With</th>
<th>Without†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Income/(Loss)</td>
<td>(620)</td>
<td>(175)</td>
</tr>
<tr>
<td>Nondeductible Meals &amp; Entertainment</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Taxable Income/(Loss)</td>
<td>(570)</td>
<td>(125)</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Expected Tax Expense/(Benefit) Before Valuation Allowance Increase</td>
<td>(228)</td>
<td>(50)</td>
</tr>
<tr>
<td>Valuation Allowance Increase</td>
<td>148</td>
<td>—</td>
</tr>
<tr>
<td>Total Tax Expense/(Benefit)</td>
<td>(80)</td>
<td>(50)</td>
</tr>
<tr>
<td>Current Tax Expense/(Benefit)</td>
<td>(40)</td>
<td>(40)††</td>
</tr>
<tr>
<td>Deferred Tax Expense/(Benefit)</td>
<td>(40)</td>
<td>(10)†††</td>
</tr>
<tr>
<td>Total Tax Expense/(Benefit)</td>
<td>(80)</td>
<td>(50)</td>
</tr>
</tbody>
</table>

Incremental Effect—All Net Loss Items (30)

† Represents the “with” calculation less the tax effects of the $400 current-year loss attributable to discontinued operations and the $45 current-year loss attributable to AFS securities.

†† Loss carryback of $100 taxable loss.

††† Change in deferred tax balance from $40 DTL to $30 DTL.

The Deferred Tax Benefit for All Loss Items on a “Without” Basis Is Computed from the Following:

<table>
<thead>
<tr>
<th></th>
<th>A 12/31/X5 Deferred Taxes</th>
<th>B 12/31/X6 Deferred Taxes</th>
<th>C With/ Without Adjustment</th>
<th>B + C 12/31/X6 Deferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL</td>
<td>—</td>
<td>400</td>
<td>(400)</td>
<td>—</td>
</tr>
<tr>
<td>Accrued Liabilities</td>
<td>100</td>
<td>50</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(300)</td>
<td>(200)</td>
<td>—</td>
<td>(200)</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>75</td>
<td>120</td>
<td>(45)</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>(100)</td>
<td>370</td>
<td>(445)</td>
<td>(75)</td>
</tr>
<tr>
<td>DTA/(DTL)</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>(40)</td>
<td>148</td>
<td>(178)</td>
<td>(30)</td>
</tr>
<tr>
<td>Net DTA/(DTL)</td>
<td>(40)</td>
<td>—</td>
<td>—</td>
<td>(30)</td>
</tr>
</tbody>
</table>

Without considering the effects of the current-year loss from discontinued operations of $400 and the current-year loss in AFS securities of $45, the balance sheet would have reflected a net DTL of $30. Because the balance sheet would have reflected a net DTL and because in this example it has been assumed that all of the DTLs serve as a source of taxable income available for the recognition of DTAs, no valuation allowance would be required on a “without all loss items” basis.

(continued)
Once the incremental effect of the loss items has been computed, tax expense or benefit is allocated as follows (ASC 740-20-45-14):

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discontinued Operations 100%</td>
<td>(30) = (12) / [(12) + 0] x (30)</td>
</tr>
<tr>
<td>ASC 320 AFS Securities 0%</td>
<td>— = 0 / [(12) + 0] x (30)</td>
</tr>
</tbody>
</table>

Note: Once the benefit related to the loss items is allocated to the loss items, the residual between the amount to be allocated to components other than continuing operations (in this case ($20)) and the amount allocated to the loss items in aggregate (in this case ($30)) is allocated pro rata based on each income category’s incremental tax effect. Because there is only one item of income outside of continuing operations, the amount left to be allocated of $10 is allocated to that component.

Allocate expenses to the income categories ratably based on each category’s incremental tax effect.

Derivatives—Cash Flow Hedges 10

The total tax benefit of $80 for 20X6 was allocated as follows:

<table>
<thead>
<tr>
<th>Financial Statement Component</th>
<th>Pretax Income/(Loss)</th>
<th>Tax Allocated Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continuing Operations</td>
<td>(200)</td>
<td>(60)</td>
</tr>
<tr>
<td>Discontinued Operations</td>
<td>(400)</td>
<td>(30)</td>
</tr>
<tr>
<td>ASC 320 AFS Securities</td>
<td>(45)</td>
<td>—</td>
</tr>
<tr>
<td>Derivatives—Cash Flow Hedges</td>
<td>25</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>(620)</td>
<td>(80)</td>
</tr>
</tbody>
</table>

12.2.3.2 Treatment of Specific Components Other Than Continuing Operations

12.2.3.2.1 Intrapерiod Allocation for Equity Items Other Than Items of Comprehensive Income

ASC 740 and ASC 718 specifically allocate to shareholders’ equity the tax effects of changes during the year of the following items:

- Cumulative effect adjustments to beginning retained earnings for changes in accounting principle or error correction (ASC 740-20-45-11(a)); see Section TX 12.2.3.2.6 for additional discussion);
- Increases or decreases in contributed capital (ASC 740-20-45-11(c));
- Expenses for employee stock options recognized differently for financial reporting and tax purposes (ASC 740-20-45-11(d));
- Income tax benefits relating to dividends and dividend equivalents that are charged to retained earnings and are paid to employees for equity that is classified as nonvested equity shares, as nonvested equity share units, and as outstanding equity share options (ASC 718-740-45-8 through 45-12; see Section TX 12.2.3.2.3 for additional discussion on dividends and dividend equivalents);
- Deductible temporary differences and carryforwards that existed, but for which a valuation allowance was required, at the date of a quasi reorganization (ASC 740-20-45-11(f));
• Tax effects credited directly to retained earnings resulting from deductible dividends paid on unallocated shares held by an ESOP and charged to retained earnings (ASC 740-20-45-11(e)); and

• Changes in the tax bases of assets and liabilities caused by transactions among or with shareholders, 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 (ASC 740-20-45-11(g)).

12.2.3.2.2 Items of Other Comprehensive Income

Certain gains and losses are included in comprehensive income but excluded from net income. Such items, when recognized, are reflected directly in OCI, a component of shareholders’ equity. Generally, the tax effect of gains and losses recorded in OCI should also be recorded in OCI (ASC 740-20-45-11(b)). These gains and losses include:

• Foreign currency translation gains and losses reflected in the CTA account within OCI for foreign operations using a foreign functional currency or the foreign currency transaction gain or loss on a nonderivative instrument (ASC 830; see Section TX 12.2.3.2.2.1);

• Unrealized gains and losses on AFS debt and equity securities (ASC 320; see Section TX 12.2.3.2.2.2);

• Net unrecognized gains and losses and unrecognized prior service cost related to pension and other postretirement benefit arrangements (ASC 715); and

• The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedge instrument (ASC 815).

PwC Observation: When a jurisdiction (and in some cases a separate filing where entities within a jurisdiction do not file a consolidated return) includes more than one item of OCI (e.g., derivatives under ASC 815 and AFS securities under ASC 320), each item should be treated as a separate component of the financial statements for purposes of the application of intraperiod allocation. As a result, the incremental tax effect of each separate component of other comprehensive income should be considered. We also believe that both favorable and unfavorable adjustments (for changes in uncertain tax positions assessments) to deferred taxes recorded in OCI should, depending on the accounting policy election, either be (1) backwards traced to OCI, or (2) recognized in income tax from continuing operations (refer to Section TX 16.9.1 for additional discussion on uncertain tax positions and intraperiod allocation).

12.2.3.2.2.1 Cumulative Translation Adjustments (CTA)

Some pretax transaction gains and losses (ASC 830-20-35-2) and all translation adjustments are recorded directly in the CTA account. In addition, ASC 830-20-45-5 requires the tax effects of these items to be attributed to the CTA account, subject to intraperiod allocation.

Allocation to the CTA account is required for both current and deferred taxes on transaction gains and losses recorded in the CTA account and for deferred taxes on translation adjustments. With respect to deferred taxes provided by a parent or investor for an “outside basis” temporary difference, the method of allocating the tax
effect on the current year change in this outside basis temporary difference between continuing operations and other items (such as CTA) must be considered. Although several alternatives exist, the method chosen should be consistently applied. Amounts that are ultimately allocated to CTA include:

- The capital gain or loss effect of revaluation of contributed capital;
- The effect of exchange rate changes on beginning-of-year deferred taxes provided on unremitted earnings; and
- The effects of changes in the valuation allowance and changes in tax-planning actions that are not appropriately allocated to continuing operations.

The computation will also require appropriate consideration of foreign withholding taxes and limitations on utilization of foreign tax credits. Refer to Section TX 11.5.7.

12.2.3.2.2 Unrealized Gains and Losses on “Available-for-Sale” Debt and Equity Securities (ASC 320)

ASC 320 requires that investments classified as available-for-sale be carried at fair value. This would generally result in temporary differences because the laws in most tax jurisdictions defer the recognition of gains and losses from investments until the investments are sold. ASC 320 reflects pretax changes in market value as other comprehensive income. ASC 740-20-45-11(b), requires that the tax effects of pretax changes to OCI occurring during the year be recorded net against the pretax changes in OCI.

Appreciation on Available-for-Sale (AFS) Securities When There Is a Valuation Allowance

When there is a valuation allowance applicable to beginning-of-year deferred tax assets and there is a change in circumstances during the year that causes the assessment of the likelihood of realization in future years to change, the effect is reflected in continuing operations. However, if the reversal of the valuation allowance is directly related to the appreciation of the company’s available-for-sale portfolio during the current year (current-period income) and not to expectations of taxable income in future periods, the reversal of the valuation allowance is recorded in OCI.

Example 12-13: Appreciation in AFS Securities When There Is a Valuation Allowance

Background/Facts:
Assume the following facts for Company A:

- Tax rate of 40 percent
- At year-end 20X5, a full valuation allowance on Company A’s net deferred tax asset as shown:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA for NOLs carryforwards</td>
<td>2,000</td>
</tr>
<tr>
<td>DTA for Unrealized Loss on AFS Securities</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>DTA Before Valuation Allowance</strong></td>
<td><strong>3,000</strong></td>
</tr>
<tr>
<td>Less: Valuation Allowance</td>
<td>(3,000)</td>
</tr>
<tr>
<td><strong>Net DTA</strong></td>
<td>—</td>
</tr>
</tbody>
</table>

(continued)
• During 20X6, financial results for pretax continuing operations were breakeven and $4,000 of pretax gains from unrealized appreciation on AFS securities was included in OCI.

• At December 31, 20X6, management concluded that a full valuation allowance continued to be required.

Analysis/Conclusion:
Based on these facts, Company A has a total tax expense of zero and a net deferred tax asset of $1,400 ($7,500 pretax deductible temporary difference (DTD) and NOL carryforward at December 31, 20X5, less $4,000 pretax OCI gain = $3,500 net pretax at December 31, 20X6, times 40%) with a full valuation allowance. As pretax income related to continuing operations is zero, no tax provision or benefit is allocated to it. Due solely to the income from available-for-sale securities of $4,000, $1,600 of the prior-year valuation allowance was released. As a result, the entire valuation allowance release of $1,600 would offset the tax attributable to the $4,000 pretax gain from OCI of $1,600 ($4,000 times 40%), resulting in no tax allocated to the AFS component of other comprehensive income.

PwC Observation: It should be noted that if the company had experienced losses from continuing operations in 20X6 and income from AFS securities, the answer would be different because of the application of the exception to the general intraperiod allocation rules as articulated in ASC 740-20-45-7. In that circumstance, it is likely that some of the loss from continuing operations would attract a tax benefit, with a corresponding tax expense allocated to the AFS security component of OCI. See Section TX 12.3 for more discussion on the application of ASC 740-20-45-7.

ASC 320, Investments—Debt and Equity Securities also provides guidance on how tax effects of AFS securities would be allocated under ASC 740’s intraperiod allocation rules.

Example 12-14: Intraperiod Allocation Related to Reclassifications from Accumulated Other Comprehensive Income

Background/Facts:
In Year 1, Company X purchased equity securities for $200 accounted for as available-for-sale. At the end of Year 1, the AFS securities had a fair value of $150, resulting in an unrealized loss of $50 recorded through OCI. In Year 2, Company X sold all of the AFS securities for $150, which resulted in reclassification of the pretax loss of $50 from accumulated OCI to earnings. Company X reported pretax income from continuing operations of $200 inclusive of the loss realized on the AFS securities and a reclassification gain of $50 in OCI (thus, the effect on comprehensive pretax income from the disposition of the AFS securities is nil). Company X’s tax rate is 40 percent.

Question:
Does the reclassification adjustment of $50 from accumulated OCI to earnings impact the intraperiod tax allocation given that the net effect on comprehensive net income is nil?

(continued)
Analysis/Conclusion:
Yes. Reclassification adjustments, such as gains and losses on AFS securities reclassified from accumulated OCI to earnings, form part of the current period income (loss) from continuing operations and current period income (loss) in OCI. Therefore, their income tax effect should be evaluated in the same manner as any other item of income or loss reported in the current period. They should be considered in ASC 740’s three-step, intraperiod allocation approach. As shown in the table, Company X would first calculate the total tax expense or benefit recognized in the financial statements (“all in”). Second, it would compute the tax attributable only to its continuing operations, and third allocate the difference between these two steps to any other category (which in this case is only OCI).

<table>
<thead>
<tr>
<th>Step 1:</th>
<th>Step 2:</th>
<th>Step 3:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Tax Expense or Benefit</td>
<td>Tax Attributable to Continuing Operations</td>
<td>Allocate Remaining Tax to OCI</td>
</tr>
<tr>
<td>Pre-tax income (loss)</td>
<td>$250</td>
<td>$200</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Tax (expense) benefit</td>
<td>($100)</td>
<td>($80)</td>
</tr>
</tbody>
</table>

In this example, total tax for the period is $100. Without the disposition of AFS securities, the total tax would also be $100 (income from continuing operations would be $250 and there would be no gain in OCI). However, while the net tax effect of the reclassification adjustment in step 1 of the intraperiod allocation model is nil, there is a tax effect to allocate to continuing operations and a consequent tax offset to OCI. In this example, the reclassification adjustment resulted in splitting the total tax effect for the period ($100) between continuing operations and OCI.

Note that reclassification adjustments that are credits in OCI, such as in the example above, can also sometimes serve as a source of income that enables recognition of a tax benefit from a current-year loss in continuing operations when the loss in continuing operations would otherwise require a valuation allowance (refer to ASC 740-20-45-7 and Section TX 12.3).

12.2.3.2.2.3 Disproportionate Tax Effects Lodged in OCI

How Tax Effects Become Lodged in OCI

The tax effects reflected directly in OCI are determined pursuant to ASC 740’s intraperiod allocation rules. Under this incremental approach, subsequent adjustments to deferred taxes originally charged or credited to OCI are not necessarily reflected in OCI. Specific circumstances in which subsequent adjustments are not reflected in OCI, but instead are reflected in continuing operations, include:

- A change in enacted tax rates (because ASC 740-10-45-15 requires that the effect of a tax law change on deferred tax assets and liabilities is reflected in continuing operations).
- A change in the valuation allowance for beginning-of-year deferred tax assets that results from a change in circumstances that causes a change in judgment about the realizability of deferred tax assets in future years (because ASC 740-10-45-20 requires that this type of change in valuation allowance be reflected entirely in continuing operations).
In certain circumstances, the application of the exception to the “with-and-without approach” described in ASC 740-20-45-7 (refer to Section TX 12.3) may also result in a disproportionate tax effect in OCI.

As a result of these requirements, the tax effect lodged in OCI will not necessarily equal the net deferred tax asset or liability that is recognized in the balance sheet for the temporary differences related to the pretax items recorded in OCI.

**Clearing Disproportionate Tax Effects Lodged in Accumulated Other Comprehensive Income**

A common question when a distortion exists in OCI is, “What, if anything, should be done about the ‘reconciling items’ that remain in OCI as a result of the change in valuation allowance or change in tax rate effects having been charged or credited to continuing operations?”

ASC 740 is silent as to the disposition of a disproportionate tax effect lodged in OCI. We believe that the OCI balance must be eliminated when the circumstances upon which it is premised cease to exist. Presumably, the pretax items in OCI ultimately will be cleared to income (perhaps in an indefinite, distant future period). For example, sale of a foreign operation or actions that result in a complete liquidation requires that the related CTA account balance be recognized in income. As discussed above, if a disproportionate tax effect related to such an item has been lodged in OCI, following the prescribed ASC 740 intraperiod allocation procedures, a tax effect may remain in OCI even after the pretax item has been reclassified to income. Because the disproportionate tax effect at one time was reflected in income (either in continuing operations or in the cumulative effect of initial application of ASC 740), its clearing ordinarily will be to income from continuing operations.

**Clearing Disproportionate Tax Effects Related to Unrealized Gains and Losses of “Available-for-Sale” Debt and Equity Securities (ASC 320)**

When there is a disproportionate tax effect relating to AFS securities, the question arises as to whether the necessity to clear tax effects is determined on an item-by-item (individual investment) or an aggregate portfolio basis. The following subsections discuss each of these two approaches in more detail.

**Item-by-Item approach:**

Under the item-by-item approach, a portion of the disproportionate tax effect is assigned to each individual investment in an unrealized gain or loss position at the effective date of the change. When one of those individual investments is sold or is impaired on an other than temporary basis in accordance with ASC 320, the assigned portion of the reconciling item is removed from the available-for-sale component of OCI and charged or credited to income from continuing operations. In this way, the tax effect that related to items of accumulated OCI that was charged or credited entirely to continuing operations is offset by charges or credits to income from continuing operations in later periods, as the individual investments are sold or impaired on an other than temporary basis.

**Aggregate portfolio approach:**

Under the aggregate portfolio approach, the disproportionate tax effect remains intact as long as the investment portfolio remains. Thus, if an entity with unrealized gains and losses on equity securities elects the aggregate approach, there presumably will be no need to completely clear the disproportionate tax effect from accumulated OCI as long as the entity holds an available-for-sale portfolio.
PwC Observation: In applying the aggregate portfolio approach, we believe that the disproportionate tax effect should be cleared if at any point during the year the portfolio is liquidated, even if a portfolio is re-established during the same interim period. This view is based on the fact that, at the time the portfolio was completely liquidated, the circumstance upon which the original disproportionate effect was premised ceased to exist.

Comparing the two approaches:
The item-by-item approach obviously requires considerably more time and effort to implement. Given the absence of authoritative guidance and the fact that either approach will produce “out-of-period” tax effects, proponents of the aggregate portfolio approach argue that the item-by-item approach does not pass a reasonable cost–benefit test and therefore is inconsistent with the FASB’s rationale for prohibiting “backwards tracing” in the first place.

We have discussed these issues with the FASB staff, and they have advised us that (a) they see meritorious arguments in support of both approaches; (b) they have no basis on which to object to either approach; and (c) in the absence of further guidance on their part or the part of another authoritative body, either approach should be acceptable in practice, provided that it is used consistently. The consistency requirement would not be violated if an entity employed the item-by-item method for one financial statement component and not another. Once an accounting policy is chosen for a particular item, that policy should be applied consistently unless a change can be justified as a change to a preferable policy (consistent with the guidance in ASC 250-10-45-1, for changes in accounting principles).

Example 12-15: Disproportionate Effect Being Lodged in Other Comprehensive Income Resulting from a Change in Valuation Allowance

An industrial company’s investment in noncurrent marketable equity securities, which originally cost $1,000, had a market value of $900 at the end of 20X1. The company accounts for this investment as an available-for-sale security under ASC 320, so that the unrealized loss of $100 was charged to OCI during 20X1. The company recorded a deferred tax asset of $35, but it also provided a $35 valuation allowance; thus no tax benefit was recognized in OCI on the $100 pretax OCI loss.

In 20X2, the market value of the securities did not change. However, as a result of a change in circumstances, the company changed its estimate of future taxable income and eliminated the valuation allowance. The tax benefit of $35 was reflected in continuing operations pursuant to ASC 740-10-45-20.

At the end of 20X2, the company had the following balance sheet accounts for the investment:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>900</td>
</tr>
<tr>
<td>Deferred Tax Asset</td>
<td>35</td>
</tr>
<tr>
<td>Shareholders’ Equity</td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>35</td>
</tr>
<tr>
<td>Unrealized Loss on Available-for-Sale Equity Securities (AOCI)</td>
<td>100</td>
</tr>
</tbody>
</table>
In early 20X3, the company sold the securities for $900. Upon the sale, the company recognized in continuing operations a $100 loss on the sale; the $100 previously recognized in OCI was reclassified to income pursuant to ASC 220.

As a result of the sale, the company was able to reduce its taxes currently payable by $35, and it reflected this tax benefit in its current tax expense. However, deferred tax expense reflected the reversal of the $35 deferred tax asset related to the previously unrealized loss. Accordingly, the overall net tax effect recognized in comprehensive income on the sale was zero.

That is, as it relates to comprehensive income (the “with” calculation), nothing has happened; the $100 pretax loss has been reclassified between components of accumulation OCI and, because there was no valuation allowance at the beginning 20X3, there is no net tax benefit (the current benefit from the realized loss is offset by the deferred expense associated with the realization of the related deferred tax asset). In continuing operations (the “without” calculation), the reclassification reduced pretax income by $100, resulting in a $35 tax benefit. In the intraperiod allocation for 20X3, therefore, the $35 difference between these two calculations is allocated to OCI. This results in a net reclassification adjustment of $65 (compared with the $100 accumulated OCI balance at the beginning of 20X3), and the $35 of tax expense that had become “lodged” in OCI with the establishment of a valuation allowance in 20X1 remains “lodged” in accumulated OCI. Because there was no longer any basis for an OCI balance, the company cleared the $35 debit to deferred tax expense in continuing operations.

In this scenario, the company recognized in continuing operations a $100 pretax loss on the investment in 20X3, but since the $35 tax benefit was recognized in continuing operations in 20X2 when the valuation allowance was released, no tax benefit was recorded in continuing operations (the $35 tax benefit on the current-year loss was offset by the clearing of the $35 amount that had been lodged in OCI).

---

**Example 12-16: Disproportionate Effect Being Lodged in OCI When Adjustments (Such as Changes in Tax Laws or Rates) Are Not Reflected in OCI**

**Background/Facts:**
Assume that in 20X6 an entity acquires, at a cost of $50, marketable equity securities that are classified as available-for-sale in accordance with ASC 320. The fair market value of the securities declines to $30 as of the end of 20X6 and the entity records the unrealized loss of $20 in OCI. As required by ASC 740-20-45-11(b) the tax effect of the temporary difference related to the $20 unrealized loss (i.e., the recognition of a deferred tax asset, assuming that no valuation allowance is required), measured at the currently enacted rate of 40 percent, also is credited to OCI. At December 31, 20X6, a law was enacted (effective January 1, 20X7) to reduce the capital gains tax rate from 40 percent to 30 percent.

**Question:**
What is the accounting for the tax effects of this temporary difference (a) at the date of the tax rate change, (b) upon a subsequent change in the fair market value, and (c) when the securities subsequently are sold?

*(continued)*
Analysis/Conclusion:
a. Change in tax rates or laws: As stated in ASC 740-10-45-15, and as discussed above at Section TX 12.2.2.2.1, the effect of a change in tax rates must be included in income from continuing operations during the period that includes the enactment date. Therefore, as of the date of enactment of the tax rate change (in this case, December 31, 20X6), the entry to adjust the deferred tax asset would be:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Provision For Continuing Operations</td>
<td>2</td>
</tr>
<tr>
<td>Deferred Tax Asset</td>
<td>2</td>
</tr>
</tbody>
</table>

This accounting treatment creates a difference between (1) the “expected” net-of-tax balance in the available-for-sale component of OCI and (2) the actual balance:

| Pretax Unrealized Loss                        | 20     |
| Expected Tax Benefit (at new tax rate of 30%) | (6)    |
| **Expected Net-of Tax Balance**              | 14     |
| Reconciling Item That Results from Reflecting Change in Tax Rate Effect in Continuing Operations | (2)    |
| **Actual Balance Reflected in AOCI**         | 12     |

If, as of the date of the tax rate change, the securities portfolio was in an unrealized gain position, similar accounting treatment would apply. It should be noted, however, that if the tax rate change resulted in a decrease in the deferred tax liability related to the unrealized gains and, as a direct consequence, the entity had to increase its valuation allowance related to other deductible temporary differences, then the adjustment to the valuation allowance also would be charged to continuing operations as part of the effect of the tax rate change, since it would represent a direct effect of the law change.

b. Subsequent change in fair market value: If the fair market value of the securities increased to $40 by the end of 20X7, the $20 unrealized loss would be reduced to $10 and the related $6 deferred tax asset would be reduced to $3. As noted above, the intraperiod tax-allocation provisions of ASC 740-20-45-11(b) require that the tax effects related to “gains and losses included in comprehensive income but excluded from net income” (including, for example, changes in the fair value of AFS securities under ASC 320) also be excluded from net income. Thus, the deferred tax effect that results from the $10 reduction of the temporary difference related to the unrealized loss is allocated directly to the AFS component of OCI. The entries at the end of 20X7 would be as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available-for-Sale Securities</td>
<td>10</td>
</tr>
<tr>
<td>Unrealized Loss on Available-for-Sale Securities (OCI)</td>
<td>10</td>
</tr>
<tr>
<td>Unrealized Loss on Available-for Sales Securities (OCI)</td>
<td>3</td>
</tr>
<tr>
<td>Deferred Tax Asset</td>
<td>3</td>
</tr>
</tbody>
</table>

(continued)
The net impact of the change in fair market value is “as expected.” The reduction in the unrealized loss and the related deferred tax effect are both allocated directly to OCI, with no income statement impact.

At the end of 20X7, the “reconciling item” that was created when the tax law was changed in 20X6 is still intact:

| Pretax Unrealized Loss                      | 10 |
| Expected Tax Benefit (at 30%)              | (3) |
| **Expected Net-of-Tax Balance**            |    |
| Reconciling Item That Results from Reflecting Change in Tax Rate Effect in Continuing Operations | (2) |
| **Actual Balance Reflected in AOCI**       | 5  |

**c. Sale of Securities:** If the securities were then sold in January 20X8 for $50 (equal to original cost), the entry to record the sale would be:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available-for-Sale Securities</td>
<td>10</td>
</tr>
<tr>
<td>Unrealized Loss on Available-for-Sale Securities (OCI)</td>
<td>10</td>
</tr>
<tr>
<td>Cash</td>
<td>50</td>
</tr>
<tr>
<td>Available-for-Sale Securities</td>
<td>50</td>
</tr>
</tbody>
</table>

The temporary difference related to the $10 of unrealized loss that remained at the end of 20X7 reverses upon the sale of the asset in 20X8 and, as in 20X7, the deferred tax effect of eliminating of the remaining $3 deferred tax asset is allocated directly to the available-for-sale of OCI. The entry is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Loss on Available-for-Sale Securities (OCI)</td>
<td>3</td>
</tr>
<tr>
<td>Deferred Tax Asset</td>
<td>3</td>
</tr>
</tbody>
</table>

Prior to the clearing of the lodged tax effect of $2 that resulted from the 20X6 law change, the impact on the 20X8 income statement is “as expected,” that is, the changes in the unrealized loss and the related deferred tax effect are both allocated directly to OCI and, because there was no realized gain or loss, no income-statement impact results. However, in this instance, as the company sold its entire portfolio of securities and the circumstances under which the lodged tax effect was premised ceased to exist, the $2 lodged tax effect should be cleared to continuing operations.
Example 12-17: Disproportionate Tax Effects Lodged in OCI as a Result of the Application of the Exception to the “With-and-Without” Approach

Background/Facts:
Company X owns AFS securities accounted for under ASC 320. In 20X8, Company X reported a pre-tax loss from continuing operations of $100 and a pre-tax unrealized gain in OCI of $100 generated by AFS securities. Company X maintains a full valuation allowance. The intraperiod income tax allocation for 20X8 is summarized in the table (refer to Section TX 12.2 for discussion of the basic model):

<table>
<thead>
<tr>
<th>Comprehensive Income Step 1</th>
<th>Continuing Operation Step 2</th>
<th>OCI Step 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income (loss)</td>
<td>none</td>
<td>$(100)</td>
</tr>
<tr>
<td>Intraperiod Allocation—with-and-without</td>
<td>none</td>
<td>none</td>
</tr>
<tr>
<td>Intraperiod Allocation—ASC-740-20-45-7 (benefit)</td>
<td>none</td>
<td>$(40)</td>
</tr>
<tr>
<td>Net</td>
<td>none</td>
<td>$(60)</td>
</tr>
</tbody>
</table>

As shown in the table above, there is no tax benefit to record for the loss in continuing operations (step 2) under the “with-and-without” tax allocation approach because of the full valuation allowance.

However, ASC 740-20-45-7 provides an exception to the “with-and-without” approach to intraperiod tax allocation by requiring that all items (e.g., extraordinary items, discontinued operations, and so forth) be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations. Accordingly, as demonstrated in the table above, Company X applied the exception in ASC 740-20-45-7 and recorded a deferred tax benefit in continuing operations and a deferred tax expense in OCI. This effectively grossed up the components of comprehensive income with no net effect on the balance sheet since the deferred tax asset was offset by a deferred tax liability (Refer to Section TX 12.3.1 for further discussion).

In 20X9, Company X incurred more losses from continuing operations and due to market conditions also reduced the value of its AFS securities by $100. The $100 pre-tax loss in OCI effectively reversed the prior year’s unrealized gain in accumulated other comprehensive income (AOCI).

Question:
What should be the intraperiod tax allocation in 20X9 assuming there are no other items of income or loss? When should the tax effect (i.e., a deferred tax expense) recorded in 20X8 be cleared out of AOCI?

Analysis/Conclusion:
Under the “with-and-without” three-step intraperiod allocation approach, the “with” (step 1) and continuing operations (step 2) tax effects are nil in 20X9 given the full valuation allowance status. Therefore, there is no tax effect allocable to OCI (step 3). The recognition of loss in OCI without a corresponding tax effect creates what is referred to as a disproportionate effect.
Clearing Disproportionate Tax Effects Related to Pension and OPEB Plans (ASC 715)

When there is a disproportionate tax effect relating to pension and OPEB plans accounted for under ASC 715, the question arises as to when it would be appropriate to clear the disproportionate tax effect lodged in AOCI.

As discussed near the beginning of this Section TX 12.2.3.2.2.3, we believe that a disproportionate tax effect lodged in AOCI should be eliminated when the circumstances upon which it is premised cease to exist. As it relates to pension and OPEB plans, because the plan is what gives rise to the DTA, we believe that the disproportionate effect should not be cleared until the plan has been terminated. Because the unit of account is the pension or OPEB plan itself, we do not believe that a pro-rata approach to clearing the disproportionate effects related to an individual plan would be an appropriate alternative. For example, it would not be appropriate to clear the disproportionate effects as gains/losses and prior service costs/credits are amortized out of AOCI and into income.

12.2.3.2.2.4 Allocation of Items of Other Comprehensive Income in an Outside Basis

Temporary difference

As with other temporary differences, the allocation of deferred taxes between continuing operations and other items, such as other comprehensive income, must be considered with respect to deferred taxes provided by a parent or investor for the outside basis temporary difference.

Example 12-18: Measurement of an Outside Basis Temporary Difference in a Partnership When the Partnership has Other Comprehensive Income

Background/Facts:
Company X consolidates a partnership in which it owns a 70 percent interest. The remaining 30 percent partnership interest is owned by an unrelated party. In the current year, the partnership generates $100,000 of book income from continuing operations and $50,000 of other comprehensive income. The partnership’s taxable income for the current year is $80,000. In previous years, Company X has recorded a deferred tax liability for an excess book-over-tax basis in the partnership (outside basis difference). Company X’s applicable tax rate is 40 percent.

Question:
Does the outside book basis include Company X’s share of the partnership’s OCI? If so, what is the intraperiod allocation of any deferred tax expense related to Company X’s share of the partnership’s OCI?

Analysis/Conclusion
The outside book basis includes Company X’s share of the partnership’s OCI. The investor’s financial reporting book basis of an investment in a partnership or a corporation encompasses the investor’s share of comprehensive income. This would occur whether the investor consolidates or applies the equity method of accounting. Therefore, Company X’s share of the partnership’s OCI is a part of the overall outside basis difference between book and tax similar to any difference between its share of partnership book income and taxable income.

(continued)
In this circumstance, Company X's outside book basis would increase by 70 percent of consolidated partnership comprehensive income or $105,000 (the remaining partnership comprehensive income of $45,000 is attributable to the noncontrolling shareholder). Its outside tax basis would increase by 70 percent of partnership taxable income or $56,000. Accordingly, Company X has an additional outside-basis taxable temporary difference of $49,000 (i.e., the excess of its share of comprehensive income over taxable income) and an additional deferred tax liability of $19,600. Consistent with ASC 740-20-45-11(b), Company X would recognize $14,000 of the deferred tax expense in OCI (i.e., its share of the partnership's OCI or $35,000 times 40 percent).

### 12.2.3.2.3 Dividends

ASC 740-20-45-8(d) requires that the benefit of tax-deductible dividends be reflected in continuing operations. This general rule includes the tax effects of tax-deductible dividends on unallocated ESOP shares that are accounted for under ASC 718, as such dividends are not charged to retained earnings (ASC 718-740-45-7). However, ASC 740-20-45-11(e), provides an exception for tax-deductible dividends on unallocated shares held by an ESOP charged to retained earnings. In this case, the corresponding tax effect also is reflected in retained earnings.

In addition, ASC 718-740-45-8 through 45-12 concludes that, when an income tax benefit is realized from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units, and outstanding equity share options, the tax benefit should be recognized as an increase in additional paid-in capital (APIC) if the related awards are expected to vest. However, if the related awards are not expected to vest, the dividends or dividend equivalents are recognized as compensation costs. A change in forfeiture estimates requires a reclassification of dividends and dividend equivalents between retained earnings and compensation expense and a corresponding reclassification of the related tax benefits between APIC and income tax from continuing operation (see Chapter TX 18 for additional discussion).

ASC 718-740-45-8 through 45-12 retains the requirement in ASC 718-20-55-20 that income tax benefits of dividends and dividend equivalents should not be recognized (in APIC or in the income tax provision when a change in vesting estimates occurs) until the deduction reduces income tax payable.

### 12.2.3.2.4 Discontinued Operations

#### 12.2.3.2.4.1 Restating Prior-Period Presentation for Discontinued Operations

In the period when operations meeting the criteria in ASC 205-20-45-1 for discontinued operations are disposed of or classified as held-for-sale, prior years' results are segregated retroactively between continuing and discontinued operations in accordance with ASC 205-20-45-3 through 45-5. When this occurs, a new allocation of tax expense or benefit to continuing operations must be determined for the current and prior years. There may be, in prior years' financial statements restated to reflect the discontinued operations, one or more items other than continuing operations and the operations now presented as discontinued. ASC 740-270-45-8 specifies that the amount of tax to be allocated to discontinued operations should be the difference between the tax originally allocated to continuing operations and the tax allocated to the restated amount of continuing operations. This often will result in a different amount than would result from a complete reapplication of
the intraperiod allocation rules; however, it may be simpler to apply as amounts of
tax allocated to other components of income (loss) recognized in the prior years are
not restated. Example 15-2 in Section TX 15.3.4 discusses the accounting when
a change in tax law occurred in the prior period being restated for discontinued
operations.

**PwC Observation:** While ASC 740-270-45-8 specifically applies to interim
financial reporting, we believe its provisions apply to restating prior annual periods
as well.

The reallocation of the tax expense originally allocated to continuing operations
between continuing and discontinued operations in the restated income statements
should be based entirely on estimates that were made in preparing the prior years’
financial statements and should not reflect any hindsight. Changes in the valuation
allowance for beginning-of-year DTAs could raise questions in determining the split.
To the extent the discontinued operations were included in a consolidated tax return
along with the remaining continuing operations, the change in valuation allowance
resulting from the change in judgment about the realizability of DTAs in future years
should be recorded in continuing operations consistent with the “general rule” set
forth in ASC 740-10-45-20, as discussed previously. This would be the case even
if the change in estimate related to beginning-of-year DTAs that arose in operations
that are now classified as discontinued. As set forth at Section TX 12.2.2.2.3.2, if the
benefit of a loss is not recognized in the year when the loss is incurred, it will not,
when recognized in a subsequent year, be classified on the basis of the source of
the loss. Thus, the fact that a loss carryforward or deductible difference arose from
operations in a prior year that subsequently were classified as discontinued would
not be relevant in classifying the tax benefit initially recognized in the current year.

There is one situation, however, where departure from the general rule may be
appropriate. If the discontinued operations filed a separate tax return, it may be
appropriate to record in discontinued operations the change in assessment about the
realizability of DTAs in future years.

A question also could arise when the disposal results in a different realization, or
estimate of future realization, of DTAs from that reflected in the beginning-of-year
valuation allowance. Deferred tax assets (or liabilities) that relate to a subsidiary’s
inside basis temporary differences may simply disappear, perhaps indirectly realized
in the pretax gain or loss on sale of the subsidiary’s stock. These tax effects should
be reflected as the tax effects of the gain or loss on disposal, even though implicitly
they may reflect a change in the valuation allowance related to beginning-of-year
DTAs.

**12.2.3.2.4.2 Recording Previously Unrecognized Deferred Tax Effects of Outside Basis
Differences of Subsidiaries**

A question arises as to the intraperiod allocation of a deferred tax expense/benefit in
the following situation: The entity’s discontinued operation is in a subsidiary with an
outside basis difference. The entity has not previously recorded a deferred tax liability
or asset for the outside basis difference, for one of three possible reasons:

- An excess outside book-over-tax basis difference related to an investment in
  a foreign subsidiary was not recorded as a deferred tax liability because of the
  “indefinite reversal” criteria of ASC 740-30-25-17.
• An excess outside book-over-tax basis difference related to an investment in a domestic subsidiary was not considered a taxable temporary difference because the entity expected that the difference would reverse without tax effect (ASC 740-30-25-7).

• A deferred tax asset was not recognized for a deductible temporary difference because it was not apparent that the excess outside tax basis would reverse in the foreseeable future (ASC 740-30-25-9).

Consistent with ASC 740-30-25-10, the entity should record a deferred tax asset or liability for the outside basis difference when its expectation has changed and, in any event, no later than the date on which the component of the entity is classified as held-for-sale. There are precedents in practice that support intraperiod allocation of the related tax benefit or expense to either discontinued operations or continuing operations. We would not object to allocation to either component, provided that appropriate disclosures were made and that the approach chosen was followed consistently.

**12.2.3.2.5 Complexities in Accounting for Windfall Benefits under ASC 718**

In previous sections of this chapter, the illustrations related to windfall tax benefits have assumed a single tax rate applicable in all periods when calculating the windfall tax benefit resulting from the settlement of a stock-based compensation award. Entities may receive certain tax deductions that impact their effective tax rate and thus the incremental tax benefit of the excess tax deduction. For example, IRC Section 199 provides an entity with a permanent tax deduction related to its qualified production activities. In accordance with ASC 740-10-55-147 through 55-148, the deferred tax asset that an entity records for the book compensation cost should not be adjusted to reflect an IRC Section 199 deduction that the entity is likely to receive. However, the IRC Section 199 deduction affects the incremental tax benefit of the excess tax deduction when using the with-and-without approach to calculate the windfall tax benefit.

Example 12-18 illustrates three alternative approaches for calculating the incremental windfall tax benefit recorded to APIC when an entity is entitled to an IRC Section 199 deduction.

**Example 12-19: Calculation of Windfall Tax Benefits Including Impact of IRC Section 199 Deduction**

**Background/Facts:**

• The applicable tax rate is 35 percent.

• 4,000 stock options are granted on January 1, 2009, and all the options vest on December 31, 2009.

• Compensation cost for the award is $400,000 and is recorded during 2009 for book purposes, along with the related deferred tax assets of $140,000.

• Taxable income in 2010 is $1,000,000 before the IRC Section 199 deduction.

• The stock options are exercised on July 1, 2010, when the intrinsic value (and the related tax deduction) is $500,000. Thus, the excess or windfall tax deduction is $100,000.

• The IRC Section 199 deduction is fully phased in at 9 percent.

(continued)
Analysis/Conclusion:
Calculation of the Windfall Tax Benefit:

<table>
<thead>
<tr>
<th>With Excess Deduction</th>
<th>Without Excess Deduction ($100,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income (pre-IRC Section 199)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less: IRC Section 199 deduction</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$910,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>$318,500</td>
</tr>
<tr>
<td></td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Less: IRC Section 199 deduction</td>
<td>(99,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$1,001,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>$350,350</td>
</tr>
</tbody>
</table>

• **Alternative A:** Under this approach, an entity would calculate the windfall tax benefit as the difference between the “without” calculation of $350,350 and the “with” calculation of $318,500, or $31,850. The IRC Section 199 deduction results in an in-substance reduction of the tax rate to 31.85 percent, or 91 percent of the statutory rate. Therefore, another way to measure the windfall in this example is to compare the deferred tax asset of $140,000 with the tax benefit of $175,000 ($500,000 multiplied by 35%) and then multiply such difference (or $35,000) by 91 percent.

• **Alternative B:** A second approach to calculating the windfall tax benefit would be to compare the recorded deferred tax asset with the incremental tax benefit of the deduction. In the example above, the $500,000 intrinsic value would result in a tax benefit of $159,250 ($500,000 tax deduction multiplied by the 35 percent statutory rate multiplied by 91 percent). The tax benefit of $159,250, compared with the deferred tax asset of $140,000, would result in an excess of $19,250, which would be recorded as the windfall tax benefit.

• **Alternative C:** Under a third approach, an entity could elect to consider only the direct effects of the stock option deduction and ignore the impact of IRC Section 199. In this case, the windfall would be measured by comparing the tax deduction of $500,000 with the cumulative book compensation cost of $400,000. The tax benefit of the excess deduction, or $35,000 ($100,000 multiplied by 35 percent), is the windfall tax benefit calculated under this approach.

We believe that an entity could elect to use any of the above approaches to calculate windfall tax benefits. The approach an entity elects to use should be treated as an accounting policy decision which should be consistently followed and disclosed.

A similar allocation question arises when an entity calculates the effect of the research tax credit under U.S. tax regulations. Strict application of the with-and-without approach would appear to require allocating the benefit of the incremental research tax credit to APIC under either an Alternative A or Alternative B approach. Some entities, however, do not segregate this credit when measuring the windfall tax benefit; instead, they follow the practice of recognizing the full effect of the research tax credit in income from continuing operations, following the logic of Alternative C. The approach an entity elects to use should be applied consistently to all indirect effects of stock-based compensation deductions.
PwC Observation: A policy decision to use the approach described under Alternative C is likely to be less complex for entities to apply because, under this approach, the indirect effects of stock-based compensation deductions are not considered for purposes of measuring the windfall at settlement of the award. While simpler to apply, Alternative C is likely to cause more volatility of income tax expense reported in continuing operations, as the indirect tax effects of stock-based compensation deductions would be reflected in the income tax provision and not in APIC.

In certain situations, an entity may not pay regular tax because it has substantial NOL carryforwards; however, it may be subject to the alternative minimum tax (AMT), which is discussed more fully in Section TX 4.2.5.1. Regardless of whether the entity pays a regular tax or an AMT, the amount recognized as a windfall tax benefit (assuming no valuation allowance is needed) is the amount that reduces regular taxes payable, with the determination of the benefit subject to the policy election of tax law ordering or the with-and-without approach. That is, the tax saving from windfalls is measured at the regular tax rate (even though the entity may be paying AMT) since the windfalls effectively “save” an equivalent amount of regular NOL carryforwards that would otherwise have been used (Ex. 12-20 below illustrates this accounting). However, when any AMT credit carryforwards would be offset by a full valuation allowance, we believe the benefit recorded to APIC should be measured based on the amount of AMT saving that is a result of the windfalls.

Consider the following illustration:

Example 12-20: Income Tax Benefit under Alternative Minimum Tax

Background/Facts:

• The company has NOL carryforwards of $100 million and no valuation allowance.
• The company establishes deferred taxes for temporary differences at the regular tax rate (40 percent) in accordance with ASC 740-10-30-10.
• The company has a current-year deduction from the exercise of nonqualified stock options of $10 million. These options were granted and exercised post-adoption of ASC 718 and resulted in book compensation expense of $6 million, with a corresponding deferred tax asset of $2.4 million.
• Regular taxable income before the option deduction and NOLs is $30 million.
• AMT income is $30 million, prior to considering the effects of the stock option deduction and the allowable NOL (90 percent).
• The company has made a policy election to utilize the tax law ordering approach to calculate realized excess tax benefits from option exercises.

Calculation of the AMT tax:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMT taxable income (pre-stock option deduction)</td>
<td>$30,000,000</td>
</tr>
<tr>
<td>Nonqualified stock option deduction</td>
<td>(10,000,000)</td>
</tr>
<tr>
<td>AMT taxable income (pre-NOL)</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Application of allowable NOLs (90%)</td>
<td>(18,000,000)</td>
</tr>
<tr>
<td>AMT taxable income</td>
<td>$ 2,000,000</td>
</tr>
<tr>
<td>AMT tax rate</td>
<td>20%</td>
</tr>
<tr>
<td>AMT tax</td>
<td>$ 400,000</td>
</tr>
</tbody>
</table>

(continued)
After considering the above, the company will owe no regular taxes and will owe $400,000 in AMT tax.

**Analysis/Conclusion:**

**Determination of Windfall Tax Benefit:**

The company has a realized excess tax benefit of $1.6 million and should record a credit to APIC for this amount. This amount is equal to the $4 million excess deduction multiplied by the company's regular tax rate of 40 percent.

It may appear that the excess tax benefit reduced current taxes by only $200,000 because, without the excess stock option deduction, the company would have paid $600,000 in AMT tax ($30 million in AMT taxable income reduced by NOLs up to 90 percent multiplied by 20 percent) but ultimately paid only $400,000. However, for this company (and all companies that do not expect to be AMT taxpayers perpetually), the AMT is prepaid regular tax because the company receives a credit against future regular tax due for any AMT tax paid. Therefore, the realized excess tax deduction should be the amount by which the excess tax deduction reduced regular taxes payable—not AMT taxes payable. In this example, the entire excess stock compensation reduced regular taxes payable. Therefore, the company should record $1.6 million of excess tax benefit in APIC.

The company would record the following journal entry to recognize the tax benefit from the exercise of the stock options and the deferred tax asset related to the AMT taxes paid:

- **Dr Current tax provision (continuing operations)** $400,000
- **Dr Deferred tax asset—AMT credit** $400,000
- **Dr Deferred tax provision (continuing operations)** $11,600,000
- **Cr Income tax payable** $400,000
- **Cr Deferred tax asset** $10,400,000
- **Cr APIC** $1,600,000

It should be noted that, if the company had a policy of applying the with-and-without approach to determine realized tax benefits, none of the current-year stock option deductions would have been deemed to reduce regular taxes payable. This is because, under the with-and-without approach, the company's NOL carryforwards would be deemed to reduce taxes payable prior to any windfall tax benefits.

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**12.2.3.2.6 Tax Effect of Changes in Accounting Principle**

The cumulative effect adjustment from an accounting change generally will be included as an adjustment to beginning retained earnings. ASC 740-20-45-11(a) requires that the tax effect of the cumulative effect adjustment should also be recorded as an adjustment to beginning retained earnings, but the tax effects to be recorded are the effects that would have been recorded if the newly adopted accounting method had been used in prior years. Presumably, hindsight would not be used in this determination. Therefore, we believe that the tax effect of a cumulative effect of a change in accounting principle that is reported as an adjustment to beginning retained earnings is an adjustment of cumulative income tax expense from prior periods and not an allocation of the current period's tax expense. For example, assume that an entity has a change in accounting principle that results in a cumulative increase in prior-year financial reporting income that is to be reported as a cumulative effect adjustment to beginning retained earnings. Such an increase also would have resulted in an increase in taxable temporary differences as of that date.
The resulting deferred tax liability should be established by taking into account the deferred tax balances at the beginning of the year and the enacted tax rates expected to be in effect when those temporary differences reverse (as determined under ASC 740-10-30-8). Accordingly, if the taxable temporary differences would have allowed for a lesser valuation allowance at the beginning of the year on previously recorded deferred tax assets, the valuation allowance release also would be included in the cumulative effect. Although a change in accounting principle also may yield a revised estimate of future pretax book income, generally there will be no impact on taxable income. In any event, a change in expectation coincident with a change in accounting should not be considered part of the change in accounting.

If the cumulative effect is required to be reported as a component of net income, it would be subject to the intraperiod allocation rules. In calculating such cumulative effect, the intraperiod allocation rules would be applied to each prior period.

**PwC Observation:** The above guidance applies to the general manner in which changes in accounting principle are reported. However, any new accounting standard may specify different methods not specifically addressed here. For example, a standard could be adopted during an interim period or at the end of the year. It also might require a change in accounting to be reported in net income, as opposed to retained earnings, or other components of equity or net assets. Thus, it is important to consider the specific manner in which a change in accounting will be reported in order to determine the appropriate reporting of related tax effects.

### 12.2.3.3 Miscellaneous Intraperiod Issues

#### 12.2.3.3.1 Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature

An entity may issue a convertible debt security with a nondetachable conversion feature. The nondetachable conversion feature is not accounted for separately under ASC 470. However, when an entity issues a convertible debt security with a nondetachable conversion feature that is “in-the-money,” ASC 470-20-25-5 requires the conversion feature to be accounted for separately. This type of conversion feature is defined as a beneficial conversion feature and is recognized and measured separately by allocating to additional paid-in capital a portion of the proceeds equal to the intrinsic value of the conversion feature. That intrinsic value is calculated at the commitment date as the difference between the conversion price and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible. The convertible security is recorded at par, and a discount is recognized for the amount that is allocated to additional paid-in capital. For tax purposes, the tax basis of the convertible debt security is the entire proceeds received at issuance of the debt. Thus, the book and tax bases of the liability are different. ASC 740-10-55-51 addresses whether a deferred tax liability should be recognized for that basis difference and indicates that:

1. The recognition of a beneficial conversion feature creates a difference between the book basis and tax basis (“basis difference”) of a convertible debt instrument,

2. That basis difference is a temporary difference for which a deferred tax liability should be recorded under ASC 740, and
3. The effect of recognizing the deferred tax liability at the date of issuance should be charged to equity in accordance with ASC 740-20-45-11(c).

As the discount created by the recognition of the beneficial conversion feature is amortized, which in certain circumstances is over a period shorter than the contractual life of the debt instrument, the temporary difference reverses. The effect of that reversal is a component of the deferred tax provision for the period(s).

Deferred taxes are also required for other types of convertible debt instruments such as convertible debt instruments that (1) may be partially or wholly settled in cash and are accounted for under ASC 470, (2) provide for certain contingent payments, and (3) have call options (see Chapter TX 3 for additional discussion). The intraperiod allocation guidance described above for convertible debt instruments with a beneficial conversion feature should also apply to the tax effects from these other types of convertible debt instruments.

12.2.3.3.2 Changes in Tax Basis Resulting from a Taxable Exchange between Entities under Common Control

Certain transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity that receives the net assets. In practice, these transactions are accounted for in the financial statements of the receiving entity based on the transferring entity's historical cost and acquisition accounting is not required (ASC 805-50-05-5 and related guidance in ASC 805). In a taxable transfer/exchange, new tax bases are established for the assets of one of the entities. Because a new basis is not established for book purposes, taxable temporary differences may be reduced or eliminated, and deductible temporary differences may be increased or created. Based on the guidance in ASC 740-20-45-11(g), we believe that, as of the transfer/exchange date, the tax effects attributable to any change in tax basis (net of valuation allowance, if necessary) should be charged or credited to contributed capital. If a valuation allowance is provided against the deferred tax assets at the combination date, any subsequent release of the valuation allowance should be reported as a reduction of income tax expense and reflected in continuing operations, unless the release is based on income recognized during the same year and classified in a category other than continuing operations, consistent with the guidance at Section TX 12.2.2.2.3. Similarly, if the reporting entity can no longer realize a preexisting deferred tax asset as a result of a transaction among or with its shareholders, ASC 740-10-45-21 requires that the write-off be recorded as part of income tax expense. Chapter TX 10 includes additional discussion on common control transactions (see Section TX 10.9).

12.2.3.3.3 Presentation of the Tax Effects of the Sale of Stock of a Subsidiary

12.2.3.3.1 Computing Gain or Loss on the Sale of a Subsidiary

If the sale of a subsidiary is structured as an asset sale (e.g., an asset acquisition or a share acquisition treated as an asset acquisition), the seller will reflect a gain or loss on the sale of the assets in pretax income and will recognize any current taxes, as well as the reversal of any deferred taxes related to the business, in the tax provision. If the transaction is structured as a stock sale (e.g., a third party purchases 100 percent of the parent’s stock in the subsidiary), the tax effects of the parent include the realization of any basis difference that exists on the parent’s investment in subsidiaries being sold. In addition, the historical tax bases of the subsidiary's individual assets and liabilities generally transfer to the buyer. Is the presentation of the tax consequences of a stock sale different than it would be for the sale of
the assets of the subsidiary? In particular, is the reversal of deferred taxes that are recorded on the subsidiary’s books included in the pretax gain or loss calculation, or should it be reflected in the tax provision? Where should the tax effects related to the parent’s tax basis in the shares of the subsidiary be reported?

We believe that in a stock sale there are two acceptable methods of accounting for the reversal/sale of deferred taxes on the inside basis differences of the subsidiary sold.

Under the first approach, the pretax book gain or loss would be computed based on the parent’s carrying value of the subsidiary, including the deferred tax assets and liabilities of the entity being sold. This view reflects the fact that the acquirer, by agreeing to buy the stock of the entity (and receiving the tax carryover basis), also is buying the future deductions or future taxable income inherent in the entity.

**Example 12-21: Calculation of Pretax Gain or Loss of a Subsidiary Inclusive of Deferred Taxes**

**Background/Facts:**
- A subsidiary holds one asset, with a carrying amount of $1,000 for book purposes and a tax basis of zero.
- The tax rate for both the parent and subsidiary is 40 percent.
- The subsidiary has recorded a $400 deferred tax liability related to that temporary difference.
- The parent has a GAAP basis investment in the subsidiary of $600 ($1,000 pretax, less the $400 deferred tax liability recorded by the subsidiary) and a tax basis in the shares of the subsidiary of zero. The parent has not previously recorded a DTL on this book-over-tax outside basis difference. It is assumed that there was no held-for-sale accounting in an earlier period and, therefore, the guidance in Section TX 12.2.3.2.4.2 (which requires recognition of an outside-basis deferred tax no later than the held-for-sale date) does not apply.
- The parent sells 100 percent of the stock of the subsidiary for $1,250.

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax GAAP Gain</td>
<td>650 (= 1,250 proceeds – 600 carrying amount of investment)</td>
</tr>
<tr>
<td>Current Tax Provision</td>
<td>500 (= 1,250 proceeds – 0 tax basis x 40%)</td>
</tr>
<tr>
<td>Net Income</td>
<td>150 (= 650 pretax gain less 500 tax provision)</td>
</tr>
</tbody>
</table>

The second approach is similar to that which is used for a sale of assets. Under this approach, the pretax gain or loss is calculated based on the selling price, less the net investment in the subsidiary, excluding deferred tax amounts. Any deferred tax amounts recorded on the subsidiary would be reversed through the tax provision. The following is an example of such a presentation.
Example 12-22: Calculation of Pretax Gain or Loss of a Subsidiary Exclusive of Deferred Taxes

Assume same facts as Example 12-20.

Using the “exclusive of deferred taxes” approach, the presentation would be as follows:

- Pretax GAAP Gain 250 (= 1,250 proceeds – 1,000 carrying amount of investment)
- Current Tax Provision 500 (= 1,250 proceeds – 0 tax basis x 40%)
- Deferred Tax Benefit (400) (reversal of deferred taxes of subsidiary sold)
- Net Income 150 (= 250 pretax gain less 100 tax provision)

**PwC Observation:** In both cases, the net income from the sale is $150. The first approach reflects the view that the subsidiary’s inside basis deferred tax assets and liabilities were sold to the buyer (and presumably considered in the determination of the purchase price). The second alternative reverses the deferred taxes sold through the tax provision, consistent with where they were established.

The above examples assume that, on a pretax basis, the outside basis difference of the investment in the subsidiary equals the inside basis difference. However, this may not always be the case. As a consequence, it may be necessary to recognize additional deferred tax liabilities (or assets) on the parent’s books when it becomes apparent that a deferred tax liability on the outside basis difference no longer can be avoided (or that the outside basis will reverse in the foreseeable future for deferred tax assets). Such additional deferred tax liabilities should be recognized no later than the date on which the criteria of ASC 360-10-45-9 are met for classification as held-for-sale, consistent with the language in ASC 740-30-25-10 (Section TX 12.2.3.2.4) related to the recording of deferred tax assets. This does not, however, change the method of presentation discussed above.

Regardless of the presentation alternative selected for the tax effects attributable to inside basis differences, the tax effects associated with outside basis differences should always be reported in the tax provision.

Example 12-23: Whether to Include Deferred Taxes in the Carrying Amount of a Disposal Group Classified as Held-For-Sale

**Background/Facts:**
Company A has entered into a purchase and sale agreement with a buyer for a disposal group that meets the criteria in ASC 360-10-45-9 and therefore is classified as held-for-sale.

**Question:**
Should deferred tax assets and liabilities related to assets to be sold and liabilities to be assumed be included in the carrying amount of the held-for-sale disposal group?

(continued)
Analysis/Conclusion:
It depends. According to ASC 360-10-15-4, a “disposal group” represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A determination of whether deferred tax assets and liabilities should be included in the disposal group depends on whether the buyer will in fact be acquiring tax attributes and succeeding to the tax bases of assets and liabilities. That determination ultimately depends on the terms of the sale and the provisions of the relevant tax law in the applicable jurisdiction. In general, a disposal in the form of a sale of the shares of a corporation, in many jurisdictions results in the tax attributes and bases of the corporation’s assets and liabilities carrying over to the buyer. On the other hand, a sale which is structured or regarded under the applicable tax law as the sale of assets and liabilities generally does not include tax attributes and results in the buyer establishing new tax bases in those assets and liabilities. Accordingly, assuming the relevant tax law applied in the foregoing manner, the accounting analysis would be as follows:

Sale of shares—include deferred taxes in carrying amount

If the sale is structured as a sale of stock, deferred taxes associated with tax attributes and any book-tax basis differences in the assets and liabilities of the disposal group will be assumed by the buyer and should therefore be included in the carrying amount of the disposal group. That is because the deferred taxes meet the definition of assets to be disposed of or liabilities to be transferred (included in the definition of a disposal group in ASC 360-10-15-4).

Note that a decision to sell the shares of a subsidiary could require the recognition of additional deferred taxes associated with the difference between the seller’s carrying amount of the subsidiary’s net assets in the financial statements and its basis in the shares of the subsidiary. Because those deferred taxes will remain with, and be settled by the seller, they would not be included in the held-for-sale asset group. (Refer to ASC 740-30-25-10 and Chapter TX 11 for further guidance on the recognition of any temporary difference related to the outside basis difference.)

Sale of assets—exclude deferred taxes from carrying amount

If the sale is structured as an asset sale, the seller will retain and recover or settle the deferred tax assets and liabilities (e.g., any inside basis differences will reverse in the period of sale and become currently deductible by or taxable to the seller). Therefore, if an asset sale is expected, deferred taxes would not be included in the carrying amount of the assets and liabilities that are held for sale because they will not be transferred to the buyer (i.e., they are not part of the disposal group as defined in ASC 360-10-15-4).

12.3 Exception to the Basic Model—ASC 740-20-45-7

12.3.1 General Application of ASC 740-20-45-7

ASC 740-20-45-7 provides an exception to the “with” and “without” approach to intraperiod tax allocation. That paragraph states that all items (e.g., extraordinary items, discontinued operations, and so forth) should be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations and that should be allocated to continuing operations. We believe that “all items” means all items “below the line,” including gains and losses recognized in other comprehensive income and taxable amounts recognized in additional paid-in
capital. In this regard, we believe the amortization of an unrecognized loss out of AOCI would constitute a source of other income and would be aggregated with all other “below-the-line” gains and losses for purposes of determining whether there is a net gain from sources other than continuing operations. Similarly, an other-than-temporary impairment (OTTI) recognized for previously unrealized losses on securities would constitute a source of other comprehensive income.

To the extent that income in another component represents a source of income that enables realization of the tax benefit of the current-year loss in continuing operations, the tax rate used to determine the amount of benefit in continuing operations should be based on the rate that is applicable to that other component. An example of this concept exists in ASC 740-20-55-10 (seen below in Example 12-22). In the facts of this example, ordinary income is taxed at a higher rate than capital gains and, as under U.S. tax law, an ordinary loss reported in the same period as a capital gain reduces the capital gain. The example also assumes that the loss from continuing operations is ordinary for tax purposes and that the extraordinary gain is a capital gain for tax purposes. ASC 740’s intraperiod rules allocate to the loss from continuing operations the capital gain tax actually avoided in the current year by the offset of the ordinary loss against the capital gain.

Example 12-24: ASC 740-20-55-10 Fact Pattern (Effect of Differing Tax Rates)

**Background/Facts:**
The following example illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

- The entity’s pretax financial income and taxable income are the same.
- The entity’s ordinary loss from continuing operations is $500.
- The entity also has an extraordinary gain of $900 that is a capital gain for tax purposes.
- The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $120 ($400 at 30 percent).

**Analysis/Conclusion:**
Income tax expense is allocated between the pretax loss from operations and the extraordinary gain as follows:

<table>
<thead>
<tr>
<th>Total Income Tax Expense</th>
<th>120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Benefit Allocated to the loss from (Continuing) Operations</td>
<td>(150)</td>
</tr>
<tr>
<td>Incremental Tax Expense Allocated to the Extraordinary Gain</td>
<td>270</td>
</tr>
</tbody>
</table>

The effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, $150 ($500 at 30 percent) of tax benefit is allocated to continuing operations. The $270 incremental effect of the extraordinary gain is the difference between $120 of total tax expense and the $150 tax benefit allocated to continuing operations. In this case, an extraordinary gain taxable at the tax rate applicable to capital gains is offset, in part, by a loss from continuing operations.
Example 12-25: Application of ASC 740-20-45-7 to One Financial Statement Component Other Than Continuing Operations When a Valuation Allowance Exists

Background/Facts:
Company X, a calendar-year-end company, is taxable in only one jurisdiction. In its year-end 20X6 financial statements, Company X considers the following information when allocating its total tax expense to financial statement components:

- Company X incurred a $3,000 pretax loss from continuing operations and $800 of pretax gain from discontinued operations during 20X6.
- Company X anticipates that any net deferred tax asset at the end of the year will require a full valuation allowance.
- The applicable tax rate is 40 percent.

Analysis/Conclusion:
Company X’s total tax expense/benefit for the year ended December 31, 20X5 is zero (“with” basis). The total pretax loss of $2,200 ($3,000 pretax loss from continuing operations less $800 pretax gain recorded in discontinued operations) results in the creation of an additional deferred tax asset of $880 ($2,200 x 40%), offset by a corresponding increase in the valuation allowance. On a “without” basis, no benefit would be allocated to continuing operations because the pretax loss of $3,000 would result in an operating loss carryforward of $1,200 accompanied by a full valuation allowance. However, the exception in ASC 740-20-45-7 (described above), requires that the $800 gain recorded in discontinued operations be considered when determining the amount of benefit allocable to continuing operations. Accordingly, Company X should allocate a tax benefit of $320 to continuing operations (the actual benefit realized by the discontinued operations gain) and a tax expense of $320 to discontinued operations ($800 x 40%).

If Company X instead had recognized only $700 of loss from continuing operations (assume all other factors were the same), the amount of tax benefit allocated to the loss from continuing operations would have been $280 ($700 x 40%). In other words, the amount of tax benefit allocated to continuing operations is limited to the lesser of (1) the tax effect of the loss from continuing operations or (2) the tax avoided on the overall net pretax income from all components other than continuing operations that provide a source of realization of the continuing operations loss.

Example 12-26: Application of ASC 740-20-45-7 to More Than One Financial Statement Component Other Than Continuing Operations When a Valuation Allowance Exists

Background/Facts:
Assume there is a $2,000 loss carryforward at the beginning and at the end of the year; the underlying DTA has a full valuation allowance at both dates. During the year, there is a $1,000 loss from continuing operations, $2,000 of income from discontinued operations, and an unrealized loss from AFS securities in OCI of $1,000. The applicable tax rate is 40 percent.

(continued)
Analysis/Conclusion:

- ASC 740-20-45-7 requires recognition of a $400 tax benefit in continuing operations because a benefit was realized from the loss in continuing operations. Looking to income from financial statement components other than continuing operations, $1,000 of net income existed to realize the tax benefit generated by the loss from continuing operations in the current year. In other words, absent the net income from these other sources, the loss carryforward would have grown larger (and required a valuation allowance). Since the total tax expense is zero, a tax charge of $400 must be allocated to discontinued operations and AFS securities in accordance with ASC 740-20-45-14. Following the ASC 740-20-45-14 methodology, losses are considered first. As the current-year loss from AFS securities provides no incremental tax benefit (the total tax expense for the year is no different with or without the current-year loss from AFS securities), no benefit is allocated to the current-year loss from AFS securities. As a result, with discontinued operations the only remaining component, the entire tax expense of $400 is allocated to discontinued operations.

PwC Observation: To the extent that there is more than one financial statement component other than continuing operations, the tax expense required to be reflected as a result of the application of ASC 740-20-45-7 should be allocated to these components consistent with the guidance in ASC 740-20-45-14. In cases where ASC 740-20-45-7 is applied when there is a full valuation allowance at both the beginning of the year and the end of the year, application of the guidance in ASC 740-20-45-14 generally will result in the allocation of tax expense to current-year gain items on a pro rata basis.
Chapter 13:
Certain Quasi Reorganizations
Chapter Summary

A quasi reorganization is a voluntary accounting procedure by which an entity with an accumulated retained earnings deficit adjusts its accounts to obtain a “fresh start.” A quasi reorganization may somewhat resemble a legally executed reorganization, but the procedure is accomplished without formal court proceedings and does not contemplate the creation of a new corporation, a change in corporate ownership, or a change in the rights and interests of creditors or owners. The procedure does, however, normally require the approval of either the board of directors or shareholders, depending on the laws of the state of incorporation.
Excerpt from ASC 852

ASC 852-740-45-3:
The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi-reorganization as defined and contemplated in Subtopic 852-20 ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years.

13.1 General

ASC 852-20 discusses the accounting to be applied in a quasi reorganization. Additional information on quasi reorganizations, including related accounting guidance, is available in the *PricewaterhouseCoopers Accounting and Reporting Manual*, Section 5590.2, Quasi Reorganizations.

13.2 Pre-reorganization Tax Benefits

Under ASC 852-740-45-3, the tax benefits of deductible temporary differences and carryforwards that existed at the date of a quasi reorganization must be credited directly to contributed capital when they are recognized subsequent to the quasi reorganization. Under ASC 740-10-25-5, companies are required to recognize all deferred tax assets that meet the more-likely-than-not recognition criterion. Therefore, benefits may be recorded before they are realized on a tax return. This generally will result in an entity recording a deferred tax asset for the tax benefits of deductible temporary differences and carryforwards existing at the date of the quasi reorganization. We believe that in most instances where deferred tax assets are recorded, a valuation allowance will be necessary.

Although there is no positive impact on the income statement for post-quasi reorganization recognition of pre-quasi reorganization tax benefits, there is a potentially negative impact. Any increase in the valuation allowance subsequent to the date of the quasi reorganization must be recognized in the period in which it occurs, with the effect allocated to the income tax provision for continuing operations.
Chapter 14:
Separate Financial Statements of a Subsidiary
Chapter Summary

Intercorporate (or intra-entity) tax allocation (i.e., allocating income taxes to entities within a consolidated tax group) involves related parties and typically results from an expressed or implied agreement among the parties concerning the allocation of taxes currently payable. It is not uncommon for intercorporate tax-allocation agreements to be inconsistent with arrangements that might have been derived on an arm’s-length basis. ASC 850, Related Party Disclosures, and SAS 45/AU 334 recognize that a subsidiary does not independently control its own actions and that most related party transactions, including intercorporate tax allocations, might have been structured differently if the subsidiary had not been a controlled entity.
Excerpts from ASC 740

ASC 740-10-30-27:
The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Subtopic does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria. In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intra-entity transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

ASC 740-10-30-28:
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.

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.
14.1 Acceptable Methods

ASC 740-10-30-27 through 30-28 require that the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return be allocated among the group members when those members issue separate financial statements. Further, the method adopted must be systematic, rational, and consistent with the broad principles of ASC 740. Typically, the same method should be used to allocate tax expense to each member of the consolidated tax group. However, depending on the individual facts and circumstances, it may be acceptable to use more than one allocation method for different subsidiaries in a consolidated group.

While ASC 740-10-30-27 through 30-28 does not require the use of any single allocation method, it does indicate that the following methods are inconsistent with the broad principles of ASC 740:

- A method that allocates only current taxes payable to a member of the group that has taxable temporary differences
- A method that allocates deferred taxes to a member of the group using a method fundamentally different from its asset and liability method (the deferred method that was used before 1989 is cited as an example)
- 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

14.1.1 Separate Return Method

Under ASC 740-10-30-27, it is acceptable to use a method that allocates current and deferred taxes to members of the group by applying ASC 740 to each member as if it were a separate taxpayer. In SAB Topic 1B, which discusses financial statements included in registrations of initial public offerings, the SEC staff states its belief that the separate return basis is the preferred method for computing the income tax expense of a subsidiary, division, or lesser business component of another entity included in consolidated tax returns. The SEC staff further states: “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.”

Under this method, the subsidiary is assumed to file a separate return with the taxing authority, thereby reporting its taxable income or loss and paying the applicable tax to or receiving the appropriate refund from the parent. The rules followed by the subsidiary in computing its tax or refund, including the effects of AMT, should be exactly the same as those followed by the subsidiary in filing a separate return with the IRS. Thus, it is possible that the subsidiary could recognize a loss or credit carryforward, even though there is no carryforward on a consolidated basis (i.e., they were used by the parent). Additionally, the subsidiary could reflect a current-year loss as being carried back against its taxable income in the carryback period, even though the consolidated group was in a loss carryforward position.

When the separate return method is used to allocate the current and deferred tax expense or benefit for a group that files a consolidated return, the subsidiary’s current provision would be the amount of tax payable or refundable based on the subsidiary’s hypothetical, current-year separate return. After computing its current
tax payable or refund, the subsidiary should provide deferred taxes on its temporary
differences and on any carryforwards that it could claim on its hypothetical return. The subsidiary should also assess the need for a valuation allowance on the basis of its projected separate return results. The assessment should include tax-planning strategies that are prudent and feasible (i.e., within the control of the subsidiary).

ASC 740-10-30-27 acknowledges that, if the separate return method is used, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. For example, one member might generate deferred tax assets for which a valuation allowance would be required if that member were a separate taxpayer. However, a valuation allowance may not be needed when the assessment is made from the standpoint of the consolidated group. Similarly, the sum of amounts determined for individual members may not equal the consolidated amount as a result of intercompany transactions.

14.1.2 Benefits-for-Loss

Another type of tax allocation, known as benefits-for-loss, may be considered to comply with the criteria of ASC 740-10-30-27 through 30-28. This approach modifies the separate return method so that net operating losses (or other current or deferred tax attributes) are characterized as realized (or realizable) by the subsidiary when those tax attributes are realized (or realizable) by the consolidated group even if the subsidiary would not otherwise have realized the attributes on a stand-alone basis. Thus, when the benefit of the net operating loss (or other tax attribute) is recognized in the consolidated financial statements, the subsidiary would generally reflect a benefit in its financial statements.

However, application of this policy may be complicated when the consolidated group is in an AMT position or requires a valuation allowance on its deferred tax assets. To comply with the criteria in ASC 740, the policy should not be applied in a manner that results in either current or deferred tax benefits being reported in the separate subsidiary financial statements that would not be considered realizable on a consolidated basis unless such benefits are realizable on a stand-alone basis.

While not a pre-requisite, oftentimes the benefits-for-loss policy mirrors the tax-sharing agreement between the parent and the subsidiary. To the extent that the consolidated return group settles cash differently than the amount reported as realized under the benefits-for-loss accounting policy, the difference should be accounted for as either a capital contribution or as a distribution (see TX 14.2 below).

14.1.3 Other Methods

If another method or a modified method (described above) is used, it must be determined whether that method falls within the parameters of ASC 740-10-30-27 through 30-28. The tax allocation requirements of ASC 740 pertain to the allocation of expense; yet the basic methodology of ASC 740 pertains to the determination of deferred tax liabilities or assets based on temporary differences. Although the allocation method must be consistent with the broad principles of ASC 740, it is not clear whether any correlation is intended between an individual member’s temporary differences and the portion of the consolidated deferred tax liabilities and assets that are reflected in its separate statements.

In most cases, the same allocation method should be applied to all members of the group. However, there may be facts and circumstances that prompt the use of different methods for certain members of a consolidated group.
14.2 Tax Allocation Versus Tax Sharing Arrangements

If a tax-sharing agreement differs from the method of allocation under ASC 740-10-30-27 through 30-28, the difference between the amount paid or received under the tax-sharing agreement and the expected settlement amount based on the method of allocation is treated as a dividend (i.e., when less cash was received or more cash was paid by the subsidiary than would have been expected under the method of tax allocation) or a capital contribution (i.e., when more cash was received or less cash was paid by the subsidiary than would have been expected under the method of tax allocation). For example, a single-member limited liability company (LLC) that presents a tax provision on the separate return basis, but is not required to remit cash to the parent for any amounts payable or is not entitled to receive cash for amounts receivable should recharacterize these amounts payable or receivable as a capital contribution or dividend. A single-member LLC should also recharacterize these amounts payable or receivable as a capital contribution or dividend if the parent decides not to collect or reimburse a subsidiary under a tax-sharing arrangement that would otherwise require settlement.

Example 14-1: Differences between Amounts Expected under a Tax-Allocation Method and Amounts Settled under the Tax-Sharing Arrangement

Background/Facts:
A subsidiary that prepares separate company financial statements is a member included in the consolidated tax return of the parent. The subsidiary uses the separate return method to allocate income taxes to their stand-alone financial statements. Under the tax-sharing arrangement, the subsidiary pays taxes to or receives tax refunds from the parent, based on the separate return method. When the subsidiary generates operating losses that are carried back to offset tax liabilities on the consolidated tax return, the parent establishes an intercompany account to the subsidiary in lieu of remitting cash.

In 2007, the subsidiary generated operating losses that resulted in a $100 million receivable from the parent because the subsidiary reported that, under the separate return method, the operating losses were being carried back to taxable income from prior years. The parent decided that it will not cash-settle the intercompany account with the subsidiary.

Question(s):
How should this decision be recorded in the subsidiary’s separate company financial statements? Should it be considered an operating expense or a capital distribution/dividend to the parent company?

Analysis/Conclusion:
The decision by the parent not to cash-settle the intercompany account should be recorded as a capital distribution/dividend in the separate financial statements of the subsidiary. In essence, the parent has amended the tax-sharing arrangement with the subsidiary. That is, the differences between the expected settlement amount based on the method of allocation under ASC 740-10-30-27 through 30-28 and the actual settlement amount under the tax-sharing arrangement (or amended tax-sharing arrangement as in this fact pattern) should be recorded in equity.
14.3 Change in Method

A change in tax-allocation policy is considered a change in accounting principle, as ASC 740 prescribes criteria that an intra-entity tax-allocation policy must meet to be considered acceptable under U.S. GAAP. Therefore, the change in policy must be justified as preferable given the circumstances, and an SEC registrant must obtain a preferability letter from its auditors. Companies need to follow the guidance in ASC 250, Accounting Changes and Error Corrections, which requires a retrospective application.

PwC Observation: As noted earlier, the SEC staff has stated its belief that the separate return basis is the preferred method. Accordingly, an SEC registrant following the separate return method would be unable to justify the preferability of another method (e.g., the benefits-for-loss method described in TX 14.1.2) and therefore would not be able to make a change in accounting principle.

14.4 Single-member and Multiple-member Limited Liability Companies

Questions often arise regarding how single-member and multiple-member LLCs should account for income taxes in their separate financial statements. ASC 740 does not specifically mention either type of entity. ASC 272, Limited Liability Entities, however, provides some guidance for accounting for LLCs. ASC 272-10-05-4 indicates that LLCs are similar to partnerships in that members of an LLC (rather than the entity itself) are taxed on their respective shares of the LLC’s earnings. Therefore, multiple-member LLCs generally do not reflect income taxes if they are taxed as partnerships (a partnership tax return is filed and the investors each receive K-1s) and are not otherwise subject to state or local income taxes. (However, if a multiple-member LLC is subject to state or local income taxes (i.e., because certain states impose income taxes on LLCs) the entity would be required to provide for such taxes in accordance with ASC 740.) This is also true if the multiple members are part of the same consolidated group.

Single-member LLCs, however, are accounted for differently. The U.S. federal tax law provides an election for single-member LLCs to be taxed as either associations (i.e., corporations) or “disregarded entities.” If the election is made to be taxed as an association, there is no difference between classification as a single-member LLC and a wholly owned C corporation for federal income taxes. If a single-member LLC does not specifically “check the box,” it is automatically treated as a disregarded entity. This means that, for federal income tax purposes, single-member LLCs are accounted for as divisions of the member and do not file separate tax returns. For example, if the member was a C corporation, the earnings and losses of the LLC would automatically roll up into the member’s corporate tax return, where they would be subject to tax at the corporate rate. From a federal income tax perspective, there is no substantive difference between a single-member LLC that is treated as a disregarded entity and a division that is included in the consolidated tax return. Therefore, for LLCs that are included in a public filing and subject to complying with SAB Topic 1B’s “carve-out” accounting, income taxes should be provided. For LLCs not subject to SAB Topic 1B, we believe that presenting a tax provision is the preferred accounting policy election. For those entities that do not present an income tax provision, we would expect disclosures stating why income taxes have not been provided.

Conversely, if the single member was a partnership, the earnings and losses of the LLC would automatically roll up into the member’s partnership return and be passed through to the individual partners. In this case, we believe that the single-member
LLC, regardless of whether they are included in a public filing, should not provide income taxes in their separate financial statements. In situations where the LLC is owned by a second single-member LLC, the character of the member of the second LLC (for example, a C corporation or a partnership) should determine the presentation of income taxes in the separate financial statements of the lower-tier LLC.

Disclosure of the entity’s accounting policy should be provided with regard to income taxes in the separate financials of the single-member LLC. The accounting policy should be applied consistently from period to period. For private companies that present a tax provision, disclosures should be consistent with those required by ASC 740-10-50-17.

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**Example 14-2: Determining Whether a Wholly Owned, Multi-member LLC Is an In-substance, Single-member LLC**

**Background/Facts:**
An LLC is 50 percent owned by two parties, Company X and Company Y (both C corporations). However, the LLC is a public registrant through the issuance of public debt. Further, Company X is owned by a C corporation, Company Z. The LLC’s separate company financial statements appropriately did not provide for income taxes because it was a multi-member LLC and thus a flow-through entity for tax purposes. In a subsequent purchase transaction, Company Y was acquired by Company Z. After the acquisition of Company Y by Company Z, the LLC is ultimately wholly owned by Company Z.

**Question:**
After the purchase transaction is completed, should the LLC provide taxes in its separate company financial statements in accordance with SAB topic 1B? The organization structure after the transaction follows below.

![Organization Structure Diagram]

**Analysis/Conclusion:**
No. We believe that the determination of whether taxes should be provided in the LLC’s separate financial statements should focus on whether the tax law considers the entity to be a flow-through entity. In this case, Company X and Company Y continue to retain their respective interests in the LLC. Therefore, the LLC is still considered a partnership for federal income tax purposes, and the separate financial statements of the LLC should not include any provision for income taxes.
14.5 Disclosures

ASC 740-10-50-17 requires an entity that is a member of a group that files a consolidated tax return to disclose the following items in its separately issued financial statements:

- 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
- 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 disclosures are presented

These disclosure requirements are in lieu of, rather than in addition to, the general disclosure requirements discussed in Chapter TX 15 of this monograph. The disclosure requirements are essentially the generic requirements of ASC 850, which are applied to intercorporate tax allocation. We believe that it is generally appropriate in separate company financial statements to include a description of the types, and potentially the amounts, of significant temporary differences. Further, for SEC registrants, disclosures should be as complete as those required for separate return taxpayers (if practicable).

Some intercorporate tax-sharing agreements require the group members to settle currently with the parent the deferred and current tax liability or receivable. This may simply mean that the deferred tax provision is credited or charged to an intercompany account, where it loses any separate identity as tax-related. Thus, the separate statements of the subsidiary will not have deferred tax liabilities and/or assets that are reflective of its temporary differences. In such circumstances, we strongly suggest disclosing, at least in aggregate, the amounts of the taxable and deductible temporary differences and/or carryforwards, in addition to the corresponding amounts included in the intercompany accounts.

When an entity has been included in a consolidated U.S. tax return, it is jointly, with other members of the consolidated group, and severally liable for any additional taxes that may be assessed. There may be circumstances in which it is appropriate to disclose this contingent liability, based on the disclosure requirements for unasserted claims.

14.6 Impact of a Change in Tax Basis on Separate Historical Financial Statements

ASC 740-20-45-11 addresses the way an entity should account for the income tax effects of transactions among or with its shareholders. ASC 740-20-45-11 provides that the tax effects of all changes in tax bases of assets and liabilities caused by transactions among or with shareholders should be included in equity. In addition, if a valuation allowance was initially required for deferred tax assets, as a result of a transaction among or with shareholders, the effect of recording such a valuation allowance should also be recognized in equity. However, changes in the valuation allowance that occur in subsequent periods should be included in the income statement.

For example, ASC 740-20-45-11 would apply in the separate financial statements of an acquired entity that does not apply push-down accounting to a transaction in which an investor entity acquires 100 percent of the stock (i.e., a non-taxable
transaction) of the acquired entity. If, for tax purposes, this transaction is accounted for as a purchase of assets (e.g., under IRC Section 338(h)(10)), there would be a change in the tax bases of the assets and liabilities. However, because the purchase accounting impacts are not pushed-down to the separate financial statements of the acquired entity for book purposes, there would be no change in the carrying value of the acquired entity’s assets and liabilities. In this situation, both the impacts of the change in tax basis and any changes in the valuation allowance that result from the transaction with shareholders would be recognized in equity. However, changes in the valuation allowance that occur in subsequent periods should be included in the income statement.

Example 14-3: Interaction of Push-down Accounting and Deferred Taxes on a Subsidiary’s Separate Financial Statements

Background/Facts:
Company A (a public company) purchased Company B’s stock (a privately-held company) in a transaction accounted for as a taxable business combination (i.e., an asset purchase for tax purposes), as a result of an election under IRC Section 338(h)(10). Company B is required to issue separate company financial statements that will not be filed with the SEC. Company B uses the separate return method in recording taxes in the separate financial statements.

Question:
Should Company B record deferred taxes related to goodwill (which is equal for book and tax purposes on a consolidated basis at the time of the business combination) in its separate financial statements if Company B (1) applies push-down accounting, or (2) does not apply push-down accounting?

Analysis/Conclusion:
As a private company, Company B has the choice of whether or not to apply push-down accounting in accordance with ASC 805-50-25-3. However, regardless of whether or not push down accounting is applied, the tax basis in goodwill is stepped up as a result of the asset purchase. Thus, Company B will enjoy the benefit of the amortization of the tax basis in goodwill.

Scenario 1—Push-Down Accounting:
No. Deferred taxes related to goodwill are not recognized at the date of acquisition. Company B would reflect book goodwill at the amount that is pushed down. In this example, the book push-down amount equals tax goodwill and, thus all goodwill is classified as component 1 as described in ASC 805-740-25-8 through 25-9. As goodwill is amortized and deducted for tax purposes, a book over tax difference on the component 1 goodwill is created (assuming the book goodwill has not been impaired) for which a deferred tax liability would be recorded.

Scenario 2—No Push-Down Accounting:
Yes. Deferred taxes related to goodwill are recognized at the date of acquisition. Company B would not record book goodwill in its separate financial statements. However, the tax basis (in this case tax-deductible goodwill) created, as a result of the election to treat the business combination as an asset purchase, is attributable to Company B and should be reflected in Company B’s separate financial statements. ASC 740-20-45-11(g) indicates that the effects of “all changes in the tax bases

(continued)
of assets and liabilities caused by transactions among or with shareholders shall be included within equity.” Accordingly, Company B would report an increase to contributed capital by the amount of the DTA initially recorded. Subsequently, changes to the DTA resulting from amortization of the goodwill for tax purposes would be reported as a component of deferred tax expense in the income statement and will offset the current tax benefit attributable to the amortization of goodwill, resulting in no impact on the effective tax rate subsequent to the combination.

Example 14-4: Accounting for the Income Tax Effect of a Taxable Distribution by a Subsidiary to Its Parent on the Subsidiary’s Separate Financial Statements

Background/Facts:
Company A owns 100 percent of Company B. Company B makes a taxable distribution of appreciated property to Company A. Separate financial statements must be issued at the level of Company B. In Company B’s financial statements, the distribution is recorded for GAAP purposes at book value and reflected as a distribution to Company A; as such, no gain is recognized for book purposes. However, Company B is taxed in its jurisdiction on the excess of the distributed property’s fair value over its tax basis.

Question:
How should the tax effect of this transaction be reflected in the separate financial statements of Company B?

Analysis/Conclusion:
ASC 740-20-45-11(g) states that tax effects of all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders should be included in equity. Furthermore, ASC 740-20-45-11(c) states that the tax effects of an increase or decrease in contributed capital shall be charged or credited to shareholders’ equity. Accordingly, in the example above, Company B should reflect the tax effects of the transaction as a reduction of paid-in capital. The application of ASC 740-20-45-11 should be made with respect to the reporting entity.

Note: The analysis/conclusion discussed above is applicable to the separate financial statements of Company B. The accounting would be different for the consolidated statements of Company A. Specifically, Company A would need to consider ASC 740-10-25-3(e), which prescribes the accounting for the income tax effects of intercompany transactions rather than ASC 740-20-45-11(g).

Example 14-5: Accounting in Separate Company Financial Statements for the Tax Consequences of a Transfer of Shares That Results in an IRC Section 311(b) Gain on a Consolidated Tax Basis

Background/Facts:
Parent A owns 100 percent of the stock of Subsidiary B, which in turn owns 100 percent of Subsidiary M. A domestic subsidiary, Subsidiary M falls within the same tax jurisdiction as Subsidiary B. To determine income taxes, Subsidiary B prepares separate company financial statements using the separate return method. Parent A files a U.S. consolidated tax return that includes Subsidiaries B and M.

(continued)
Subsidiary B distributes the stock of Subsidiary M to Parent A through a nonreciprocal transfer of the stock to Parent A at book value. The book basis that Subsidiary B has in Subsidiary M's stock exceeds the tax basis of its investment, but is less than the fair value of the shares. The transfer of Subsidiary M by Subsidiary B triggers an Internal Revenue Code (IRC) Section 311(b) tax gain, which is deferred for tax return purposes because the transfer occurs within the consolidated tax group. Based on its facts and circumstances, Parent A does not expect to recover the related Section 311(b) gain tax-free. On a consolidated basis, the gain will be recognized upon the dissolution of the consolidated group (e.g., when the distributing company, Subsidiary B, is no longer considered part of the consolidated group) or the sale of Subsidiary M to a third party. A diagram of the organization and transfer follows:

Question:
Should Subsidiary B record the tax effects of this transaction in its separate company financial statements, even though the Section 311(b) gain is a deferred intercompany transaction on a consolidated tax basis?

Analysis/Conclusion:
Yes. Under the separate return method, Subsidiary B must calculate the income tax effects of this transaction in accordance with ASC 740-10-30-27 through 30-28 as if it were a stand-alone entity. However, because the transaction involves a shareholder (i.e., parent), ASC 740-20-45-11 must also be considered. The transfer of Subsidiary M to Parent A should be characterized as a transfer that would trigger recognition of the 311(b) gain on a separate return basis. Accordingly, Subsidiary B should recognize the tax effects of this transfer, as a tax liability would have been triggered if Subsidiary B had been a stand-alone company (the accounting required under a separate return method). The income tax consequence generated from this distribution is based on the difference between the fair value of the shares distributed and the tax basis of such shares.

The income tax consequence should be accounted for as follows:

1. Difference between the outside book basis in Subsidiary M and the tax basis (i.e., outside basis difference)

Typically, Subsidiary B would assert that Subsidiary M would be divested in a tax-free manner. This is because Subsidiary M is a domestic subsidiary, and therefore a deferred tax liability would not have been previously recorded for the outside basis difference (ASC 740-30-25-7). Because Subsidiary M was divested in a manner

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that was not tax-free, Subsidiary B must record the tax effects of any previously unrecognized outside basis difference through the income statement, with a corresponding liability recorded in the balance sheet. This tax consequence is the result of a change in Subsidiary B’s expectations about the amount of time or the method ultimately used to recover its investment in the subsidiary. The effect of this change should be recognized in the income statement in the period during which the expectation changes.

This conclusion would be the same for a domestic subsidiary (as described in the fact pattern above) or a foreign subsidiary for which a deferred tax liability was not provided due to the provisions of ASC 740-30-25-17.

If a deferred tax liability had been previously recorded for the difference between the book basis and the tax basis related to Subsidiary B’s investment in Subsidiary M, and if that deferred tax liability represented the actual tax consequence for the outside basis difference, no incremental tax consequence should be recognized in the income statement of Subsidiary B. For example, the tax rates used to measure the deferred tax liability (i.e., capital gains rate) would need to be consistent with the actual tax rate applied to the transfer (i.e., capital gains rate). However, any differences between the deferred tax liability previously recorded on the outside basis difference and the actual tax rate applied to the outside basis difference would need to be recognized through the income statement in the period during which the expectation changes.

2. Difference between the fair value and book basis of the stock

To the extent that a tax liability is generated from Subsidiary B’s transfer of Subsidiary M’s shares to Parent A, the portion of the tax liability related to the excess of fair value over book value should be accounted for as a direct charge to equity by analogy to ASC 740-20-45-11, which provides that “the tax effects of all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders should be included in equity.” This portion of the tax liability is not related to a previously unrecognized outside basis difference, but rather is considered an incremental tax effect of an equity restructuring between the company (Subsidiary B) and its shareholder (Parent A).

Note: The cash settlement of this liability depends on the terms of the intercompany tax-sharing agreement. If Subsidiary B will not be responsible for the tax due either currently or at some future date, the extinguishment of that liability is considered a capital contribution by Parent A to Subsidiary B and should be recorded as a credit to equity.

14.7 Uncertain Tax Positions and Separate Financial Statements of a Subsidiary

The recognition and measurement provisions of ASC 740 are applicable to the uncertain tax positions in the separate financial statements of a member of a consolidated tax group to the same extent that they are applicable to the consolidated group. Accordingly, the assumptions used for determining the unrecognized tax benefits in the separate financial statements of the group member should be consistent with those used in the consolidated financial statements.

Questions have arisen regarding the appropriate disclosures related to unrecognized tax benefits for separate statements of a member of a group that files as part of a consolidated tax return. The following example illustrates the correlation between the intercorporate allocation accounting policy under ASC 740-10-30-27 through 30-28 and its related impact on the disclosure requirements for unrecognized tax benefits.
Example 14-6: Disclosures in Separate Company Financial Statements

Background/Facts:
Subsidiary B is wholly owned by Company A and is included as a member of the Company A consolidated federal income tax return. Subsidiary B is included in the consolidated financial statements of Company A and also prepares its own separate company financial statements.

Question:
Should Subsidiary B include all of the disclosures related to unrecognized tax benefits required by ASC 740-10-50-15 and 50-15A in its separate company financial statements?

Analysis/Conclusion:
If practicable, separate company financial statements should be prepared so that they are as similar as possible to a complete set of GAAP financial statements. However, ASC 740-10-50-17 requires specific disclosures for an entity that is a member of a group that files a consolidated tax return. We believe that these disclosure requirements are offered in lieu of, rather than in addition to, the disclosure requirements for consolidated financial statements. Consistent with the general principles of separate company financial statements, we believe that the decision to include the disclosures required by ASC 740-10-50-15 and 50-15A in separate company financial statements depends primarily on the level of other income tax footnote disclosures presented in the separate company financial statements. Common methods of allocating income taxes in separate company financial statements and related disclosures are provided below:

1. Separate return method (i.e., no modifications)

Under the separate return method for allocating consolidated income tax expense, a subsidiary is allocated income tax expense as if it were a separate taxpayer. In SAB Topic 1(B), the SEC staff stated its belief that this is the preferred method for allocating income taxes in separate company financial statements, as this allocation method is intended to reflect all tax consequences on a stand-alone basis. Because it is common practice for entities applying the separate return method to provide all disclosures required by ASC 740-10-50, users of this method should include all applicable disclosures required by ASC 740-10-50-15 and 50-15A.

2. Modified separate return method (i.e., settlement of uncertain tax position)

This method of allocating consolidated income tax expense is identical to the separate return method, with one noteworthy exception: Any subsequent changes in assessment about the sustainability of tax positions should be allocated to the parent. Thus, under the tax-sharing agreement, the subsidiary bears no risk associated with any subsequent change in the sustainability of uncertain tax positions. For example, assume that a subsidiary takes a position in its tax return that does not meet the recognition threshold of ASC 740-10-25. In this case, the subsidiary records tax expense as if the position provided no benefit. For the fact pattern presented above, we do not believe that all of the applicable disclosures required by ASC 740-10-50-15 and 50-15A are required because the tax-allocation method stipulates that the effects of changes in recognition and measurement of uncertain tax positions are allocated to the parent. However, we do believe that the company should provide transparent disclosures of the company’s intercorporate (continued)
tax-allocation policy and the manner in which the benefits from uncertain tax
positions are allocated (both in the year in which the position is taken and the year in
which subsequent changes to recognition and measurement occur).

3. Any other acceptable allocation policy

If a company employs an intercorporate tax-allocation accounting policy, other
than the separate return method or the separate return method with a modification
for tax uncertainties, that is consistent with the provisions of ASC 740-10-30-27
through 30-28, we believe that the level of disclosures related to unrecognized tax
benefits should be based on the current level of disclosure related to income taxes
in general. If the financial statements contain disclosures that are consistent with
those of a complete set of GAAP financial statements (i.e., all ASC 740 disclosures),
all of the applicable disclosures required by ASC 740-10-50-15 and 50-15A should
be included. However, if the financial statements do not include all other disclosures
required by ASC 740, but include only those disclosures required by ASC 740-10-
50-17, we do not believe that inclusion of all disclosures related to unrecognized tax
benefits is required.

14.8 Carve-out Financial Statements

Carve-out financial statements refer to financial statements prepared by an entity
for a division or other part of its business that is not necessarily a separate legal
entity, but is part of the larger consolidated financial reporting group. The preparation
of carve-out financial statements can be complex and is often highly judgmental.
Preparing the tax provision for carve-out financial statements can likewise be
challenging, particularly if separate financial statements (including a tax provision)
have not historically been prepared. However, for taxable entities, the exclusion of a
tax provision in such financial statements is not an option because a tax provision is
required for the carve-out financial statements to be in compliance with ASC 740.

The methods for intercorporate tax allocation for a carve-out are the same as the
methods described previously for the separate financial statements of a subsidiary
that is part of a consolidated tax group. However, preparing a tax provision for carve-
out financial statements can present a unique set of financial reporting issues. These
include the following:

• Understanding the purpose of the carve-out financial statements and the
corresponding pre-tax accounting: Carve-out financial statements are often
guided by the legal or strategic form of a business transaction that involves
capital formation, or the acquisition or disposal of a portion of a larger entity.
Alternatively, the statements may be guided by regulatory requirements for certain
industry-specific filings. Understanding the overall context and intended use of
the statements is important in deciding which tax provision allocation “method” to
apply and in aligning the application of the chosen allocation method to the pre-
tax accounts.

Persons responsible for preparing a tax provision should coordinate closely with
those responsible for the pre-tax aspects of the carve-out financial statements.
The tax provision should be based on the financial statement accounts that are
included in the carve-out entity. Accordingly, one must fully understand the pre-tax
accounts that will be included in the carve-out statements, as well as the impacts
of any adjustments to such accounts, in order to reflect the appropriate income
tax effects.
The tax provision can be affected by methodologies being used for revenue or cost allocations that differ from historical practices. Carve-out financial statements should reflect all the costs of doing business. That typically requires an allocation of corporate overhead expenses (and the related tax effects) to the carve-out entity—even if allocations were not previously made. Similarly, it may be necessary to allocate other expenses, such as stock-based compensation, to the carve-out entity. An appropriate methodology for determining the pool of “windfall benefits” applicable to the carve-out entity will then also need to be adopted (see Section TX 18.12.1).

Stand-alone financials may also reflect “push-down” accounting adjustments, which can often relate to debt obligations of the parent or other members of the reporting group. The tax provision would be prepared based upon such pre-tax accounts. Accordingly, the stand-alone entity would be assumed to have tax basis in such debt for purposes of applying ASC 740 and, as a consequence, no temporary difference or deferred tax consequence would arise from the push-down.

- **Intercompany transactions**: Intercompany transactions that were formerly eliminated in the consolidated financial statements (e.g., transactions between the carve-out entity and other entities in the consolidated financial statements) generally would not be eliminated in the carve-out financial statements. For example, sales of inventory to a sister company that are eliminated in the consolidated financial statements generally would remain in the carve-out statements. Accordingly, the income tax accounting for those transactions would also change. Specifically, ASC 740-10-25-3(e) (which prescribes the accounting for the income tax effects of intercompany transactions) would not apply to such transactions in the carve-out financial statements.

  Similarly, it may be appropriate to reflect in carve-out statements intercompany transaction gains (or losses) that were previously deferred in a consolidated tax return. It would be necessary to assess whether the respective income tax accounting effects are recognized in equity, in accordance with ASC 740-20-45-11(c) or (g).

- **Intercompany cash settlement arrangements**: When a company is preparing carve-out financial statements, the underlying cash flows related to taxes during the historical period may have no relationship to the actual tax liabilities of the carved-out entity. As such, there could be a series of equity transactions (capital contributions and dividends) that account for the differences between actual cash flow and the taxes that are allocated under the accounting policy chosen for intercorporate tax allocation.

- **Hindsight**: ASC 740-10-30-17 states that “all available evidence . . . shall be considered . . .” and that “historical information is supplemented by all currently available information about future years.” Notwithstanding ASC 740-10-30-17, we generally believe that hindsight should not be used to apply ASC 740 when preparing carve-out financial statements for prior years. Accordingly, if an assumption that existed in one year changed in the succeeding year as a result of economic events, hindsight should not be used to apply the new assumption to the prior year. For example, consider this scenario: A deferred tax asset was supportable in Year 1 based on the fact that the entity had been profitable and had no negative evidence, but, as a result of significant subsequent losses, a valuation allowance was required in Year 2. Without using hindsight, we believe that it would be appropriate to set up a deferred tax asset without a valuation allowance in Year 1 and then to record a valuation allowance in Year 2 based on the subsequent developments.
Historical assertions made by management of the consolidated group: At times, management may indicate in a carve-out situation that it would have made different assertions or tax elections if the entity had been a stand-alone entity. However, it is generally not appropriate to revisit historical assertions or elections made by management of the consolidated group because the tax provision for the carve-out entity is an “allocation” of the group tax provision. Similarly, it would generally be inappropriate to reassess the historical recognition and measurement of uncertain tax positions when preparing carve-out financial statements. The preparation of carve-out financial statements, in and of itself, should not be considered to constitute new information that would justify recording a change with respect to uncertain tax positions.

For example, some carved-out entities have questioned whether it would be appropriate to revisit the indefinite reinvestment assertion (ASC 740-30-25-17) that the parent reflected in its consolidated financial statements. We do not believe that this would be appropriate. However, if the carve-out entity expects its assertions may change in the near future (e.g., after it has been separated from the consolidated group), it may be appropriate to disclose such expectations and the estimated financial reporting impact of such a change.

In certain limited situations, it may be appropriate for a stand-alone entity’s carve-out financial statements to deviate from the assertion or election made by management of the consolidated group as illustrated below in Example 14-7. In this narrow fact pattern, the federal tax regulations provide for a choice in the treatment of foreign taxes paid. Companies are allowed to deduct foreign taxes paid or may find it more beneficial to claim a credit for those payments.

Example 14-7: Consideration of Foreign Taxes Paid in Separate Company Financial Statements of Subsidiary

Background/Facts:
Company A is a multinational company that generates U.S. foreign tax credits (FTCs) as a result of taxes paid which could alternatively be elected to be claimed as U.S. federal tax deductions. In 20X1, Company A generated FTCs in the amount of $100. Despite a current year loss at Company A, the FTCs were fully utilized in the U.S. consolidated tax return filed by Company A's parent. Although Company A is included in its parent's consolidated financial statements, it also prepares separate company financial statements using the separate return method for the allocation of income taxes. Since Company A does not expect to have sufficient foreign source income to utilize the FTCs, if it were filing a separate return, Company A would deduct the foreign taxes paid rather than claiming them as a credit.

Question(s):
Under the separate return method for allocating income taxes, how should Company A record the tax effects of its foreign taxes paid?1

1 Eligibility to claim a U.S. federal tax deduction does not extend to foreign taxes “deemed paid” under IRC Sec. 902. To the extent a company elects to deduct foreign taxes, it would forgo any deemed paid credits for the years in which deductions are taken.
**Analysis/Conclusion:**
ASC 740-10-20-37 requires the consolidated amount of current and deferred tax expense for a group that files a consolidated income tax return to be allocated among the group members when those members issue separate financial statements.²

Under the separate return method, a subsidiary is assumed to file its own stand-alone tax returns. Thus, it is possible that a subsidiary could recognize a hypothetical loss or credit carryforward in its separate company accounts even if no carryforward exists on a consolidated basis. The subsidiary must then assess the need for a valuation allowance against any such credits or loss carryforwards on the basis of its separate evidence in accordance with ASC 740-10-30-19.

In this case, Company A would recognize a $100 FTC carryforward deferred tax asset in its stand-alone accounts, even though there is no FTC carryforward reflected in its parent’s consolidated balance sheet accounts. Company A would then need to assess the credit carryforward for realization.

To the extent Company A determines that it cannot realize the FTC on a separate return basis and would need to record a valuation allowance, it would be able to deduct foreign taxes paid (rather than treating them as creditable) as an option available under U.S. tax law. Thus, Company A would record a valuation allowance of $65 (assuming a 35 percent tax rate), which represents the excess benefit of claiming a credit over a deduction.

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**Example 14-8: Undistributed Foreign Earnings**

**Background/Facts:**
A spin-off entity plans to avail itself of the indefinite reinvestment exemption (ASC 740-30-25-17) for providing income taxes on foreign undistributed earnings and other outside basis differences in the years following the spin-off. However, the parent group of the spinnee did not make this assertion and, in fact, actually repatriated earnings. Management contends that if the spin-off entity had been a separate stand-alone entity, it would not have repatriated earnings and would have asserted indefinite reinvestment.

**Question(s):**
Can the spin-off entity’s separate historical financial statements reflect assertions regarding the indefinite reinvestment of foreign earnings that differ from historical events? Can the spin-off entity therefore avail itself of the indefinite reinvestment exemption for the carve-out years?

**Analysis/Conclusion:**
No, it would be inappropriate for the spin-off entity’s separate historical financial statements to reflect a different indefinite reinvestment assertion than existed historically. Specifically, the tax consequences of foreign income should be reflected on a stand-alone basis in the periods the income was earned (i.e., the ASC 740-30-25-17 exemption should not be used). However, the entity would not be precluded from changing its indefinite reinvestment assertion for future periods (i.e., post spin-off). If such a change is made, the effects should be reflected in the period the assertion changes.

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² The same principle would apply to combined, unitary or other similar tax returns, including non-U.S. jurisdictions.
Example 14-9: Accounting for a Change in Indefinite Reinvestment Assertion as a Result of a Nontaxable Spin-off Transaction

Background/Facts:
In 20X8, Company A made a decision to spin-off Subsidiary B (“Sub B”) and its controlled foreign corporation (“CFC”), in a nontaxable transaction. Company A’s management will prepare carve-out financial statements for Sub B in connection with the anticipated transaction.

Historically, Company A asserted indefinite reinvestment under ASC 740-30-25-17, regarding Sub B’s outside basis difference in its investment in CFC (i.e., no deferred tax liability (“DTL”) was recorded on the outside book-over-tax basis difference). After the spin-off, however, Sub B will no longer be able to assert indefinite reinvestment. This is because after the spin-off, Sub B will no longer receive funding from Company A and therefore will need to repatriate CFC’s cash in order to fund its U.S. operations and repay separate company borrowings. Absent the spin-off transaction, Company A would expect to continue to assert indefinite reinvestment (i.e., no other factors exist that would cause Company A to change its indefinite reinvestment assertion).

Question:
At what point in time, and on whose books (i.e., spinnor’s or spinnee’s), should the tax effect of a change in the indefinite reinvestment assertion (i.e., the recording of a DTL for the outside basis difference) as a result of the nontaxable spin-off be recorded?

Analysis/Conclusion:
We believe that there are two acceptable accounting alternatives to consider:

Alternative #1: Record the DTL on both the spinnor’s and spinee’s books when the decision to consummate the spin-off transaction is made (i.e., prior to the spin).

This view is supported by ASC 740-30-25-19, which provides that “... If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance.” In addition, this (continued)
view is consistent with ASC 740-30-25-10, which indicates that a company should record a DTL for the outside basis difference when it is apparent that the temporary difference will reverse in the foreseeable future (i.e., no later than when the subsidiary qualifies to be reported as discontinued operations).

Proponents of this alternative point to the fact that the temporary difference related to Sub B’s outside basis difference in its investment in the CFC existed prior to the change in assertion, but, by virtue of the indefinite reinvestment exception, Company A was not required to accrue income taxes on the undistributed earnings of the CFC. Consequently, the moment it becomes apparent that some or all of the undistributed earnings of the subsidiary will be remitted in the foreseeable future, Company A should record the DTL on the outside basis difference.

**Alternative #2:** Record the DTL on both the spinnor’s and spinee’s books at the time of the spin-off transaction.

This view is supported by analogy to Section TX 6.2.5.2, which indicates that in the event of an increase in valuation allowance as a result of a spin-off, the financial statements of the parent should reflect a charge to continuing operations at the time of the spin-off *even though such a charge would not have been required if the spin off had not occurred.*

Proponents of this alternative point to the fact that absent the spin-off transaction, Company A would continue to assert indefinite reinvestment under ASC 740-30-25-17, therefore Company A’s expectations regarding the indefinite reversal of the temporary difference will not change until the consummation of the spin-off.

Note: As it relates to the charge to establish the DTL on Company A’s books (i.e., due to the change in indefinite reinvestment assertion), we would not object to intraperiod allocation of the related tax expense to either discontinued operations or continuing operations, provided that appropriate disclosures were made and the chosen accounting method was consistently applied (See Section TX 12.2.3.2.4.2 for further discussion).
Chapter 15:
Financial Statement Presentation & Disclosure
Chapter Summary

ASC 740 not only provides guidance on the calculation of income tax expense, but also includes requirements for the presentation in the financial statements of the tax provision, uncertain tax positions, and deferred tax assets and liabilities. In addition to the information provided on the face of the financial statements, certain disclosures must be made according to the standard. These requirements and related interpretations are discussed in this chapter.
15.1 Balance Sheet Presentation of Deferred Taxes

Excerpts from ASC 740

ASC 740-10-45-4:
In a classified statement of financial position, an entity shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting.

ASC 740-10-45-5:
The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

ASC 740-10-45-6:
For a particular tax-paying component of an entity and within a particular tax jurisdiction, all current deferred tax liabilities and assets shall be offset and presented as a single amount and all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an entity shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions.

ASC 740-10-45-7:
A deferred tax liability or asset for a temporary difference that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability.

ASC 740-10-45-8:
A temporary difference is related to an asset or liability if reduction of the asset or liability causes the temporary difference to reverse. As used here, the term reduction includes amortization, sale, or other realization of an asset and amortization, payment, or other satisfaction of a liability.

ASC 740-10-45-9:
A deferred tax liability or asset that is not related to an asset or liability for financial reporting (see paragraphs 740-10-25-24 through 25-26), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference.

ASC 740-10-45-10:
A deferred tax liability or asset for a temporary difference may not be related to an asset or liability because there is no associated asset or liability or reduction of an associated asset or liability will not cause the temporary difference to reverse. The classification required by the preceding paragraph disregards any additional temporary differences that may arise and is based on the criteria used for classifying other assets and liabilities.
15.1.1 Principles of Balance Sheet Classification

Deferred tax assets and liabilities must be classified in the balance sheet as current or noncurrent. The deferred tax assets and liabilities should receive the same classification as the financial statement asset or liability generating the temporary difference that gave rise to the deferred tax asset or liability. For classification purposes, deferred tax balances related to temporary differences of financial statement assets and liabilities do not consider when a temporary difference is expected to reverse. For example, temporary differences related to inventory and vacation accruals will be classified as current because these balances are current in the financial statements. A temporary difference related to property, plant, and equipment should only be classified as noncurrent, thus mirroring the classification of the underlying asset on the financial statements and ignoring the fact that a portion of the temporary difference may reverse in the current year as a result of depreciation.

Deferred tax balances can also be generated from temporary differences that are not related to financial statement assets and liabilities. Common examples include (1) organizational costs expensed for financial reporting, but deferred for tax return purposes, (2) long-term contracts accounted for using the percentage-of-completion method for financial reporting purposes and under completed contract for tax purposes, and (3) unremitted earnings of a foreign subsidiary that are not considered indefinitely reinvested. These deferred tax assets and liabilities should be classified in the balance sheet based on their expected reversal date (i.e., the year in which the temporary difference reversal or carryforward is expected to affect the amount of taxes payable or refundable). If a deduction or carryforward is expected to expire unused, it should be classified as noncurrent. In certain instances, there could be both a current and noncurrent portion related to a temporary difference that is not related to a financial statement asset or liability.

15.1.2 Valuation Allowance and Balance Sheet Classification

When companies have recorded valuation allowances against net deferred tax assets and carryforwards, consideration must be given to classification of the valuation allowance. ASC 740-10-45-5 states that “the valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.”

The pro rata allocation, as opposed to a specific identification allocation, should be performed on a gross basis (i.e., before the netting of deferred tax assets and deferred tax liabilities). This can produce unusual results. For example, assume that a valuation allowance has been provided for particular deductible differences or carryforwards for which the deferred tax assets are classified as noncurrent. Despite this, a portion of the valuation allowance should be allocated on a pro rata basis to any current deferred tax assets. An unusual outcome may also result if a valuation allowance has been used to reserve the entire net deferred tax asset. See Chapter TX 5 for a more detailed discussion of valuation allowances. Example 15-1 demonstrates the pro rata allocation of a valuation allowance.

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Example 15-1: Pro Rata Allocation of a Valuation Allowance

A company has current and noncurrent deferred tax assets of $100 and $200, respectively, and current and noncurrent deferred tax liabilities of $200 and $40, (continued)
respectively. This results in a net deferred tax asset of $60. It is determined that a valuation allowance is required based on significant negative evidence. The deferred tax liabilities will reverse in a manner that allows for recognition of deferred tax assets in an equal amount, thus requiring a valuation allowance of $60 against the net deferred tax asset.

The valuation allowance is allocated based on the gross deferred tax assets (assuming a single tax jurisdiction), as presented below:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Percentage</th>
<th>Total VA</th>
<th>Allocated VA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current DTA</td>
<td>$100</td>
<td>33%</td>
<td>$60</td>
</tr>
<tr>
<td>Noncurrent DTA</td>
<td>200</td>
<td>67%</td>
<td>60</td>
</tr>
<tr>
<td>Total DTA</td>
<td>$300</td>
<td></td>
<td>$60</td>
</tr>
</tbody>
</table>

The following table summarizes the computed amounts and amounts presented on the balance sheet:

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset</td>
<td>$100</td>
<td>$200</td>
</tr>
<tr>
<td>Valuation allowance</td>
<td>(20)</td>
<td>(40)</td>
</tr>
<tr>
<td>Net deferred tax asset</td>
<td>$80</td>
<td>$160</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>$200</td>
<td>$40</td>
</tr>
</tbody>
</table>

15.1.3 **Offsetting and Multiple Jurisdictions**

ASC 740-10-45-6 requires that all current deferred tax assets and liabilities within a single tax jurisdiction be offset and presented as a single amount and that all noncurrent deferred tax assets and liabilities within a single tax jurisdiction be offset and presented as a single amount. The paragraph also states that the current and noncurrent deferred tax assets and liabilities of different tax-paying entities or different jurisdictions cannot be netted. A classification procedure must be completed for each applicable tax-paying entity in each tax jurisdiction. Therefore, in a single balance sheet, deferred taxes may appear under four different classifications: current asset, current liability, noncurrent asset, and noncurrent liability.

A question may arise as to whether netting is permitted in a jurisdiction that does not allow tax consolidation, but has annual elective group relief provisions for affiliated members. To answer this question, it must first be determined whether the companies are considered a single tax-paying component. We believe that the determining factors for this classification are (1) whether the taxing authorities can pursue one subsidiary for the other's income tax liabilities and (2) whether the election allows for offset in all cases (e.g., whether it allows carryback or carryforward of losses among affiliated members). If the taxing authority can pursue one subsidiary for the other's income tax liabilities and if offset is unconditionally available, the subsidiaries may be considered, in substance, a single tax-paying component, which would make offsetting appropriate. However, if both of these conditions are not met, the two entities should be considered separate tax-paying components and the deferred tax balances should not be offset, irrespective of whether the entity plans to avail itself of the group relief provisions.
15.1.4 Contingencies and Uncertain Tax Positions

Due to the complexity and interpretation of tax law, it may be unclear whether positions taken in an entity's income tax return will be sustained or will result in additional tax payments in future periods. Accounting for these positions in accordance with the ASC 740 guidance on accounting for unrecognized tax benefits will frequently result in the recognition of potential tax liabilities or a decrease in recognized tax assets. The financial reporting and disclosure requirements related to contingencies and uncertain tax positions are discussed in Section TX 15.5 and Chapter TX 16.

15.2 Balance Sheet Disclosures

Excerpts from ASCs 740, 942, 944 and 995

**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.

**ASC 740-10-50-3:**
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).

**ASC 740-10-50-6:**
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).

**ASC 740-10-50-8:**
A nonpublic entity shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type.

(continued)
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.

ASC 740-30-50-2:
All of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable.
b. The cumulative amount of each type of temporary difference.
c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable. While paragraph 740-30-25-14 prohibits recognition of a tax benefit for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized, favorable tax treatment would be reflected in measuring that unrecognized deferred tax liability for disclosure purposes.
d. The amount of the deferred tax liability for temporary differences other than those in (c) (that is, undistributed domestic earnings) that is not recognized in accordance with the provisions of paragraph 740-30-25-18.

ASC 942-740-50-1:
All of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to a savings and loan association's bad-debt reserve for financial reporting:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable.
b. The cumulative amount of each type of temporary difference.
c. The amount of the deferred tax liability for temporary differences (that is, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender) that is not recognized in accordance with the provisions of paragraphs 740-10-25-3, 740-30-25-5, 740-30-25-18, and 942-740-25-1 through 25-3.

(continued)
ASC 944-740-50-1:
The following information shall be disclosed if a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Section 740-10-25:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of temporary difference

c. The amount of the deferred tax liability for temporary differences other than the policyholders’ surplus of a life insurance entity that is not recognized in accordance with the provisions of paragraph 740-10-25-3.

ASC 995-740-50-2:
All of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exception to comprehensive recognition of deferred taxes for deposits in statutory reserve funds by U.S. steamship entities:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of temporary difference

c. The amount of the deferred tax liability for temporary differences attributable to the statutory reserve funds of a U.S. steamship entity that is not recognized in accordance with paragraph 995-740-25-2.

ASC 740 and SEC regulations require the following disclosures relating to deferred tax balance sheet accounts:

1. **Gross deferred tax liabilities, gross deferred tax assets, the valuation allowance, and the net change in the valuation allowance**

   ASC 740-10-50-2 requires disclosure of the total deferred tax assets and the total deferred tax liabilities computed under the basic model described in Section TX 4.1. This would exclude deferred tax charges related to intercompany transactions and deferred tax credits arising from leveraged leases. The taxes paid on an intercompany transaction accounted for under ASC 740-10-25-3(e) are different from deferred tax assets recognized under ASC 740-10-30-5 because the prepaid tax from an intercompany transfer represents an asset resulting from a past event whose tax effect is simply deferred.

   There will be circumstances in which judgments about future taxable income (i.e., excluding reversals) enter into the determination of the valuation allowance. In such cases, we expect that management will find it most prudent to indicate in the financial statements the extent to which realization of the tax assets is dependent on such future taxable income. As discussed in Section TX 15.8.5.3, in some situations, the SEC staff expect certain incremental disclosures with respect to deferred tax assets. See Section TX 15.8.
In certain rare situations it may be appropriate to use a zero rate or to write off the asset against the valuation allowance. The effect is to reduce the amounts of gross deferred tax assets and valuation allowance that are disclosed. A write-off might be appropriate, for example, if a company has a loss carryforward that has not yet expired in a country where it no longer conducts business. As with many other areas of ASC 740, such a determination will require the application of professional judgment and a careful consideration of the relevant facts and circumstances.

There are certain carryforwards (e.g., certain AMT and foreign tax-credit carryforwards) that, because of an entity’s particular facts and circumstances, have a corresponding full valuation allowance. We believe that in situations where the likelihood of utilization is remote, it is acceptable to write off the deferred tax asset against the valuation allowance, thereby eliminating the need to disclose the gross amounts.

If limitations caused by a change in ownership (Section 382) mathematically preclude use of a portion of a carryforward or a deductible difference, writing off the deferred tax asset against the valuation allowance is considered appropriate. When there are carryforwards and built-in losses that are subject to the same aggregate limitation, it is appropriate to reflect the permanent loss of tax benefits as an unallocated reduction of gross deferred tax assets.

2. The approximate tax effect of each type of temporary difference and carryforward that gives rise to significant portions of deferred tax liabilities and assets (prior to valuation allowances)

ASC 740-10-50-2 requires that public companies disclose the amounts of significant types of temporary differences. SEC Regulation S-X Rule 4-08(h) does not impose a mechanical hurdle for determining which types of temporary differences are, in fact, significant. Judgment must therefore be applied to ensure a reasonable and meaningful presentation. However, as a practical benchmark, we believe that a particular type of temporary difference should be considered significant if its deferred tax effects equal 5 percent or more of either total deferred tax assets (i.e., before valuation allowance) or total deferred tax liabilities, whichever is greater.

3. The nature and effect of any significant matters affecting comparability of information for all periods presented (unless otherwise evident from other disclosures)

4. The amounts and expiration dates of loss and tax credit carryforwards for tax purposes

Companies should also disclose the nature and potential effects of any tax law provision that might limit the availability or utilization of those carryforward amounts (e.g., limitations caused by change in ownership).

For both regular tax and AMT, there is an annual limitation under Section 382 on the use of loss and other carryforwards and of certain built-in losses if there has been a cumulative change in ownership of more than 50 percent within a three-year period.

If the annual limitation is triggered, it could result in a permanent loss of potential tax benefit (e.g., when an entire carryforward cannot be utilized prior to its expiration because of the annual limitation). Therefore, the recorded deferred tax asset and the amount of carryforward disclosed should be reduced. When such limitation delays the utilization of loss carryforwards and built-in losses that arose from a purchase business combination, disclosure on the use of loss carryforwards is appropriate.
The rules for computing a change in ownership are complex. However, it is possible for the limitation to apply to an entity that is not an acquired entity in a business combination. The limitation could be triggered, among other events, by exercises of stock options, conversions of convertible debt or preferred stock, new common stock offerings, or treasury share purchases.

Unless the prospect of such a change in ownership is remote, we recommend disclosing the potential limitation in all circumstances by means of a brief statement such as, “If certain substantial changes in the entity’s ownership occur, there would be an annual limitation on the amount of the carryforward(s) that can be utilized.” If there are circumstances (e.g., a planned public offering or outstanding convertible debt whose exercise price is below market) that make the change in ownership reasonably possible in the foreseeable future, a general description of those circumstances may be warranted. More specific disclosures concerning the limitation should be made if the triggering event is probable.

Disclosure of the amount of the annual limitation is required if the event actually occurs. Refer to ASC 946-740-55-2 for additional guidance on certain regulated investment companies.

5. Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be credited directly to contributed capital

6. Temporary differences for which a deferred tax liability has not been recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:
   a. A description of the types of temporary differences and the types of events that would cause those differences to become taxable
   b. The cumulative amount of each type of temporary difference
   c. Temporary differences related to investments in foreign subsidiaries and foreign joint ventures, which would include, but would not be limited to, unremitted earnings and cumulative translation adjustments, the amount of unrecognized deferred tax liability if determining that amount is practicable, or a statement that determination is not practicable
   d. The amount of any unrecognized deferred tax liability for each type of temporary difference (e.g., unremitted domestic corporate joint venture earnings prior to 1993 for calendar-year companies), excluding temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures

No disclosure is required for unremitted earnings of domestic subsidiaries if such earnings are not a temporary difference. This is because the parent expects to receive these earnings tax-free (see Chapter TX 11). In addition, earnings that arose prior to the mandatory effective date of ASC 740, which would have been a temporary difference exception “grandfathered” by the standard, do not require disclosure.

For foreign subsidiaries and corporate joint ventures, the disclosures apply to unremitted earnings and, if applicable, to the entire excess book over tax outside basis.

If it is at least reasonably possible that within one year there will be a change in either an indefinite reversal assertion or in the expected method of recovery of the investment in a domestic subsidiary, disclosure under ASC 275-10-50-9, which is discussed in Section TX 15.7, may be required.
7. **The amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments, either on the face of the statements in which those components are displayed or in the notes to the financial statements as required by ASC 220-10-45-12**

8. **Specific disclosures required in the separate statements of a member of a consolidated tax group (See Chapter TX 14)**

### 15.3 Income Statement Presentation

Total income tax expense or benefit for the year generally equals the sum of total income tax currently payable or refundable (i.e., the amount calculated in the income tax return) and the total deferred tax expense or benefit.

### 15.3.1 Deferred Tax Expense or Benefit

The total deferred tax expense or benefit for the year generally equals the change between the beginning-of-year and end-of-year balances of deferred tax accounts (i.e., assets, liabilities, and valuation allowance) on the balance sheet. In certain circumstances, however, the change in deferred tax balances is reflected in other asset and liability accounts. These circumstances include the following:

If a business combination has occurred during the year, deferred tax liabilities and assets, net of the valuation allowance, are recorded at the date of acquisition as part of the purchase price allocation (see Section TX 10.4). When a single asset is purchased, other than as part of a business combination in which the amount paid is different from the tax basis of the asset, the tax effect should be recorded as an adjustment to the carrying amount of the related asset.

ASC 805, *Business Combinations*, changes the accounting for the initial recognition of acquired deferred tax assets subsequent to the acquisition date. The release of a valuation allowance that does not qualify as a measurement period adjustment is reflected in income tax expense (or as a direct adjustment to equity as required by ASC 740), subject to the normal intraperiod allocation rules discussed in Chapter TX 12. The release of a valuation allowance within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected first as an adjustment to goodwill, then as a bargain purchase gain (ASC 805-740-45-2).

Similarly, adjustments to uncertain tax positions made subsequent to the acquisition date are recognized in earnings, unless they qualify as measurement period adjustments. See Section TX 10.5.5 for a discussion of evaluating whether an adjustment within the measurement period relates to circumstances that were included in the acquirer’s assessment at the date of the acquisition.

See Section TX 10.6.2 for a discussion of adjustments to uncertain tax positions and initial recognition of pre-reorganization benefits subsequent to “fresh start” reporting.

Other changes in the deferred tax balances, including those resulting from foreign currency exchange rate changes, may not be classified as a tax expense or benefit:

- When the U.S. dollar is the functional currency, revaluations of foreign deferred tax balances are reported as transaction gains and losses or, if considered more useful, as deferred tax benefit or expense, as described in ASC 830-740-45-1.
• When the foreign currency is the functional currency, revaluations of foreign deferred tax balances are included in cumulative translation adjustments. The revaluations of the deferred tax balances are not identified separately from revaluations of other assets and liabilities.

15.3.2 Interest and Penalties

ASC 740-10-45-25 gives companies the option of classifying interest as a component of income tax expense or interest expense and of classifying penalties as a component of income tax expense or another expense classification, depending on their accounting policy. The guidance requires that companies disclose their policy and the amount of interest and penalties charged to expense in each period, as well as the cumulative amounts recorded in the balance sheet.

Even though ASC 740-10-50-19 does not offer guidance on the balance sheet classification of accrued interest and penalties, we believe that it should be consistent with the income statement classification. ASC 740 is also silent on the topic of classification of interest income received as it relates to income taxes. We believe that the classification of interest income and interest expense should be consistent (i.e., either as a component of tax expense or as a pretax income line item). See Section TX 16.6.1.1 for a discussion on interest income on uncertain tax positions.

15.3.3 Professional Fees

Companies often incur professional fees by working with attorneys and/or accountants to minimize income tax payables (e.g., implement tax strategies, resolve tax contingencies, or defend tax strategies). These fees do not represent payments to taxing authorities and therefore should not be classified in the income statement as income tax expense or benefit.

15.3.4 Change in Tax Laws, Rates, or Status

Adjustments to all deferred tax balances are reflected in continuing operations, including those that arise by charge or credit to other categories, when those adjustments reflect enacted changes in tax laws, tax rates, or tax status. (See further discussion of the accounting for changes in tax rates and tax status in Chapters TX 7 and TX 8, respectively.)

When a rate change is enacted with retroactive effects, ASC 740-10-30-26 specifies that the current and deferred tax effects of items not included in income from continuing operations that arise during the current year but before the date of enactment should be adjusted to reflect the rate change as of the enactment date. The adjustment should be reflected in income from continuing operations. If an election to change an entity's tax status is approved by the tax authority or filed, if approval is not necessary, in year 2 before the issuance of financial statements for year 1, the effect of the change in tax status should not be recognized in year 1’s financial statements. In accordance with ASC 740-10-50-4, however, the entity’s financial statements for year 1 should disclose (1) the change in the entity's tax status for year 2 and (2) the effects of the change, if material. Example 15-2 illustrates the application of a change in tax laws and how this presentation is affected by intraperiod allocation.
Example 15-2: Change in Tax Law When Prior Year Results Are Restated for Discontinued Operations

**Background/Facts:**
In a prior year, a provincial tax law was enacted, which resulted in a charge to Company A’s consolidated financial statements. Pursuant to ASC 740-10-45-15, this effect was appropriately recorded in continuing operations in the financial statements for that fiscal year. In the current year, Company A agreed to sell all of its operations in the country in which the tax law changed and to recast the operations from this jurisdiction to discontinued operations pursuant to ASC 360, *Property, Plant, and Equipment*. The results from continuing operations no longer include any operations in the jurisdiction in which the tax law change was enacted.

**Question:**
Should the effects of the tax law change that were originally recorded in continuing operations also be reclassified to discontinued operations, or should they remain in continuing operations in the recasted financial statements?

**Analysis/Conclusion:**
Section TX 12.2.3.2.4.1 discusses the intraperiod allocation for prior years that are subject to recasting under ASC 360. The amount of taxes associated with the discontinued operations should be the difference between the taxes previously reported in continuing operations and the amount of taxes allocated to continuing operations after the ASC 360 triggering event. ASC 740-10-35-4 and ASC 740-10-45-15 state that deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

Subsequent to disposal, Company A will have no operations in the jurisdiction in which the tax law was enacted. There are no provisions in ASC 740 that would allow Company A to “backwards trace” the effects of this tax law change and reclassify them as discontinued operations. Therefore, the effect of the tax law change on deferred tax assets and liabilities should remain in continuing operations.

15.3.5 Income Taxes and Net Income Attributable to Noncontrolling Interests

The financial statement amounts reported for income tax expense and net income attributable to noncontrolling interest differ based on whether the subsidiary is a C-corporation or a partnership. The tax status of each type of entity causes differences in the amounts a parent company would report in its consolidated income tax provision and net income attributable to noncontrolling interests.

- **C-corporation:** A C-corporation is generally a taxable entity and is responsible for the tax consequences of transactions by the corporation. Therefore, a parent that consolidates a C-corporation would include the income taxes of the C-corporation, including the income taxes attributable to the noncontrolling interest, in the consolidated income tax provision. Net income attributable to the noncontrolling interest would be calculated as the noncontrolling interest’s share of the C-corporation’s net income, which would include a provision for income taxes.

- **Partnership:** The legal liability for income taxes of a partnership generally does not accrue to the partnership itself. Instead, the investors are responsible for income taxes on their share of the partnership’s income. Therefore, a parent that
consolidates a partnership would only report income taxes on its share of the partnership’s income in the consolidated income tax provision. This would result in a reconciling item in the parent’s income tax rate reconciliation that should be disclosed, if material. Net income attributable to the noncontrolling interest would be calculated as the noncontrolling interest’s share of the partnership’s net income, which would not include a provision for income taxes.

Note: The guidance relating to “partnerships” should also be applied to other “pass-through” entities, such as limited liability companies and subchapter S-corporations.

Example 15-3: Presentation of Income Tax and Net Income Attributable to Noncontrolling Interest When the Subsidiary is a C-Corporation or a Partnership

Background/Facts:
Company A has a 70 percent ownership interest in Subsidiary B. The other 30 percent is owned by an unrelated party. Company A consolidates the financial statements of Subsidiary B. Company A had pre-tax income from continuing operations of $400 for the year ended December 31, 2009. This amount includes $100 of pre-tax income from continuing operations from Subsidiary B. Company A’s tax rate for the period is 40 percent For purposes of this example the tax effects of any outside basis differences have been ignored and Subsidiary B is assumed to have no subsidiaries of its own.

Question:
How should income tax expense and net income be determined and presented in the consolidated financial statements if Subsidiary B is a C-corporation or a partnership?

Analysis/Conclusion:

Analysis Assuming Subsidiary B is a C-corporation with a 40% Tax Rate

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations, before tax</td>
<td>$400</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>160^1</td>
</tr>
<tr>
<td>Net income</td>
<td>240</td>
</tr>
<tr>
<td>Less: Net income attributable to noncontrolling interest</td>
<td>18^2</td>
</tr>
<tr>
<td>Net income attributable to Company A</td>
<td>$222</td>
</tr>
</tbody>
</table>

^1 $400 x 40%.
^2 $60 x 30% [calculated as ($100 – (100 x 40%)) x 30%].

Analysis Assuming Subsidiary B is a Partnership

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations, before tax</td>
<td>$400</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>148^3</td>
</tr>
<tr>
<td>Net income</td>
<td>252</td>
</tr>
<tr>
<td>Less: Net income attributable to noncontrolling interest</td>
<td>30^4</td>
</tr>
<tr>
<td>Net income attributable to Company A</td>
<td>$222</td>
</tr>
</tbody>
</table>

^3 $370 x 40% [calculated as ($400 – (100 x 30%)) x 40%].
^4 $100 x 30%.

When the subsidiary is a partnership, income attributable to noncontrolling interest would be a reconciling item in Company A’s tax rate reconciliation that should be disclosed if material.
15.4 Income Statement Disclosures

Excerpts from ASC 740

ASC 740-10-50-9:
The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. Current tax expense (or benefit)
b. Deferred tax expense (or benefit) (exclusive of the effects of other components listed below)
c. Investment tax credits
d. Government grants (to the extent recognized as a reduction of income tax expense)
e. The benefits of operating loss carryforwards
f. Tax expense that results from allocating certain tax benefits directly to contributed capital
g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity
h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. For example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer’s valuation allowance for its previously existing deferred tax assets as a result of a business combination (see paragraph 805-740-30-3).

ASC 740-10-50-10:
The amount of income tax expense (or benefit) allocated to continuing operations and the amounts separately allocated to other items (in accordance with the intraperiod tax allocation provisions of paragraphs 740-20-45-2 through 45-14 and 852-740-45-3) shall be disclosed for each year for which those items are presented.

ASC 740-10-50-12:
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.

(continued)
ASC 740-10-50-13:
A nonpublic entity shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

ASC 740-10-50-14:
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.

ASC 740 and SEC regulations require the following disclosures about income statement amounts:

1. The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to items that are included in other categories, such as discontinued operations, changes in accounting principles, and extraordinary items

   The amount of income tax expense or benefit allocated to continuing operations would ordinarily be shown on the face of the income statement.

2. A reconciliation (using dollar amounts or percentages) of the income tax expense attributable to continuing operations to the statutory regular tax rate applied to pretax income from continuing operations

   The reconciliation should include the estimated amount and the nature of each significant reconciling item.

   Common rate differentials include the following:
   
   — Change in the valuation allowance for deductible temporary differences or carryforwards (adjusted for expirations of carryforwards or their use in the current year)
   
   — Use of the current year’s permanent differences or tax credits in the calculation of taxes payable or deferred taxes
   
   — The effect on beginning deferred tax balances of rate changes enacted in the current year and the effect on temporary differences originating in the current year if expected to reverse in a year for which a different rate has been enacted
   
   — Foreign tax rates differential related to unremitted foreign earnings that are reinvested indefinitely
   
   — When graduated rates are a significant factor, changes to the prior year’s assessment of expected future level of annual taxable income and the difference between the average rate at which deferred taxes are provided and the incremental effect implicit in the reconciliation

   Although ASC 740 does not define a “significant” item in the rate reconciliation, Rule 4-08(h) of Regulation S-X currently requires disclosure of individual reconciling items that are more than 5 percent of the amount computed by multiplying pretax income by the statutory tax rate (e.g., for a U.S.-based entity subject to the 35 percent statutory tax rate, any item that increases or decreases the tax rate by 1.75 percent). Care should be taken to ensure that items are not disaggregated to avoid this requirement, reconciling items below this threshold are displayed in appropriate categories, and groupings are consistent from year to year.
3. Significant components of income tax expense attributable to continuing operations include the following:
   a. Current tax expense or benefit
   b. Deferred tax expense or benefit (exclusive of the effects of other components listed below)
   c. Investment tax credits
      ASC 740-10-50-20 requires disclosures about the method of accounting for investment tax credits and the amounts involved (if material). Without reference to materiality, the U.S. tax law also requires that the method of accounting for the investment credit be disclosed in any filing with a federal agency, including the SEC, in which the credit is used.
      Generally accepted accounting principles in certain countries outside the United States may allow specific tax credits (e.g., research and experimentation credits) to be reflected outside of income tax expense and reported on a net basis against the expense to which they relate. However, we do not believe that this presentation complies with U.S. GAAP. Rather, we believe that tax credits should be presented as a component of income tax expense.
   d. Government grants (to the extent recognized as a reduction of income tax expense)
   e. The benefits of operating loss carryforwards
      ASC 740-10-55-212 through 55-216 includes an example illustrating this disclosure.
   f. Tax expense that results from allocating certain tax benefits directly to contributed capital
   g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates, or a change in the tax status of the entity
      As with the 1993 Tax Act, when there is an enacted change in tax rates that is retroactive to the beginning of the current year, a question arises as to the amount that should be disclosed pursuant to ASC 740-10-50-9(g). Should the amount disclosed be the total adjustment at the enactment date (including the adjustment of deferred taxes provided during the current year prior to the enactment date), or should the amount disclosed be the effect of the rate change on beginning-of-year deferred tax balances? We believe that disclosure of either amount is acceptable.
      The effect of the rate change on beginning-of-year deferred tax balances may be easier to measure, and its use may simplify reporting. If prior to the enactment date no items have given rise to tax entries other than to continuing operations, this amount should be included in the rate reconciliation.
      Further, the effect of the rate change on deferred taxes previously provided against continuing operations in the current year may not be particularly meaningful by itself. Current and deferred taxes would need to be adjusted as of the enactment date, but ASC 740-10-50-9(g) does not specifically require the disclosure of the effect of the rate change on taxes currently payable. When current or deferred tax entries have been made during the year to categories other than continuing operations, their adjustment as of the
enactment date, which would be reflected in continuing operations, must also be disclosed in the rate reconciliation.

We believe that it would generally be adequate to disclose (1) the effect of the rate change on beginning-of-year deferred tax balances and (2) the effect of the rate change on current and deferred taxes provided prior to the enactment date in categories other than continuing operations. Both of these items should be included in the rate reconciliation. Other disclosures might also be satisfactory. In any case, the amount(s) disclosed should be clearly described.

h. Adjustments to the beginning-of-the-year balance of a valuation allowance resulting from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years

ASC 740-10-55-79, states that “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 can be grouped in an “other” category. ASC 740-10-55-212 through 55-216 provides three illustrative examples to satisfy this disclosure requirement.

15.5 Disclosures for Uncertain Tax Positions

15.5.1 Annual Disclosures

Excerpts from ASC 740

ASC 740-10-50-15:
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.

(continued)

\(^1\) References “a” and “b” were intentionally left out of this listing as they have been superseded by Accounting Standards Update 2009-06, which has been incorporated into ASC 740.
Disclosures for uncertain tax positions require the use of professional judgment. While management might be concerned with including information in the financial statements that could be helpful to the taxing authority examining its disclosures, stakeholders, whose needs often differ from those of the taxing authorities, base their investment decisions on the same financial statements. ASC 740 addresses this tension in part by requiring a qualitative discussion of only those positions that management expects will change significantly within the next 12 months. Further, for public entities, the quantitative rollforward of unrecognized tax benefits is prepared on a worldwide aggregated basis. More recently, many U.S. taxpayers are now required to furnish certain information about their uncertain tax positions to the Internal Revenue Service by attaching “Schedule UTP” to their income tax returns.

As these disclosure requirements are considered, a question that may arise is the periods that the annual disclosure requirements of unrecognized tax benefits should be provided for. The introduction to ASC 740-10-50-15 and 50-15A indicates that the disclosures should be provided at the end of each annual reporting period presented. To meet this requirement, we believe disclosures related to historical information reflected in the financial statements (e.g., the tabular reconciliation of unrecognized tax benefits) should be based on the years for which the relevant income statements are presented. For disclosures that are primarily forward-looking in nature (e.g., the total amount of unrecognized tax benefit that, if recognized, would affect the effective tax rate), we believe it is appropriate to present this information as of the most recent balance sheet date only. However, we are aware that an alternative point of view is
that the requirements of ASC 740-10-50-15 and 50-15A should be presented for all post-adoption periods presented. We believe either approach is acceptable for disclosures that are primarily forward-looking in nature.

15.5.1.1 Disclosure of Accounting Policy on Classification of Interest and Penalties

Entities are required to disclose their accounting policy for the classification of interest and penalties in the footnotes to the financial statements. The policy chosen must be applied consistently.

See Section TX 16.6.3 for a discussion of the accounting policy election for classification of tax-related interest and penalties.

15.5.1.2 Total Amount of Interest and Penalties Recognized in the Statement of Operations and Total Amount of Interest and Penalties Recognized in the Statement of Financial Position

ASC 740 requires an annual disclosure of the total tax-related interest and penalties recorded in the statement of operations and the total amount of interest and penalties accrued as of the balance sheet date.

Questions may arise as to whether this disclosure should be (1) net of any interest income and (2) net of any potential tax benefit. We believe that interest expense should be disclosed on a gross basis. However, if an entity also wishes to disclose the amount of interest income, as well as any related tax benefits, it would not be precluded from doing so.

15.5.1.3 Reasonably Possible Significant Changes in Unrecognized Tax Benefits That May Occur Within the Next 12 Months

Companies must disclose the nature of uncertain positions and related events if it is reasonably possible that the positions and events could change the associated unrecognized tax benefits within the next 12 months (including previously unrecognized tax benefits that are expected to be recognized upon the expiration of a statute of limitations within the next year).

Specifically, ASC 740 requires the following disclosures:

- Nature of the uncertainty
- Nature of the event that could occur within the next 12 months to cause the change
- Estimate of the range of the reasonably possible change or statement that an estimate of the range cannot be made

In preparing this disclosure, we believe that all facts and circumstances, including the likelihood that a taxing authority will (or will not) identify an uncertain tax position, should be considered. Thus, if an uncertain tax position does not meet the recognition threshold, but management expects the statute of limitations to expire within the next 12 months and does not expect the taxing authority to identify the exposure, the total amount of the unrecognized tax benefit should be disclosed to note that a change is expected within the next 12 months, provided the amount is significant.
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**PwC Observation:** Given that most uncertain tax positions have a range of possible outcomes (from being fully sustained to being fully disallowed), we believe that, in most cases, entities should be able to provide a quantitative range of the possible changes in unrecognized tax benefits that could change within the next 12 months.

We would expect management to exercise judgment in determining the level of aggregation that is appropriate for this disclosure. While we expect some level of aggregation, we believe that the information should be appropriately detailed to provide a reader of the financial statements with some context as to which circumstances may cause the unrecognized tax benefits to significantly change.

Although the disclosure noted in ASC 740-10-50-15(d) is an annual disclosure, ASC 740 did not change the early warning disclosure requirements of ASC 275. Accordingly, disclosures for reasonably possible significant changes in unrecognized tax benefits should be disclosed on a rolling 12-month basis. As a result, at each interim period, entities should have processes and controls in place that allow them to identify unrecognized tax benefits capable of changing significantly within the next 12 months.

**PwC Observation:** The specific disclosures required by ASC 740, combined with the SEC staff's continued focus on such disclosures, should result in more timely discussion of expected changes. This discussion should address, among other issues, disclosures about expected settlements or the statute of limitations on a significant exposure within the next 12 months. We believe, given the attention that this particular disclosure has received, that significant unexpected adjustments to tax reserves (whether favorable or unfavorable) will occur less frequently.

15.5.1.4 **Tax Years Still Subject to Examination by a Major Tax Jurisdiction**

ASC 740 requires that entities report all tax years that remain open to assessment by a major tax jurisdiction. We believe in certain situations, it may be conceivable that a major tax jurisdiction might be disclosed in a jurisdiction where the company has not filed a tax return. For example, the company may have taken a tax position regarding a tax status of one of its entities whereby the potential tax exposure related to the company could be significant. In this fact pattern, the company may need to provide the tax jurisdiction for the related exposure.

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**Exhibit 15-1: Illustrative Disclosure: Accounting for Unrecognized Tax Benefits**

This exhibit appears in ASC 740-10-55-217 and illustrates the guidance in ASC 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 (continued)
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>25,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Additions/Reductions 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.

**PwC Observation:** For entities adopting the ASC 740 guidance for uncertain tax positions, conversations with the FASB staff have confirmed that presentation of accrued interest and penalties for periods prior to the adoption is not required. Entities, however, may choose to include accrued interest and penalties for periods prior to the adoption with appropriate disclosure indicating that the amounts were determined under a different basis of accounting.

**15.5.1.5 Tabular Reconciliation of Unrecognized Tax Benefits**

**15.5.1.5.1 Comprehensive Basis**

This quantitative disclosure requirement calls for a reconciliation of the beginning and ending balances of the unrecognized tax benefits from uncertain positions. This rollforward is required on a comprehensive basis. Therefore, it must include all unrecognized benefits, whether they are reflected in a liability (liability for unrecognized tax benefits), a decrease in a deferred tax asset (irrespective of whether a valuation allowance would be required), or even an off-balance-sheet exposure such as a questionable stock option windfall benefit that has not been recorded because the Board prohibits recognition prior to an actual reduction in taxes payable.
PwC Observation: An investor in a pass-through entity (e.g., partnerships, S-corps, or LLCs) should include in its tabular reconciliation its respective interest in the entity’s underlying unrecognized tax benefits, notwithstanding whether such entity is consolidated or accounted for under the equity method. Conversely, an investor in a non-pass-through entity (e.g., an investment in a C corporation), that is accounted for under the equity method would not be expected to include the uncertain tax positions of the non-pass-through investee in its tabular reconciliation. However, disclosures of significant tax uncertainties of a non-pass-through investee that may affect the investor may be appropriate. Refer to Section TX 16.2.2.2 for additional guidance.

Example 15-4: Including in the Tabular Reconciliation Items That Do Not Initially Result in a Liability for Unrecognized Tax Benefits

Example 1

Background/Facts:
Assume that various tax positions taken on a tax return resulted in an NOL carryforward with a potential benefit of $10 million and that the related DTA would have attracted a full valuation allowance. Assume also that only $3 million of the potential $10 million tax benefit satisfies the recognition and measurement requirements of ASC 740.

Question:
What amount should be included in the tabular reconciliation of unrecognized tax benefits?

Analysis/Conclusion:
$7 million, the difference between the amount taken on the tax return ($10 million) and the amount that was recognizable for financial reporting purposes ($3 million), should be included in the tabular reconciliation of unrecognized tax benefits. In this case, the gross DTA and related valuation allowance reported in the income tax footnote (for reporting balance sheet NOLs and valuation allowances) should be $3 million and none of the $3 million would be recognized on the balance sheet (deferred tax asset of $3 million offset by $3 million valuation allowance). The $7 million reduction in the DTA is considered an unrecognized tax benefit and would be included in the annual tabular reconciliation, regardless of the valuation allowance. In summary, all gross unrecognized tax benefits, whether they result in a liability or a reduction of DTAs and/or refundable amounts, should be included in the tabular reconciliation.

Example 2

Background/Facts:
Company A expects to file a refund claim (related to a current period tax position) after the balance sheet reporting date, and an unrecognized tax benefit of $10,000 will be included within the refund claim.

Question:
Should this unrecognized tax benefit be included in the year-end tabular reconciliation, even though the refund claim that will give rise to the unrecognized tax benefit has not been filed as of the balance sheet date?

(continued)
Analysis/Conclusion:
Yes. Whether a claim for refund is filed as of the current-period balance sheet date or is expected to be filed, and is related to a current period or prior period tax position, at some later date, a tax position may be included in a refund claim if that claim must be evaluated for recognition and measurement under the ASC 740 accounting model. When the expected benefits included in a refund claim are not fully recognized in the financial statements because the underlying position fails the requirement for recognition/measurement (e.g., the refund claim is based on aggressive tax planning), the portion of the tax benefit that does not meet recognition/measurement requirements (i.e., the unrecognized tax benefit) cannot be recorded in the financial statements. Though not recognized in the financial statements, the unrecognized tax benefit associated with this claim must be disclosed in the tabular reconciliation as required by ASC 740-10-50-15A(a).

Example 3

Background/Facts:
In the fourth quarter of 20X1, Company A, generated a loss of $1 million related to the sale of an investment. Because Company A did not have ordinary income or capital gains in the current year or the applicable carry-back periods, the loss became a carryforward. Management expects to take a tax return filing position characterizing the loss as ordinary rather than capital in nature. There is some support in the law for the position; however, in applying ASC 740-10-25-6, management concludes that the position does not meet the more-likely-than-not recognition threshold. The applicable tax rate in the jurisdiction is 40 percent for both ordinary income and capital gains; however, capital losses can only be used to offset capital gains. Company A recognized a $400 thousand deferred tax asset (DTA) because the carryforward constitutes a tax attribute regardless of the nature of the loss. In 20X2, Company A generated a profit that was all ordinary in nature and utilized all of its loss carryforwards to reduce taxable income and taxes payable.

Question:
How should the unrecognized tax benefit (UTB) be recorded and presented in 20X1 and 20X2?

Analysis/Conclusion:
At December 31, 20X1, a liability for the UTB will not be recorded as the tax position to be taken characterizing the loss as ordinary has not resulted in a potential underpayment of tax. We believe, nonetheless, that $400 thousand of UTB should be included in the 20X1 tabular reconciliation. ASC 740-10-50-15A requires a tabular reconciliation of the beginning and ending balances of UTBs. ASC 740-10-20 defines a UTB as “the difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10.” We believe this requirement is intended to apply comprehensively, to all changes to tax return positions which would arise based upon application of the ASC 740 recognition and measurement principles. That includes positions characterizing a loss carryforward since the characterization determines the tax consequences of the attribute. The capital loss attribute that would arise if the position is unfavourably settled should not offset the related UTB in the table because the tabular reconciliation only includes unrecognized benefits.

In 20X2, a $400 thousand UTB liability should be recorded on the balance sheet because at that time Company A began utilizing the “as filed” 20X1 loss carryforward to reduce taxable income and thus pay less income tax than they would have had the original $1 million loss been determined to be capital in nature. For the tabular (continued)
reconciliation, since the $400 thousand UTB was included in 20X1, no additional entry is necessary in 20X2. In addition, a DTA for the future deductible amount associated with the capital loss should continue to be recorded during 20X2 (and possibly beyond) even though, on an “as filed” basis, Company A utilized the loss carryforward on the 20X2 tax return.

It should be noted that in both 20X1 and 20X2, Company A must assess the realizability of the DTA based upon whether there is sufficient future taxable income of the appropriate character (i.e., future capital gains). Otherwise, a valuation allowance would be required against the DTA. In that case, the UTB amount would also be included in the disclosure required by ASC 740-10-50-15A(b) of UTBs that, if recognized, would affect the effective tax rate. In addition, respective disclosure of loss carryforwards should be provided on an ASC 740 “as-adjusted” basis.

Example 4

Background/Facts:
Company A has emerged, on the last day of its accounting and tax year, from a bankruptcy proceeding which resulted in a significant portion of the Company’s debt being cancelled. For tax law purposes, Company A does not have taxable income for the debt extinguishment but instead is required to reduce its income tax attributes and tax basis of property, subject to various computational rules. Company A would realize a permanent exclusion of taxable income (known as “black hole income”) to the extent its cancelled debt exceeds the reduction in tax attributes and other tax basis as required under the law.

Company A’s expected tax return position vis-à-vis the required reduction of its tax attributes/tax basis results in maintaining a significant amount of tax basis in various assets including equipment, plants and real estate. This tax return position would lead to realizing a larger “black hole” gain. However, there is uncertainty as to whether, upon examination by the taxing authority, the basis in such assets would be reduced by an amount greater than the Company is claiming in its tax return. The expected filing position is not more-likely-than-not sustainable based on technical merits and Company A is required to reserve the tax basis benefit consistent with ASC 740-10-25-6. Per ASC 740-10-25-6, an entity shall only recognize the financial statement effects of a tax position when it is more-likely-than-not, based on technical merits, that the position will be sustained upon examination.

Question:
How should Company A present and disclose the uncertain tax benefit related to the debt extinguishment?

Analysis/Conclusion:
ASC 740 acknowledges that 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 (ASC 740-10-25-17). Accordingly, a taxable or deductible temporary difference is measured as a difference between the reported amount of an asset/liability in the financial statements and the tax basis as determined under the recognition and measurement principles pertaining to uncertain tax positions.

Therefore, in determining the temporary differences related to an asset, Company A would compare its carrying value as reported in its financial statements to the greatest amount more-likely-than-not to be sustainable upon an examination by the relevant tax authorities.

(continued)
As discussed in ASC 740-10-45-11 through 45-12, a liability for unrecognized tax benefits should not be combined with deferred tax liabilities or assets, unless it arises from a taxable temporary difference. In Company A’s situation, the unrecognized tax benefit related to its expected tax filing position results in a taxable temporary difference. Therefore, the unrecognized tax benefit should be classified as a deferred tax liability. Furthermore, for U.S. public companies, the unrecognized tax benefit presented as a deferred tax liability should be disclosed in the tabular reconciliation of uncertain tax benefits consistent with ASC 740-10-50-15A. A disclosure is required beginning in the period in which the position (i.e., the debt extinguishment) is reflected in the financial statements (i.e., when it affects the measurement of a deferred tax liability).

Note: Company A would remeasure at each reporting period the taxable basis differences in the underlying asset consistent with the recovery of the asset for book purposes and adjust the deferred tax liability. A reclassification between deferred tax liability and a separate liability for unrecognized tax benefits would also be necessary to the extent the uncertain tax basis reduces income tax payable. In addition, interest on the potential tax underpayment would generally also be required as the uncertain tax basis is utilized.

15.5.1.5.2 Disclosure of Gross Unrecognized Tax Benefits

In circumstances where an unrecognized tax benefit in one jurisdiction would have an impact on a tax liability in another jurisdiction (such as a state unrecognized tax benefit affecting the amount of state taxes that would be deductible for U.S. federal purposes), the tabular reconciliation of unrecognized tax benefits should not include consideration of an unrecognized tax benefit’s effect in other jurisdictions. Indirect effects of uncertain tax positions on other jurisdictional tax calculations should be recorded in the financial statements. They should not be reflected in the tabular rollforward.

Example 15-5: Exclusion of Indirect Effects of Uncertain Tax Positions from the Tabular Disclosure

**Background/Facts:**
Company A has an uncertain tax position in State X of $1,000, which has not met the recognition threshold under ASC 740. If the position is not sustained, Company A will receive a $350 federal benefit for state taxes paid on $1,000.

**Question:**
Given the available facts, how should the tabular rollforward be presented?

**Analysis/Conclusion:**
In this case, only the $1,000 state unrecognized tax benefit should be included in the tabular disclosure.

For purposes of balance sheet classification, consistent with ASC 740-10-45-11, Company A should have a state liability for unrecognized tax benefits of $1,000 and a $350 federal deferred tax asset.
15.5.1.5.3 Interest and Penalties

Interest and penalties should not be included in the annual tabular reconciliation as unrecognized tax benefits, even if the accounting policy classifies interest and penalties as a component of income taxes.

15.5.1.5.4 Treatment of Deposits

If an advance deposit is made (regardless of whether it is refundable on demand or considered by the taxing authority as a payment of taxes), it should have no impact on the amount of unrecognized tax benefit that is reflected in the tabular reconciliation. This is because advance deposits are essentially equivalent to advance tax payments. As such, they should not be included as an offset to unrecognized tax benefits in the annual tabular reconciliation disclosure.

15.5.1.5.5 Required Information

ASC 740-10-50-15A(a) prescribes the following minimal line items (which can be further extended by the preparer):

- Gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
- Gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
- Amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
- Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations

PwC Observation: Management may also consider including additional line items, such as one noting that the entity reclassified a liability to or from a deferred tax liability to reflect exposures that only affect timing. Management may also disaggregate the above line items to provide further details, such as details about changes that affected the effective tax rate and changes that were recorded outside the income statement (e.g., recorded as a component of other comprehensive income, or against goodwill for uncertainties arising from business combinations or decreases due to the disposal of the respective business unit).

15.5.1.5.5.1 The Gross Amounts of Increases and Decreases in Unrecognized Tax Benefits as a Result of Tax Positions Taken During a Prior Period

Amounts reported on this line represent an uncertain tax position taken in a prior year for which measurement has changed for one of two reasons: (1) the entity met one of the subsequent recognition thresholds in ASC 740-10-25-8, or (2) new information supported a change in measurement.
PwC Observation: When an entity decides to not take a position it was previously expecting to take, and as a consequence, reverses the liability previously recorded for the position, it may be appropriate to disclose the reversal of the liability in a separate line item, such as “Decrease in unrecognized tax benefits as a result of the withdrawal of positions previously taken or expected to be taken.” The entity may, however, choose to show the decrease in the liability in the line item “Decrease in unrecognized tax benefits as a result of positions taken during the prior periods.” However, in that case, the entity should consider separately disclosing that the adjustment relates to a change in intention in regards to a particular filing position.

15.5.1.5.5.2 Increases and Decreases in Unrecognized Tax Benefits Recorded for Positions Taken During the Year

To the extent that an uncertain tax position is taken during the year and the entity’s assessment of the amount of benefit to be recognized changes within the same annual reporting period, the tabular reconciliation should only reflect the net addition in existence at the end of the year when disclosing the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the year. As we understand it, the FASB staff acknowledged that references to “decreases in unrecognized tax benefits” for this line of the tabular reconciliation should have been stricken from the guidance when the Board’s deliberations changed the tabular reconciliation from a quarterly disclosure to an annual disclosure. However, the FASB staff did emphasize that material changes in unrecognized tax benefits that occur during an interim period should be disclosed during the interim period and that an entity should not delay disclosure of material changes until the end of the annual reporting period.

PwC Observation: Questions have arisen on how the effects of “rolling” positions should be presented in the tabular rollforward. For example, a company takes an uncertain tax position in its current year return, and also took that same uncertain tax position in a previous year return. The statute of limitations on the earlier year position expires in the current year. We believe that the impact of the position taken in the current year should be reflected in the “Increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period” line item, and the impact of the expiration of the statute of limitations on the same position taken in an earlier year should be reflected in the “Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations” line item in the tabular rollforward.

15.5.1.5.5.3 The Amounts of Decreases in the Unrecognized Tax Benefits Relating to Settlements with Taxing Authorities

Certain settlements with taxing authorities may result in no cash payments (e.g., a taxing authority may concede a position taken on a tax return resulting in no cash payments to the taxing authority for that position). Only amounts paid or tax attributes (e.g., NOLs) used in lieu of payment should be included in this line item of the tabular reconciliation. A decrease in unrecognized tax benefits resulting from concessions or adjustments by the taxing authority should be reflected as a change to prior-period unrecognized tax benefits.
**PwC Observation:** To the extent that unrecognized tax benefits on a prior-year uncertain tax position were both established and paid out in the same year, entities should report the movement gross. That is, an increase should be reflected in “The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period” line, while the payment of cash to settle the position should be reflected in “The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities” line.

Similarly, we believe that the recording of a liability on one position and the settlement of an unrelated position during the same period, even if for a similar amount, should be reported gross. For example, assume that in the current year the taxing authority concedes on position A, which was fully reserved and resulted in a $100 liability, and proposes a $100 adjustment for the full $100 tax benefit claimed on an unrelated position B, the benefit of which was previously recognized in full on the financial statements. As part of an overall settlement with the taxing authority, the entity agrees to pay $100 to settle position B. Assuming a beginning balance of $200, a reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at the beginning of the year</td>
<td>$200</td>
</tr>
<tr>
<td>Additions based on tax positions related to the current year</td>
<td></td>
</tr>
<tr>
<td>Additions for tax positions of prior years (position B)</td>
<td>100</td>
</tr>
<tr>
<td>Reductions for tax positions of prior years (position A)</td>
<td>(100)</td>
</tr>
<tr>
<td>Settlements (position B)</td>
<td>(100)</td>
</tr>
<tr>
<td>Balance at the end of the year</td>
<td>$100</td>
</tr>
</tbody>
</table>

Moreover, a settlement reached with a taxing authority as of year-end should generally be shown in the line item “Decrease in unrecognized tax benefits relating to settlements with taxing authority,” notwithstanding that the actual cash payment is made subsequent to year end. This is because the uncertainty related to these particular tax positions has been resolved as of the balance sheet date and it is clear that a payment will be made subsequent to year end.

15.5.1.5.5.4 **Reductions to Unrecognized Tax Benefits Resulting from a Lapse of the Applicable Statute of Limitations**  

Amounts reported in this line represent the tax benefits that were sustained by the entity because the taxing authority’s period of assessment has passed.

15.5.1.6 **Unrecognized Tax Benefits That, If Recognized, Would Affect the Effective Tax Rate**  

ASC 740-10-50-15A(b) requires disclosure of the total amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate. That is, only unrecognized tax benefits that affect (if recognized) the tax provision within continuing operations should be disclosed. Certain unrecognized tax benefits may not affect the tax provision within continuing operations, such as (1) timing-related uncertainties (e.g., accelerated depreciation) (2) excess tax deductions from stock-based compensation recorded in equity under ASC 718, Compensation—Stock Compensation, and APB 25, (3) acquisition-related measurement period adjustments pursuant to ASC 805, and (4) measurement period adjustments occurring in
connection with reorganizations in fresh-start balance sheets pursuant to ASC 852. To assist users of the financial statements, supplemental disclosures should be provided for resolutions of uncertain tax positions that, if sustained, would affect items other than the tax provision from continuing operations. A supplementary disclosure, for example, might specifically identify the amount of gross unrecognized tax benefits included in the ending balance, whose tax effects, if recognized in the financial statements, would be recorded in equity and/or goodwill.

As described in Section TX 15.5.1.5.2, the indirect effects in other jurisdictions should not be included within the tabular rollforward. We understand, however, that for purposes of applying the disclosure requirements specified in ASC 740-10-50-15A(b), one might consider the indirect effects in other jurisdictions.

**PwC Observation:** Based on the sample disclosure, as well as discussions with the FASB staff, it appears that this disclosure is intended to identify uncertainties that are not solely related to timing differences (i.e., permanent differences). That said, there are a number of situations in which the resolution of exposures unrelated to timing might not impact the effective tax rate. They might include, for example, resolution of uncertain positions related to equity transactions or changes within the measurement period for acquired uncertain tax positions that result from new information about facts and circumstances that existed as of the acquisition date. Further, uncertain tax positions embedded in a net operating loss carryforward that carries a full valuation allowance would not impact the effective tax rate, as long as the uncertainty is expected to be resolved while a full valuation allowance is maintained. It is unclear whether any of these positions would be required in this disclosure and whether there will be any clarification of the disclosure requirement. To provide a more comprehensive picture of the entity’s tax position and potential future tax consequences, companies should consider additional transparency around this disclosure. For example, if an uncertain tax benefit would create an additional net operating loss carryforward, along with an additional valuation allowance, a company may disclose that if the unrecognized tax benefit is recognized, it would affect the effective tax rate. However, it would be in the form of a net operating loss carryforward, which would attract a full valuation allowance.

**15.6 Income Tax Related Disclosures for Stock Compensation**

The following should be disclosed in relation to the tax effects of stock-based compensation awards:

- The amount of cash resulting from the settlement of the awards, and the corresponding tax benefit that the entity realized for the current year.
- The total compensation cost that the entity recognized in income, as well as the total recognized tax benefit for all income statements that the entity presented.

See Section TX 18.21 for a more detailed discussion of disclosures and for additional guidance on the presentation of tax effects relating to ASC 718.

**15.7 Significant Risks & Uncertainties Disclosure**

ASC 725, *Risks and Uncertainties* requires disclosures in annual and interim financial statements of risks and uncertainties (e.g., use of estimates) related to certain key information that help users in predicting future cash flows and results of operations.
Although ASC 740-10-50-15(d) essentially codified ASC 275 for uncertain tax positions, the disclosures requirement in ASC 275 is still relevant guidance for other income tax matters, such as valuation allowances and indefinite reversal assertions for unremit earnings of foreign subsidiaries. Additional disclosures may be required with respect to assumptions that management uses to estimate its balance sheet and income statement tax accounts. When it is at least reasonably possible that a material adjustment will occur in the near term (this is generally considered approximately one year), the financial statements should reflect this potential uncertainty along with a range of potential changes to its recorded amounts. This requirement is discussed in ASC 275-10-50-6 through 50-15, and an example relating to valuation allowances is offered in ASC 740-10-55-218 through 55-222.

As noted above, the threshold for disclosure is “reasonably possible,” indicating that probability is more than remote. The premise behind this threshold is that significant one-time charges or benefits, such as a change in the assessment of the need for a valuation allowance, should not surprise the reader of the financial statements. This is particularly important for public companies because of their quarterly reporting requirements. The more significant the change in estimate and the more time that elapses between the event and the filing date, the more difficult it may be for a company to justify that a significant one-time event was not reasonably foreseeable at the time of its most recent filing.

### 15.8 SEC Disclosures

#### 15.8.1 Additional Footnote Disclosures

Several disclosures required by the SEC are not specifically required by ASC 740. They include the following:

- The source of income (loss) before tax expense (benefit) must be classified as either foreign or domestic.
- The amounts applicable to U.S. federal income taxes, to foreign income taxes, and to other income taxes must be stated separately for each major component of income tax expense (i.e., current and deferred).
- The fact that an entity conducting business in a foreign jurisdiction has been granted a tax holiday from income taxes for a specified period must be disclosed. In such an event, an appropriately referenced note must (1) disclose the aggregate dollar and per-share effects of the tax holiday and (2) briefly describe the factual circumstances, including the date on which the special tax status will terminate (SAB Topic 11C).

These disclosure requirements apply not only to continuing operations, but also to total pretax income and total tax expense. However, question 7 of SAB Topic 6I indicates that “overall” disclosures of the components of total income tax expense (i.e., current vs. deferred and U.S. federal vs. foreign vs. other) are acceptable. It is not necessary to make such disclosures with respect to each of the different categories (continuing operations, discontinued operations, extraordinary items, etc.) in which income tax expense is reported.

#### 15.8.2 Contractual Obligations Table

The SEC concluded that, in accordance with SEC Regulation S-K Item 303(a)(5), liabilities for unrecognized tax benefits should be considered when a registrant prepares the contractual obligations table.
There are various formats that those disclosures might follow. Deciding which of the various formats should be used is a matter of professional judgment. However, the ultimate goal of the disclosures is to provide transparent information that enables investors to understand the impact of uncertain tax positions on the company’s liquidity.

If a company can make reliable estimates about the periods in which cash outflows relating to its liabilities are expected to occur, it should include those estimates in the relevant columns of the contractual obligations table. For instance, any liabilities classified as a current liability in the company’s balance sheet should be presented in the “Less than 1 Year” column of the contractual obligations table.

If, however, a company cannot make reliable estimates of the cash flows by period, the company should consider alternative methods of conveying relevant information to investors. For instance, the company might consider including its liabilities in an “all other” column in the table (with a transparent note disclosure). Alternatively, the company might rely on a note disclosure alone (including quantitative information).

15.8.3 Interim Reporting (Form 10-Q Filings)

Companies are required to disclose in quarterly reports any material changes to contractual obligations that occur outside the ordinary course of business. The method by which any material changes are disclosed is a matter of professional judgment.

A company should evaluate whether the inclusion of liabilities for unrecognized tax benefits in its disclosures of contractual obligations represents a material change to its prior disclosures. If including the liabilities does, in fact, represent a material change, the company should use judgment to determine the appropriate means of conveying this information to investors. The SEC’s management discussion and analysis (MD&A) rules do not specifically require companies to include the contractual obligations table in quarterly reports. However, the inclusion of an updated table is one way to effectively disclose material changes. Another method provides in the contractual obligations disclosures a discussion of the impact of the liabilities. As noted above, the ultimate goal of the disclosures is to provide transparent information that enables investors to understand the impact of uncertain tax positions on the company’s liquidity.

15.8.4 Schedule II Requirement

In addition to the disclosure requirements mentioned, S-X Rule 5-04 requires that valuation allowance details be provided on Schedule II, as prescribed in Rule 12-09. If the information required by Schedule II is otherwise provided in the financial statements or notes, the schedule can be omitted.

15.8.5 MD&A Disclosures

SEC registrants must also make certain disclosures related to income taxes in the MD&A of SEC filings.

15.8.5.1 Effective Tax Rate

In their MD&A, registrants should explain the reasons for significant changes in the effective income tax rate from year to year and the effect that income tax payments would have on liquidity and capital resources.
In addition, qualitative disclosures related to an entity's effective tax rate should be carefully considered in each period. For example, absent commentary to the contrary, a reader of the financial statements should be entitled to assume that an entity's effective tax rate for the most recent periods will continue into the near-term future. If items impacting the effective rate in the current period will not recur in such a way that the expected tax rate will be substantially different going forward, MD&A disclosure of the one-time items is required. This will be the case regardless of whether the items are significant enough to require separate disclosure in the effective tax rate reconciliation.

15.8.5.2 Accounting Estimates & Contingencies

In December 2003, the SEC issued FRR 72 to remind companies of existing SEC guidance and to provide additional guidance, interpretation, and requirements related to MD&A disclosures, as specified in Items 303 of Regulations S-K and S-B. However, FRR 72 does not amend existing disclosure requirements and it provides interpretive guidance on three focused areas, one being critical accounting estimates. Although not specifically stated, we believe that this includes tax contingencies. The interpretation provides that the MD&A should, among other things, supplement the description of estimates already provided in the accounting policy section of the notes to the financial statements, including such factors as how the entity arrived at the estimate, how accurate the estimate/assumption has been, how much the estimate/assumption has changed from the past, and whether the estimate/assumption is reasonably likely to change in the future.

15.8.5.3 Realization of Deferred Tax Assets

The SEC requires certain disclosures with respect to deferred tax assets in certain circumstances. The following is a transcript of comments made by the SEC at the AICPA Conference on Current SEC Developments on January 12, 1993:

The SEC staff would insist that a registrant provide additional disclosures regarding the realization of its deferred tax asset in those situations in which the deferred tax asset comprises a significant portion of the registrant's total assets and/or stockholders' equity and it is not apparent that the registrant’s existing level of income would be sufficient to realize the deferred tax asset. If realization of a material deferred tax asset will require material improvements in profitability, or material changes in trends, or material changes in the relationship between reported pretax income and federal taxable income, or material asset sales or similar non-routine transactions, the staff believes that a discussion in MD&A of these factors is necessary. The staff believes that the registrant should provide sufficient disclosures in MD&A to inform the reader as to what factors and assumptions led management to arrive at its conclusion that the deferred tax asset would be realized in the future.

The staff recommended that the following disclosures be provided in MD&A:

1. A discussion of the minimum amount of future taxable income that would have to be generated to realize the deferred tax asset and whether the existing levels of pretax earnings for financial reporting purposes are sufficient to generate that minimum amount of future taxable income. If not sufficient, a discussion of the extent of the future increase in profitability that is necessary to realize the deferred tax asset, quantified to the extent possible, and the significant assumptions relied upon by management in concluding that it is more-likely-than-not that the results of future operations will generate sufficient taxable income to realize the deferred
tax asset, for example, anticipated improvements in profitability resulting from improved gross margins, additional store openings, cost reduction programs, and corporate restructurings.

2. The historical relationship between pretax earnings for financial reporting purposes and taxable income for income tax purposes, including a discussion of the nature and amount of material differences between such amounts. A table reconciling pretax income to taxable income for each of the years for which financial statements are presented has been used to accomplish this objective.

3. A discussion of tax-planning strategies that would be available to generate future taxable income if the registrant were unable to generate sufficient future taxable income from ordinary and recurring operations.

4. The annual amounts of net operating loss carryforwards for income tax purposes that expire by year.

At the 1994 Conference, the staff added that “disclosures regarding significant deferred tax assets arising from deductible temporary differences such as OPEBs should include the expected timing of reversal of those temporary differences.” The staff recognized that estimates may be required since there are no actual expiration dates for the deductible temporary differences and that less precise disclosures would need to be accepted in certain circumstances. For example, disclosures regarding significant deferred tax assets arising from deductible temporary differences might provide annual reversals by year of significant deductible temporary differences that give rise to deferred tax assets for the first five years, followed by groupings for subsequent five-year periods.

15.9 Exemptions for Nonpublic Entities

Certain exceptions to the above requirements are made for nonpublic entities. A nonpublic entity does not need to numerically reconcile the statutory and effective rates or provide numeric information regarding the types of temporary differences and carryforwards that give rise to deferred tax assets and liabilities. However, in both cases, a nonpublic entity must disclose the nature of significant items. In addition, nonpublic and nontaxable entities are also exempt from disclosing the net difference between the tax bases and the reported amounts of assets and liabilities, a required disclosure for public nontaxable entities.
Chapter 16:
Accounting for Uncertainty in Income Taxes
Chapter Summary

In June 2006, the FASB issued guidance to address diversity in practice regarding the accounting for uncertain tax positions. The guidance standardized this area of accounting by prescribing a comprehensive two-step model that indicates how an entity should recognize and measure uncertain tax positions.

The guidance also requires disclosures specific to uncertain tax positions. Guidance issued in September 2009 eliminated certain of these disclosure requirements for nonpublic entities. All entities are required to disclose open tax years by major jurisdiction and certain information relating to reasonably possible near-term changes in the total amount of unrecognized tax benefits. The guidance also requires disclosures for all entities related to interest and penalties. In addition to these disclosures, public entities are required to provide a tabular rollforward of unrecognized tax benefits and the amount of unrecognized tax benefits, which, if recognized, would affect the effective tax rate.
16.1 Background

Significant elements of the ASC 740 model for recognition and measurement of uncertain tax benefits include the following:

**Recognition threshold for recording uncertain tax benefits:** A tax benefit from an uncertain position may be recognized in the financial statements only if it is more-likely-than-not that the position is sustainable, based solely on its technical merits and consideration of the relevant taxing authority’s widely understood administrative practices and precedents (Section TX 16.3).

**Measurement:** If the recognition threshold for the tax position is met, only the portion of the tax benefit that is greater than 50 percent likely to be realized upon settlement with a taxing authority (that has full knowledge of all relevant information) should be recorded (Section TX 16.4).

**Change in judgment:** The assessment of the recognition threshold and the measurement of the associated tax benefit might change as new information becomes available. Changes in conclusions for both recognition and measurement should be the result of “new information,” not a mere re-assessment of existing facts (Section TX 16.5).

**Interest/Penalties:** A taxpayer is required to accrue all interest and penalties that, under relevant tax law, the taxpayer would be regarded as having incurred. Accordingly, interest would begin to accrue in the same period during which it would begin to accrue under the relevant tax law. Penalties should be accrued in the first period for which a position is taken (or is expected to be taken) on a tax return that would give rise to the penalty. How an entity classifies interest and penalties in the income statement is an accounting policy decision that, once elected, must be consistently applied (Section TX 16.6).

**Balance sheet classification:** Liabilities for unrecognized tax benefits are classified as long-term, unless cash payment is expected within the next 12 months (Section TX 16.7).

**Disclosures:** ASC 740-10-50 requires qualitative and quantitative disclosures, including (1) the accounting policy classification of interest and penalties; (2) a rollforward of all unrecognized tax benefits that is presented as a reconciliation of the beginning and ending balances of the unrecognized tax benefits on a worldwide aggregated basis; (3) the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate; (4) the amount of interest and penalties that have arisen during the year and are cumulatively accrued on the balance sheet; (5) a discussion of reasonably possible changes to the balance of unrecognized tax benefits that could occur within 12 months after the reporting date; and (6) a description of tax years that remain subject to examination by major tax jurisdictions (Section TX 16.8). Note: Guidance issued in September 2009 eliminated certain of these disclosure requirements for nonpublic entities. Section TX 15.5 includes the disclosure requirements for uncertain tax positions and identifies which are applicable to all entities and which are applicable to public entities only.

**Transition and Effective Date:** For public entities and nonpublic consolidated entities of public entities that apply U.S. GAAP, the guidance in ASC 740 for unrecognized tax benefits is effective for all entities, except certain investment
companies,\(^1\) for annual financial statements for fiscal years beginning after December 15, 2006. For nonpublic entities that elected deferral of the guidance in ASC 740 for uncertain tax positions, it is effective in the annual financial statements for fiscal years beginning after December 15, 2008. The terms “public” and “nonpublic” entities are defined in the ASC Master Glossary.

**Cumulative Effect from Adoption:** The cumulative effect of adopting the provisions of ASC 740 for uncertain tax positions is required to be reported and presented separately as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year. The cumulative-effect adjustment is the difference between the net amount of assets and liabilities recognized in the statement of financial position prior to the application of the ASC 740 guidance for uncertain tax positions and the net amount of assets and liabilities recognized as a result of applying such guidance. The cumulative-effect adjustment does not include items that would not be recognized in earnings, such as the effect of adopting the guidance on tax positions related to business combinations. For example, assume a calendar year-end nonpublic entity adopts the recognition and measurement criteria of ASC 740 for uncertain tax positions as of January 1, 2009. The company would record a cumulative effect adjustment in its financial statements as of January 1, 2009, for income tax uncertainties existing as of December 31, 2008. The effect of adjusting tax positions related to business combinations prior to the effective date of FAS 141(R) should consider the guidance that was in effect immediately prior to the effective date of ASC 805.\(^2\)

### 16.2 Scope

ASC 740 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. ASC 740 also provides accounting guidance for the related income tax effects of individual tax positions that do not meet the recognition thresholds required in order for any part of the benefit of that tax position to be recognized in an entity’s financial statements.

The guidance in ASC 740 applies to taxes (and thus uncertain tax positions) that are “based on income.” The FASB staff has stated that its intention was not to change the accounting for uncertainties related to non-income tax positions (see Section TX 16.2.1.4). Therefore, the guidance in ASC 740 related to uncertain tax positions should *not* be applied by analogy to non-income based taxes, such as sales taxes, value-add taxes, or property taxes.

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\(^1\) On December 22, 2006, the SEC’s Office of the Chief Accountant and Division of Investment Management issued a letter that deferred implementation of the FASB guidance for unrecognized tax benefits for certain entities. “The SEC’s letter stated that a fund may implement the guidance in its net asset value (NAV) calculation as late as its last NAV calculation in the first financial statement reporting period required for its fiscal year beginning after December 15, 2006. For example, a calendar-year, open-end or closed-end fund would be required to implement the guidance no later than its NAV calculation on June 29, 2007 (the last business day of its semi-annual reporting period), and the effects would need to be reflected in the fund’s semi-annual financial statements, contained in its Form N-CSR filing.

\(^2\) Companies should consider the guidance in EITF Issue No. 93-7, “Uncertainties Related to Income Taxes in a Purchase Business Combination.”
16.2.1 **Entities Within the Scope of the Recognition and Measurement Criteria of ASC 740-10-05-6**

The guidance related to the recognition and measurement of uncertain tax positions within ASC 740 is applicable to business entities, not-for-profit organizations, pass-through entities, and entities (such as investment trusts and registered investment companies) whose tax liability is subject to 100 percent credit for dividends paid that are potentially subject to income taxes. It applies to all jurisdictions and all tax positions accounted for under ASC 740, regardless of the nature of the entity or taxing jurisdiction. Therefore, the requirements of ASC 740 are applicable to tax positions taken by a not-for-profit or governmental entity including those that would affect the amount of unrelated business income taxes. The requirements of ASC 740 may also be applicable to certain S corporations that have converted from C corporation status and have deferred taxes related to built-in gains recorded.

**PwC Observation:** Entities in the United States, that receive a 100 percent credit for dividends paid, such as real estate investment trusts (REITs), have not generally been the focus of examinations by the Internal Revenue Service. Still, these entities must consider the uncertain tax positions that they have taken or expect to take using the recognition and measurement criteria prescribed by ASC 740. This includes a consideration of any administrative practices and precedents of the relevant taxing authorities.

16.2.1.1 **Foreign Registrants**

Foreign registrants and non-issuer foreign businesses that follow their local GAAP and present a footnote reconciling their local GAAP to U.S. GAAP for U.S. regulatory filing purposes are required to apply the recognition and measurement criteria in ASC 740 to determine net income and shareholders’ equity in accordance with U.S. GAAP. Determining whether disclosures under ASC 740-10-50-15, 50-15A and 50-19 are required depends on whether a foreign entity presents its U.S. GAAP reconciliation under Item 17 or Item 18 of Form 20-F. A non-issuer foreign business that provides a quantitative reconciliation under Item 17 of Form 20-F is not required to apply the disclosure provisions established in ASC 740-10-50-15, 50-15A and 50-19. Foreign registrants that present a U.S. GAAP reconciliation must present the reconciliation in accordance with Item 18 of Form 20-F, and therefore are required to provide the complete disclosures. Additional guidance is available in PwC SEC Volume 8010.42.

16.2.1.1.1 **Non-U.S. Parent Entity**

A non-U.S. parent entity may file U.S. GAAP consolidated financial statements that include both the non-U.S. and U.S. subsidiaries. The parent entity must calculate the impact of applying ASC 740’s guidance for recognition and measurement of unrecognized tax benefits for the group as a whole (i.e., for all income tax jurisdictions) because the guidance is applicable to all positions accounted for under ASC 740, regardless of the taxing jurisdictions.

**PwC Observation:** Determining whether ASC 740 is applicable (and thus whether its guidance on uncertain tax positions is applicable) depends on whether the underlying tax structure represents a tax that is based on income. Section TX 1.2 discusses how entities can determine whether a tax structure is based on income for the purposes of ASC 740.
16.2.1.2 Recognition and Measurement of Uncertain Tax Positions in a Business Combination

In a taxable business combination, positions may be taken in allocating the acquisition price and in filing subsequent tax returns, which are expected to be challenged by the taxing authority and perhaps litigated. Similarly, in nontaxable business combinations there may be uncertainties about the tax basis of individual assets or the pre-acquisition tax returns of the acquired business.

The recording of income-tax-related uncertainties acquired in a business combination is performed in accordance with the recognition and measurement criteria of ASC 805-740.

Adjustments to uncertain tax positions made subsequent to the acquisition date are recognized in earnings, unless they qualify as measurement period adjustments. Measurement period adjustments are recorded first as an adjustment to goodwill, then as a bargain purchase. A measurement period adjustment is an adjustment within the measurement period that relates to facts and circumstances that existed at the acquisition date.

The guidance for recognition of adjustments to acquired income tax uncertainties also applies to existing uncertainties arising in a business combination consummated prior to January 1, 2009. See Section TX 10.6 for further discussion on the treatment of income tax uncertainties in a business combination.

16.2.1.3 Separate Financial Statements

ASC 740-10-30-27 addresses separate financial statements of a subsidiary and requires that entities adopt a method for allocating taxes to the subsidiary that is “systematic, rational, and consistent with the broad principles established by this Subtopic.” Accordingly, we believe that entities should expand their accounting policies for the preparation of separate financial statements to include uncertain tax positions.

See Chapter TX 14 for guidance on accounting for separate entity financial statements.

16.2.1.4 Non-Income-Based Taxes

The guidance in ASC 740 related to uncertain tax positions is not applicable by analogy to other taxes, such as sales and use taxes, value-added taxes, or property taxes. As a general rule, sales and use taxes, value-added taxes, and property taxes do not constitute “taxes based on income” as defined by ASC 740-10-15. That said, the definition of “taxes based on income” should be interpreted broadly to include virtually any tax system that incorporates a concept of revenue minus some costs. To determine whether a particular tax is “based on income,” the laws for a given jurisdiction must be considered. For example, the Texas “Margin Tax” enacted in 2006 was determined to be an income tax accounted for under ASC 740 (Section TX 1.2 discusses how to determine whether a tax structure is based on income for the purposes of ASC 740).

Entities have historically applied ASC 450 Contingencies, to the recognition of non-income-based tax exposures (e.g., property, value-added taxes, and other taxes and governmental fees systems) that are not based on income, but are instead based on other measures, such as gross receipts, revenue, or capital. We believe that
uncertainties associated with these systems should continue to be accounted for as contingencies pursuant to ASC 450.

Example 16-1: Consideration of Detection Risk When Evaluating Uncertainty in Non-Income Based Taxes

Background/Facts:
Manufacturers and importers of medical devices are subject to an excise tax on the sales price of medical devices sold in the United States. Company A, a wholly owned U.S. subsidiary of a foreign parent, is both a manufacturer and distributor of medical devices in the U.S. Company A produces Product B for sale to its customers and also buys Product C from its parent for sale to Company A’s customers.

There is uncertainty around whether Product B is subject to the excise tax since Product B is a so-called “dual use” device that has both medical and non-medical uses. Company A is taking the position that Product B is not subject to the excise tax. There is also uncertainty as to the intercompany pricing of Product C, upon which the excise tax applies.

Company A and its parent believe that it is highly unlikely that the taxing authority will examine its positions with respect to Products B and C.

Question:
Should detection risk be considered in determining whether an amount should be accrued for potential exposure associated with the positions?

Analysis/Conclusion:
When evaluating uncertainty in non-income based taxes, Accounting Standards Codification (ASC) 450, Contingencies, (ASC 450) is typically applied to determine whether a benefit or liability should be recorded. In our view, the guidance in ASC 450-20-55-14, which requires an entity to determine the degree of probability a suit may be filed or a claim asserted prior to evaluating the potential outcomes, is not applicable to a self-assessment tax system supported by provisions of existing law. Therefore, the possibility that a position will not be examined is not relevant in determining whether the position qualifies for financial statement recognition.

In this case, Company A needs to determine whether Product B is subject to the excise tax, and whether the intercompany pricing of Product C represents a fair market price.3 Company A should perform this assessment assuming the taxing authority is fully aware of the matters (i.e., without considering the risk of detection). Company A evaluates uncertainties related to taxes other than income taxes using ASC 450 and, within that guidance, applies the loss contingencies approach. As such, if it is probable4 that Product B is subject to the excise tax or that Product C’s

(continued)

3 The regulations assume that the sale of the taxable article occurs in an arm’s-length transaction (that is, in a transaction between two unrelated parties) at a fair market price (i.e., the price at which the article would be sold to an independent wholesale distributor).

4 There is some ambiguity as to whether probable should be interpreted to mean more-likely-than-not (i.e., a greater than 50 percent chance of occurring) or a higher threshold (e.g., a 75 percent chance of occurring). Although the appropriate threshold may vary according to the particular circumstances, practice generally has applied the higher threshold (i.e., roughly 75 percent) and we do not take exception to this.
intercompany price does not represent a fair market price, and the amount of the tax due can be reasonably estimated, Company A would accrue its obligation and disclose the nature and amount of the accrual. If an unfavorable outcome is probable, but the amount of the loss cannot be reasonably estimated, Company A would comply with the disclosure requirements in ASC 450-20-50-3 through 50-8. Company A would also comply with the disclosure requirements if an unfavorable outcome is not probable, but reasonably possible, and can be estimated.

### 16.2.2 Identifying Uncertain Tax Positions

ASC 740 offers a rather expansive definition of the term “tax position.”

Excerpt from FASB Master Glossary

**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.

Generally, entities seek to legitimately reduce their overall tax burden and to minimize or delay cash outflows for taxes by implementing tax-efficient business structures, entering into tax-advantaged transactions, and seeking tax-optimal transactions with affiliates (among other things). But even without these tax-motivated activities, the average corporate tax return will include numerous positions taken in the ordinary course of business that are subject to significant and varied interpretation (e.g., common leasing and financing arrangements, or incentive compensation).

Due to the complexities of many tax systems and today’s business environment, we believe that almost all entities will have some uncertain tax positions in open tax years. Such uncertain positions may also include issues that had no effect on the income statement, such as allocation of purchase price to assets and liabilities acquired in business combinations, issues related to share-based payment, or positions that relate to a fully reserved net operating loss (NOL) carryforward.

Entities will need to determine and assess all material positions, including all significant uncertain positions in all tax years that are still subject to assessment or challenge under relevant tax statutes. The assessment should include any position taken (or expected to be taken) on a tax return, including (1) the decision to exclude
from the tax return certain income or transactions, (2) the assertion that a particular equity restructuring (e.g., a spin-off transaction) is tax-free when that position might actually be uncertain, or (3) the decision not to file a tax return in a particular jurisdiction for which such a return might be required.

16.2.2.1 Decision Not to File a Tax Return

An entity’s decision not to file a tax return in a jurisdiction where it might have nexus in a particular U.S. state or a permanent establishment in a foreign tax jurisdiction is considered a tax position.

If the entity is unable to support the technical sustainability of its position at the prescribed recognition threshold, it must recognize a liability for the realized, but unrecognizable tax benefit (i.e., by not filing and consequently not paying tax, the entity essentially realizes the benefit of taking this position). The entity must also recognize interest and any penalties, even though it has not been audited by the taxing authority. If the entity is able to support the technical sustainability of its position, it will need to measure the benefit as the largest amount that is cumulatively greater than 50 percent likely to be sustained upon settlement. If the amount measured is less than the full benefit of not filing returns, the difference is reflected as a liability.

In jurisdictions where failing to file a tax return prevents the statute of limitations from commencing, it is possible that the liability may never reverse, enabling interest and penalties to accrue in perpetuity. This would not eliminate the need to recognize a liability under ASC 740. If, when assessing nexus, the jurisdiction in question has a widely understood practice of pursuing back-taxes for a limited number of years, the entities subject to that jurisdiction should apply the “administrative practices” accommodation described in ASC 740-10-25-7(b) by accruing taxes, interest, and penalties (if applicable) for those years. Section TX 16.3.2.5 discusses the application of administrative practice and precedent to the recognition of a liability for an unrecognized tax benefit, while Section TX 16.6.2 discusses the application of administrative practice and precedent to interest and penalties.

16.2.2.2 Equity and Partnership Investments

The need to analyze uncertain tax positions is broader than analyzing the population of entities included in a consolidated set of financial statements. For example, a corporation that owns an interest in an entity that, for tax purposes, is classified as a partnership may use equity accounting to account for its partnership interest. The corporation should analyze significant uncertain tax positions that exist within the partnership since positions taken by the partnership affect both the current and deferred tax provision of the corporate partner. That is, a corporate partner’s distributive share of partnership income or loss should be the share of partnership income or loss that can be recognized by the partner pursuant to ASC 740. For example, a U.S. partnership issues Schedule K-1s to its partners and reports the partners’ distributive share of partnership income or loss. The difference between amounts reported on Schedule K-1 and amounts that should be reported pursuant to ASC 740 would represent unrecognized tax benefits.

Additionally, a reporting entity may have investments in other entities that are taxable as corporations and are also accounted for under the equity method of accounting. While the entity is not required to separately report uncertain tax positions of the equity method investee, it should consider analyzing any significant uncertain tax positions that may exist in the investee to ascertain whether those positions
could affect its investment in the equity method investee. Disclosures of significant uncertainties that may affect the corporate investor’s accounting for its equity investments may be appropriate.

16.2.2.3 Uncertain Tax Positions Relating to Temporary Differences

Uncertain tax positions relating to temporary differences do not generally affect the aggregate amount of taxes payable over time; however, they can generate an economic benefit by delaying the tax payment. An example of such a position is the appropriate period of depreciation or amortization for an asset, or the appropriate fiscal year in which a clearly permissible deduction should be taken. Historically, some entities may have only accrued a liability for the interest (and possibly the penalty exposure). They may not have further analyzed the sustainability of the position because disallowance would merely result in the conversion of a deferred tax liability into a current tax payable. ASC 740 requires that such an analysis be performed at each reporting date, and ASC 740-10-55-111 through 55-112 prescribes the separation of the associated deferred tax balance into (1) the deferred tax balance based on the sustainable book/tax difference on each reporting date, pursuant to ASC 740’s recognition and measurement model, and (2) a liability for any unrecognized benefit. Section TX 16.3.2.9 provides specific examples of how to calculate deferred taxes and liabilities for unrecognized tax benefits for uncertainties relating to temporary differences.

**PwC Observation:** The identification, assessment, and tracking of all material uncertainties surrounding temporary differences might substantially increase the effort needed to apply ASC 740 and thus may require entities to employ more processes and control mechanisms.

16.3 Recognition

16.3.1 Unit of Account

**Excerpt from ASC 740**

**ASC 740-10-25-13:**
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.

The unit of account defines the level at which a tax position should be analyzed. A tax exposure could have multiple elements or parts that are interrelated with varying implications on the expected tax benefits. Therefore, the selection of a unit of account (i.e., the appropriate level of disaggregation) can affect the amount of tax benefit that may be recognized in the financial statements.
For many tax exposures, the selection of the appropriate unit of account is intuitive (e.g., company-wide cost of meals and entertainment in a taxing jurisdiction). However, for some tax exposures, such as a special deduction for qualified domestic manufacturing activities or transfer pricing, determining a unit of account can be a complex exercise that involves a number of different factors (e.g., different jurisdictions, activities, characteristics of the benefits).

The Board decided not to provide definitive application guidance on these questions, stating that facts and circumstances specific to each entity and position should be considered and that no single defined unit of account would be applicable to all situations. However, ASC 740-10-25-13 indicates that at least two factors should be considered in all situations: (1) the manner in which the entity prepares and supports its tax return and (2) the anticipated level at which the taxing authority will address issues during an examination. Therefore, to determine the appropriate unit of account, management should consider the tax return computation of a deduction, credit, or income generated by the position, including the workpapers, schedules, and technical analysis that support the calculation. An entity should also consider the audit approach that a taxing authority might take when examining the position and the entity’s audit experience related to the same or a similar position.

**Exhibit 16-1: Determining the Unit of Account**

**ASC 740-10-55-83 through 55-86**

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.

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.

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.
PwC Observation: To determine the proper unit of account, we believe that an entity should also reference the level of disclosures in the return and associated schedules, and consider its past experience with the relevant taxing authorities. Further, the significance of the exposure in relation to the overall tax return should affect the determination of the appropriate level of aggregation. A position that results in a tax return benefit that is significant within the context of the entity’s operations or key measures might suggest that a more disaggregated analysis should be performed.

16.3.1.1 Consistency in a Tax Position’s Unit of Account

Once a unit of account for a given tax position has been determined, it should be applied consistently to that position from period to period, unless changes in circumstances suggest that a change in the analysis is warranted. Factors that might prompt management to change its assessment of the appropriate unit of account include, but are not limited to, changes in organizational structure and level of activity, changes in product line or service offering, changes in regulatory environment, and experience with the taxing authority. These types of changes would be characterized as a change in estimate.

Exhibit 16-2: Change in the Unit of Account

ASC 740-10-55-88 through 55-89

Assume that the facts outlined in Exhibit 16-1 are also true for this exhibit.

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.

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.
**PwC Observation:** The determination of the appropriate unit of account, a task that relies heavily on the use of professional judgment, can significantly impact the level of liabilities required. For example, if in year 1, the entity had determined that the unit of account for its $1 million research and experimentation credit (R&E) should be at the individual cost level (as it did in year 2), some of the costs related to project 4 (for which it was determined that the recognition threshold had not been met) might have been recognizable in year 1. Determining an uncertain tax position's unit of account should be a key focus of management when it is developing processes and policies that will enable it to meet the requirements of ASC 740.

### 16.3.1.2 Consideration of Offsetting Positions

The unit of account of a particular tax position should be based on an individual tax position's own information, facts, and technical merits. The possibility of offset in the same or another jurisdiction and the possibility that the position might be part of a larger settlement should not affect the determination of the unit of account.

### 16.3.1.3 A Single Unit of Account for Multiple Transactions That Are Similar

An entity may have multiple transactions or positions that are similar and likely to be evaluated in aggregate by the relevant taxing authority. In certain cases, management’s assessment might support one unit of account for all of the transactions combined (e.g., the unit of account is 50 similar transactions analyzed as one).

Accepting a single unit of account is possible if management, using professional judgment, concludes that the transactions are substantially the same in terms of (1) the expected tax benefits, (2) the relevant technical issues and uncertainties, and (3) the approach that a taxing authority will take during an examination (i.e., a portfolio approach). While evaluating the tax positions under a portfolio approach, a taxing authority may reject certain positions as a means of settlement because they are precluded from negotiating a settlement on an individual position. Still, as long as the related positions are substantially the same, the unit of account would be all of the transactions combined, and measurement would consider the settlement of the positions under a portfolio approach. Accordingly, the positions would be measured in aggregate, even though the expected taxing authority approach may involve disparate resolutions of individual positions in order to achieve an aggregated outcome that is consistent with the taxing authority’s discretion.

### 16.3.1.4 Unit of Account for Multiple Transactions That Are Dissimilar

An entity may take positions with respect to multiple transactions that require a separate unit of account for each transaction. If all of the positions meet the requirements for recognition, but the taxing authority’s settlement approach is expected to aggregate the positions (i.e., a portfolio approach), a key question arises: Can a single, combined unit of account be used for measurement if separate units of account were used for the recognition assessment?

As stated above, we believe that the unit of account should be the same for recognition and measurement of a tax position. When the appropriate unit of account is determined to be the individual transaction, the individual transaction is identified as a tax position for ASC 740 purposes, and the recognition and measurement steps should be applied to that discrete position. A taxing authority’s portfolio approach...
to settlement can be viewed as another possible outcome in a range of possible outcomes to be used in the measurement analysis of the greatest amount of tax benefit that is more-likely-than-not to be sustainable for each individual transaction.

For example, assume that a research credit has five individual tax positions that all meet the recognition threshold and are expected to be settled using a portfolio approach. The taxpayer expects to receive 80 cents on the dollar for those five positions in aggregate. Under this approach, 80 percent of each individual position would be separately recognized (i.e., each position is expected to be settled under a portfolio approach at 80 percent of the benefit taken on the tax return). This is acceptable if there is evidence to suggest that the relevant taxing authority has accepted such a settlement approach in the past.

### 16.3.2 Recognition Threshold for Uncertain Tax Positions

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<thead>
<tr>
<th>Excerpt from ASC 740</th>
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<tbody>
<tr>
<td><strong>ASC 740-10-25-6:</strong></td>
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<td>An entity shall initially recognize the financial statement effects of a tax position when it is more-likely-than-not, based on the technical merits, that the position will be sustained upon examination. The term more-likely-than-not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. 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>
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| **ASC 740-10-25-7:** |
| In making the required assessment of the more-likely-than-not criterion: |
| 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. |
| 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. |
| c. Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions. |
The tax positions identified in the above process will result (in one form or another) in a lower current or expected tax burden for the entity. The question then becomes one of recognition: When, if ever, should the tax return benefit (or expected tax return benefit) be recognized for financial reporting purposes? The following principles should be employed when assessing the recognition of the benefits from an uncertain tax position.

16.3.2.1 More-likely-than-not Recognition Threshold

For a position to qualify for benefit recognition under ASC 740-10-25-6, the position must have at least a more-likely-than-not chance of being sustained based on its technical merits, if challenged by the relevant taxing authorities and taken by management to the court of last resort.

In deciding whether a tax position meets the recognition threshold, an entity must assume that the taxing authority has full knowledge of the position and all relevant facts available as of the reporting date. That is, an entity must be able to conclude that the tax law, regulations, case law, and other objective information regarding the position's technical merits sufficiently support the sustainability of the position's benefits with a likelihood that is greater than 50 percent (this does not include a consideration of detection or examination risk).

If an entity decides that a particular position meets the more-likely-than-not recognition threshold, the entity essentially asserts its belief that it is entitled to the economic benefits associated with a tax position. If management cannot reach this conclusion, none of the tax benefit provided by the position can be currently reflected in the financial statements.

Management should consider a wide range of possible factors when asserting that the more-likely-than-not recognition threshold has been met. The entity's processes should ensure that all relevant tax law, case law, and regulations, as well as other publicly available experience with the taxing authorities, have been considered.

A tax position that is supported by little authoritative guidance or case law may still have a more-likely-than-not chance of being sustained (and, thus, of being recognized) based on facts, circumstances and information available at the reporting date. The absence of specific authoritative guidance or case law does not automatically preclude a more-likely-than-not determination. Rather, other sources of authoritative tax law, although they do not specifically address the tax position, could be relevant in concluding whether a position meets the more-likely-than-not recognition threshold.

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Example 16-2: The Meaning of the Term “Court of Last Resort” as Used in ASC 740-10-55-3

Background/Facts:
State A has enacted a tax law that utilizes a nexus model, which subjects Company B to income taxes in State A. Based on the tax law as currently written in State A, Company B cannot meet the more-likely-than-not recognition threshold of ASC 740-10-25-6 based on its technical merits. However, Company B believes that it is more-likely-than-not that the tax law enacted by State A would be overturned by the U.S. Supreme Court (if heard), based on the constitutional grounds of state tax law based on an economic nexus model. Company B’s view is supported by a competent legal analysis.

(continued)
In determining whether the recognition criteria is met, ASC 740-10-55-3 states that “The recognition threshold is met when the taxpayer (the reporting entity) concludes that, consistent with paragraphs ASC 740-10-25-6 through 25-7 and ASC 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.” Company B believes that the court of last resort would be the U.S. Supreme Court, as this is the highest court that could potentially hear its case.

Question(s):

Question #1
Should Company B consider the U.S. Supreme Court to be the court of last resort, even though it is unlikely that the Supreme Court would ultimately agree to hear the case?

Question #2
Should Company B factor the state tax law being overturned by the U.S. Supreme Court into its application of the recognition step?

Analysis/Conclusion:
The conclusions provided below have been developed based on informal guidance provided by the FASB staff.

Question #1
Yes. Because, in this fact pattern, the U.S. Supreme Court is the highest court that has discretion to hear a case surrounding the constitutionality of an enacted state law, Company B’s conclusion that it is the court of last resort is appropriate. ASC 740-10-25-6 states that “the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any.” Since the litigation process would include the ability to appeal whether a tax law conflicts with a higher level law, that appeal and the resultant outcome should be considered in assessing compliance with the more-likely-than-not criterion for initial recognition. As a result, when determining the appropriate court of last resort as part of ASC 740-10-25’s recognition step, companies should focus on identifying the highest court that has discretion to hear the specific case in question, even though that court may not ultimately hear the case.

Question #2
Yes. In considering the litigation process, Company B would include an assessment based on the technical merits of whether the issue is in conflict with federal law. As a result, the technical analysis of whether State A’s tax law would be overturned by federal law should be considered in assessing the more-likely-than-not recognition criteria.

Given the number of cases that are filed with the U.S. Supreme Court, a question arises as to whether or not Company B would need to assess the likelihood of its case ultimately being heard by the court of last resort in the recognition step. We believe that a denial of a request for a hearing by the court of last resort is considered company specific and not dispositive of the technical issue in question. Therefore, while the court of last resort may deny a request to hear a company’s case, the denial would not affect another company’s previous conclusion regarding whether its tax position met the recognition threshold. Our view is supported by the FASB staff’s view that Company B should not factor this assessment into the recognition step, but should instead consider it within the context of the measurement step. That is, the

(continued)
individual probabilities for determining the greatest amount of tax benefit that has a greater than 50 percent probability of being realized should consider the likelihood that the U.S. Supreme Court will agree to hear the case. We would generally expect companies arguing that a state tax law is unconstitutional to record only a tax benefit associated with that tax position if the cumulative probability of a settlement with the state taxing authority is greater than 50 percent. Therefore, if the state tax jurisdiction is unwilling to settle the tax position with the company and it is less than 50 percent likely that the U.S. Supreme Court will hear the case, the company may need to establish a liability through application of the measurement step for the entire unrecognized tax benefit.

PwC Observation: Determining whether the recognition threshold has been met and identifying how to appropriately measure qualifying positions (Section TX 16.4) is often a highly fact-dependent task that requires a considerable reliance on professional judgment. Two entities with similar positions might reasonably arrive at different conclusions, depending on which factors management believes are relevant and how those factors are weighted. Management should ensure that its judgments and estimates are reasonable and that the underlying internal control processes are reliable.

16.3.2.2 Sources of Authoritative Tax Laws

Sources of tax authority that should be considered in determining whether an uncertain tax position meets the recognition threshold under ASC 740-10-25 vary depending on the jurisdiction (federal, state, or foreign) within which a tax position arises. In general, relevant sources include statutes (including the underlying legislative intent), regulations, certain taxing authority rulings, case law, and treaties. For U.S. federal income tax purposes, those authorities in general include, but are not limited to, the following:

- Internal Revenue Code (IRC) and other statutory provisions.
- Regulations interpreting such statutes.
- Revenue Rulings, Revenue Procedures, Notices, and Announcements.
- Tax treaties and regulations thereunder and Treasury Department and other official explanations of such treaties.
- Court cases.
- Congressional intent as reflected in committee reports, joint explanatory statements and floor statements made by one of the bill’s managers.
- General explanations of tax legislation prepared by the Joint Committee on Taxation (the “Blue Book”).
- Internal Revenue Service information or press releases.
- Pronouncements published in Internal Revenue Bulletins.
- Private Letter Rulings (PLRs), Technical Advice Memoranda (TAMs), Chief Counsel Advice, Field Service Advice, and similar documents.

When determining whether recognition has been satisfied, consideration should be given to the weight of the particular authorities cited in relation to the weight of authorities supporting contrary treatment and the authorities’ relevance,
persuasiveness and the types of document providing the authority. Also, an authority does not continue to be an authority to the extent that it is overruled or modified by a body with the power to overrule or modify the authority.

In the U.S., when a tax position arises in a state or local jurisdiction, Public Law (P.L.) 86-272, which governs state nexus requirements in interstate commerce, and any similar federal laws governing interstate commerce are considered authoritative, in addition to the particular state’s tax statutes and regulations. When a tax position arises in a foreign jurisdiction, continental business and tax legislation (e.g., the European Union Directives that govern taxation of cross-border flow of, among other things dividends, royalties, and interest within member states) may, depending on the jurisdiction, also be considered authoritative.

In addition, certain rulings and agreements if issued to the taxpayer by the taxing authority would typically form the basis for meeting the recognition threshold, provided the decision therein is favorable to the taxpayer and if the facts and representations that form the basis of the ruling are complete and accurate. These authorities include, for example:

- Private Letter Rulings or a Technical Advice Memorandum.
- Advance Pricing Agreements (APAs), which are entity-specific transfer pricing agreements with the taxing authority.
- Competent Authority resolution, which is a formal agreement between the taxing authorities of two countries interpreting provisions in a bilateral income tax treaty for the elimination of double taxation applicable to entity-specific facts and circumstances.
- Pre-filing agreements.

As it relates to taxpayers who were not a party to the ruling or agreement, such rulings/agreements are generally not binding on the taxing authority and are of more limited authority.

16.3.2.3 Tax Opinions and External Evidence

Management will also have to determine whether the entity has sufficient internal resources to appropriately assess an uncertain tax position or whether the entity will need support from third parties to make this assessment (e.g., opinions from external tax advisors).

ASC 740-10-25-6 acknowledges that 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.”

Whether management decides to obtain a tax opinion to affirm the sustainability of a position based on its technical merits depends, among other things, on the significance (i.e., the nature and complexity) of a tax position taken or expected to be taken on a tax return. A large number of tax positions will have clear support in the tax law and will not require substantial documentation efforts to satisfy the recognition assessment. For example, the deductibility of certain noncash expenses might not relate to whether the taxpayer is entitled to the position, but to the amount of benefit and the appropriate tax period(s) (i.e., measurement). However, there will also be a number of positions that require management to expend a significant amount of time and energy gathering evidence in support of its more-likely-than-not assertion.
Where appropriate, management should document its conclusion, including the information and factors considered, how those factors were weighted, and which factors might be particularly susceptible to change. Those factors most susceptible to change should be monitored closely.

An entity that obtained a more-likely-than-not opinion from an outside tax advisor in an earlier financial reporting period may need to consider the relevancy of the opinion to the current-period assessment and whether the tax opinion needs to be reissued. As stated above, ASC 740-10-25 does not require a more-likely-than-not tax opinion for determining whether a tax position meets the technical merits of a tax law. However, in certain situations, a more-likely-than-not opinion may need to be obtained. In those circumstances, if there has been no change to the relevant tax laws or other relevant factors/information that existed at the time when the tax opinion was first written and upon which the opinion is based, the opinion letter would not need to be reissued. If, however, new information or developments that could affect the position become available, and/or changes in tax laws, regulations, and interpretations that might affect the position have occurred since the time at which the original opinion was written, a new or updated opinion may be necessary.

PwC engagement teams are required to consult with Assurance Risk Management within PwC’s National Professional Services Group in situations where an outside tax advisor has provided the client with a written analysis or opinion, and the client is proposing either to limit our access to the complete, un-redacted material or to restrict what we may require for documentation.

16.3.2.4 Examination by Taxing Authority (Detection Risk)

ASC 740-10-25-7 and ASC 740-10-30-7 require an entity to assume, in assessing both recognition and measurement, that an uncertain tax position will be discovered by a taxing authority and that the taxing authority will examine the position with access to all relevant facts and information using resources that have sufficient experience and expertise in the area of tax law creating the uncertainty. ASC 740’s recognition and measurement guidance requires entities to presume that a taxing authority has full knowledge of a position, even if the entity has no history of being examined by taxing authorities or the chance of the taxing authority actually identifying the issue (if it were to conduct an audit) is remote.

16.3.2.5 Administrative Practices and Precedents

The assessment of sustainability is based on the technical merits of the position, including consideration of “administrative practices and precedents” (ASC 740-10-25-7(b)). Administrative practices and precedents represent situations in which a tax position could be considered a technical violation of tax law. However, it is widely known, well understood, and a consistent practice of the taxing authority (with full knowledge of the position being taken) to nonetheless accept the position. When asserting that a particular administrative practice or precedent is applicable to a particular tax position, an entity should presume that the taxing authority will examine the position using the same information that is available to the entity.

While administrative practices and precedents do not need to be sanctioned by taxing authorities in formal regulation or letter ruling, it should be clear (through the taxing authorities’ well-known past actions or declarations) that a tax position is more-likely-than-not to be sustained (if examined), despite its apparent conflict with the enacted tax law. Unless it becomes known that the taxing authority will no longer accept a particular administrative practice, preparers should consider these practices.
in forming their conclusions as to whether a position has satisfied the recognition threshold.

Exhibit 16-3 describes an administrative practice related to asset capitalization.

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**Exhibit 16-3: Administrative Practice Related to Asset Capitalization**

**ASC 740-10-55-91 through 55-92**

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.

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.

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**PwC Observation:** We believe that, in certain cases, the consideration of widely understood administrative practices in the recognition or measurement step is an appropriate means of achieving relevant financial reporting. That said, use of the administrative practices and precedents accommodation must be limited and considered only if a tax position might be deemed a technical violation of the tax law or if there is compelling evidence that the taxing authority has and is expected to accept the tax position as an administrative accommodation.

We can foresee situations in which a particular agent or examiner within a taxing authority has historically accepted a position that is generally not accepted by other agents auditing other taxpayers in similar businesses. Regardless of how a particular agent has treated an item in the past, the recognition step requires that tax positions be evaluated on the technical merits of the position when assessing recognition under ASC 740-10-25-7. The historical action of one agent or examiner would not represent a consistent administrative practice that is "widely understood" and hence would not generally be relevant in determining whether the recognition threshold is met.

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**16.3.2.5.1 Administrative Practices and Precedents Available to Entities That Self-report**

Many jurisdictions offer amnesty programs or limit the tax they assess in past periods for taxpayers that have voluntarily come forward and admitted noncompliance in previous years. However, the administrative practice or precedent that may be
available to self-reporting entities for nexus-related issues may not be available to those entities that fail to come forward and are subsequently identified by the taxing authority. Accordingly, it would not be appropriate for an entity that has no intention of coming forward to consider an administrative practice made available to those that do come forward, unless there is substantial evidence that both types of taxpayers will be treated the same way by the taxing authority.

The same concept may also apply to REITs and regulated investment companies (RICs) which have uncertain tax positions that could affect their qualification for special treatment under the relevant tax law. These specialized entities can often cite experience with taxing authorities and describe how those authorities have historically handled inadvertent, self-reported disqualifying events that could have led to the entity’s disqualification as a REIT or RIC. However, entities with no intention of self-reporting cannot rely on administrative practices or precedents related to the taxing authorities’ historical treatment of self-reporting entities. Entities with no intention of self-reporting can only rely on the taxing authorities’ practices for handling disqualifications identified during an audit, and only if those practices are widely understood and consistently applied.

16.3.2.5.2 Nexus-Related Administrative Practices and Precedents

In general, an entity may have some form or combination of legal, structural, or commercial ties to a jurisdiction (e.g., employees, inventory, fixed assets, commissioneer arrangements, contract manufacturing arrangements, and others). An entity with such ties could potentially have nexus, and would therefore be required to file a tax return under the tax laws of the relevant jurisdiction. ASC 740-10 defines a tax position in part as “A decision not to file a tax return.” Absent an applicable administrative practice, a nexus position (i.e., a decision not to file a tax return in a particular jurisdiction if nexus potentially exists) that does not meet ASC 740-10-25-5’s recognition threshold would require the accrual of tax, interest, and penalties for the entire period in which nexus could be asserted by the taxing authority.

However, as a matter of administrative convenience, some jurisdictions have limited the number of years for which an entity would be required to file back tax returns. Under ASC 740-10-25-7, that practice should be considered in management's decision to record tax, interest, and/or penalties.

ASC 740-10-55-94 through 55-95 provide the following example about the use of administrative practices and precedents within the context of nexus.

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**Exhibit 16-4: Administrative Practices Related to Nexus Positions**

**ASC 740-10-55-94 through 55-95**

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...

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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.

16.3.2.5.2.1 Application of Administrative Practices to U.S. State Jurisdictions

In many U.S. state jurisdictions, we understand that state and local tax experts would commonly agree that states only seek back taxes for a defined period of time if the number of open years is significant and if a reasonable position can be asserted by the taxpayer that nexus did not exist and that fraud was not present. Yet, although the practice of limiting years of assessment is widely known, the period of assessment that a respective taxing authority will ultimately choose is not. That determination is often made only after the taxing authority has considered the individual facts and circumstances of a specific taxpayer.

When a taxing authority has a history of assessing tax on a limited number of years and when that practice is widely understood, we believe that an administrative practice and precedent (as described in ASC 740-10-25-7) exists. For example, if state tax experts agree that a range of years (depending on the taxing authority's assessment of the facts and circumstances) reflects the taxing authority's practice with respect to the period of assessment, an administrative practice exists. Further, we believe that there is a rebuttable presumption that the upper limit of such a range should be considered the relevant administrative practice. Use of a data point that is from the low end, and not the high end, of the range would require convincing evidence as to why an entity's fact pattern warrants this consideration. The following example illustrates the application of administrative practices in a U.S. state scenario.

Example 16-3: Application of U.S. State Administrative Practices

Background/Facts:
Assume that a state jurisdiction has an administrative practice of limiting the assessment of taxes to three to six years if nexus within that jurisdiction is unclear. However, if nexus is clear, it is widely understood that the taxing authority will assess taxes for up to ten years.

Analysis/Conclusion:
In evaluating whether a tax return should have been filed for any of those years, we believe that each tax year would represent a separate unit of account. That is, each year should be separately analyzed to determine whether a tax return should have been filed and whether a tax exposure exists for that year. In making this determination, an entity would consider the relevancy of a taxing authority's administrative practices.

If convincing evidence causes an entity to conclude that nexus within that jurisdiction was unclear, the entity should recognize the assessment of income taxes on a rolling six-year basis. Further, if the entity believes that its tax exposure is less than six years (e.g., three years), it would need to have convincing evidence in support of that view. This rationale should not include the entity's ability to negotiate with the taxing authority. Rather, the position should be consistent with a widely understood practice for assessing the tax exposure at the lower end of the range for the particular circumstance (e.g., based on limited activity within the taxing jurisdiction).
16.3.2.6  **Assessing Recognition When Potentially Offsetting Positions Exist**

ASC 740-10-25-7 requires that each tax position be evaluated on, among other things, its own information, facts, and technical merits, without consideration of the possibility of offset or aggregation of other. For instance, a corporation must separately assess for recognition each known, significant uncertain tax position, even if the corporation expects that it will prevail on one position because it expects to settle another related tax position.

16.3.2.7  **Assessing Recognition When Potentially Indirect Benefits Exist**

A liability recorded for one position may cause a tax benefit to be recognized on another position. The resulting indirect benefit of the latter position should not affect the need to separately assess the recognition of a liability on the first tax position. For example, an uncertain tax position taken in a foreign jurisdiction must be separately assessed for recognition of a liability, even though the resulting liability would give rise to a foreign tax credit (FTC) benefit in the parent jurisdiction. The example below discusses the accounting for indirect effects (i.e., benefits) arising in a jurisdiction that is not the same jurisdiction in which the liabilities arise.

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**Example 16-4: Federal Effects of Unrecognized Tax Benefits Related to State Taxes**

**Background/Facts:**
Company A, a public entity, has taken an uncertain tax position in State X that reduces taxes payable (or increases a tax refund receivable) by $100. In assessing the uncertain tax position under the recognition and measurement criteria of ASC 740, Company A has determined that it is more-likely-than-not that the position, based on its technical merits, will be sustained upon examination. In performing the measurement step in ASC 740-10-30-7, Company A determined that $60 is the largest tax benefit that is greater than 50 percent likely to be realized upon ultimate settlement with the taxing authority. Therefore, Company A has recorded a liability of $40 for the unrecognized tax benefit in State X.

If Company A is ultimately required to make an additional payment of state taxes, it will receive an additional federal tax deduction, the benefit of which is expected to be fully realized under the recognition and measurement principles of ASC 740.

**Question:**
Should Company A record an asset for the federal tax deduction related to the liability on an unrecognized tax benefit in State X?

**Analysis/Conclusion:**
Yes, Company A should record a deferred tax asset (or potentially a current tax receivable depending on the facts and circumstances) for the federal indirect benefit from the potential disallowance of the uncertain tax position in State X. Assuming that the federal tax rate is 35 percent, the following journal entries would be made to account for the uncertain tax position and the indirect tax benefit:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Income Tax Expense</td>
<td>Cr Liability for Unrecognized Tax Benefit (State) $40</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Dr Deferred Tax Asset (Federal indirect tax benefit) $14</td>
<td>Cr Income Tax Expense $14</td>
</tr>
</tbody>
</table>

(continued)
The deferred tax asset associated with the indirect federal benefit should not be used
to offset the liability on the state tax exposure, as discussed in the last sentence of
ASC 740-10-45-11. This conclusion is also supported by ASC 740-10-45-6, which
indicates that tax assets and liabilities related to a particular tax-paying component
and within a particular tax jurisdiction should not be offset. In addition, the
unrecognized tax benefit related to the state exposure should be included on a gross
basis (i.e., not net of the federal benefit) in the annual tabular reconciliation required
by ASC 740-10-50-15A(a).

Further, the tax exposures in one jurisdiction should be evaluated separately from the
indirect benefit in another tax jurisdiction, as the accounting for the tax exposure in
one jurisdiction will not necessarily correlate to the benefit from the other jurisdiction.
For example, a valuation allowance on the indirect benefit or a change in tax laws/
rates in either of the jurisdictions may be needed. Additionally, the related interest in
one jurisdiction may be different from the interest in another jurisdiction.

16.3.2.8 Uncertainties Regarding Valuation

For tax positions where the uncertainty is based solely on a transaction’s value
(e.g., transfer pricing, value of goods donated, etc.), we believe that the recognition
threshold has been met if it can be concluded that some level of tax benefit in
the year in which the transaction occurred meets the more-likely-not recognition
threshold. If the recognition threshold is met, the uncertainty associated with the
transaction’s valuation should be addressed as part of measurement. For example,
an entity may donate shares in a privately held company to a charity and claim a
tax deduction. If the entity’s deduction is certain (based on the position’s technical
merits), the tax benefits can be recognized. However, the deduction amount may be
uncertain because of complexities surrounding the appropriate fair market value of
the donated shares. In the measurement step (discussed in Section 16.4), the entity
should consider this valuation uncertainty in determining the greatest amount of tax
benefit that is sustainable.

16.3.2.9 Timing Differences

Chapter TX 3 discusses temporary differences. As explained in Chapter TX 3, ASC
740 defines a temporary difference as the difference between the tax basis of an
asset or liability computed pursuant to the requirements in ASC 740-10 for tax
positions and its reported amount in the financial statements. ASC 740’s recognition
and measurement criteria is applicable to temporary differences between book and
tax bases, even if the only uncertainty is the timing of the position taken for tax
purposes. For example, assume that an entity deducts (for tax purposes) the entire
balance of an intangible asset in the year of an acquisition. For book purposes, the
entity amortizes the intangible asset over five years (this consequently leads to a
defered tax liability). While the ultimate deduction of the asset is certain under the
relevant tax law, the timing related to whether the deduction can be taken in full in
the year of the acquisition is uncertain.

At the AICPA National Conference on Current SEC and PCAOB Developments held
on December 11-13, 2006 (AICPA Conference), the FASB staff stated that uncertain
tax positions that relate only to timing (i.e., when an item is included on a tax return)
should be considered to have met the recognition threshold for the purposes
of applying ASC 740-10-25-5. Therefore, if it can be established that the only
uncertainty relates to the tax period(s) in which an item is taken on a tax return, it can
be concluded that the positions have satisfied the recognition step for the purposes
of applying ASC 740-10-25 and any uncertainty related to timing should be assessed as part of the measurement step.

It is our understanding, based on discussions with the FASB staff, that ASC 740-10-55-110 through 55-116 should be used to understand the intent of the standard pertaining to timing-related uncertainties. These paragraphs indicate that timing-related uncertainties meet the recognition threshold because those items will ultimately be deductible.

For example, assume that an entity had a bonus accrual and took a deduction on the current-year tax return, even though the bonus accrual was not paid out within the appropriate time frame for it to be considered a current-year deduction from a tax law perspective. Presumably, the entity would be able to conclude that the amounts are ultimately deductible (when paid) and, as such, would meet the recognition threshold. In the FASB staff’s view, the entity would not need to evaluate whether there was a basis within the tax law to accelerate the deduction on the tax return for purposes of applying the recognition step under ASC 740-10-25-5. Rather, an entity would need to determine the largest tax benefit that is cumulatively greater than 50 percent likely to be realized for the purposes of recognizing the amount of tax benefit in the financial statements. Nonetheless, in assessing the various outcomes and related probabilities as part of the measurement step, we believe that entities will need to consider the technical merits of the relevant position(s), particularly if those positions have not been settled with the taxing authority in the past.

**PwC Observation:** Because neither “timing differences” nor “permanent differences” are explicitly defined in ASC 740, we believe that there is the potential for confusion in this area. For example, consider an impairment loss reported for financial reporting purposes that will be deductible on a future tax return, but may only be realizable by the entity if it is considered an ordinary loss (and not a capital loss). Some may be inclined to argue that, in accordance with the FASB staff’s view, this constitutes a “timing-related” exposure. However, in our view, it is more appropriate to first assess whether the character of the loss (capital vs. ordinary) satisfies ASC 740-10-25-5’s recognition threshold.

The following example illustrates how ASC 740 recognition and measurement can affect the calculation of deferred taxes (Note that this example is based on the concept illustrated in ASC 740-10-55-110 through 55-112, which are included in Section TX 16.4 of this chapter).

**Example 16-5: Recognition of Timing-Related Uncertain Tax Positions**

**Background/Facts:**
Company A incurs $100 in repairs and maintenance expenses. For financial statement purposes, Company A expenses the costs in the year during which it incurs the costs. In addition, Company A plans to take the entire $100 as a deduction on its current-year tax return. However, Company A concludes that only $25 of the deduction meets the recognition threshold and measurement criteria in the current year. That is, Company A believes that the largest benefit that is greater than 50 percent likely to be realized is straight-line amortization over four years. Therefore, if the as-filed tax position (i.e., the full deduction claimed in the current-year tax return)
is not sustained, Company A would be entitled to the remaining $75 of deductions over the next three years. Company A is a profitable taxpayer in the current year, and has a 40 percent tax rate in this jurisdiction.

**Question:**
How should Company A compute its liability for unrecognized tax benefits and calculate its deferred taxes?

**Analysis/Conclusion:**
The measurement and calculation of temporary differences and deferred taxes are based on the difference between the tax basis of an asset or liability computed pursuant to ASC 740’s recognition and measurement criteria and its reported amount in the financial statements. For financial reporting purposes, Company A has no book basis in the asset because it fully expensed the associated costs. Yet, Company A does have a tax basis computed under ASC 740, although it deducted the entire cost on the current-year tax return. The tax basis computed under ASC 740 is $75 (i.e., the cost of $100 less the current-year recognized tax benefit of $25). At the reporting date, Company A has a $75 deductible temporary difference, which is the difference between the tax basis computed under ASC 740 (or $75) and the book basis (or zero). Company A would record the following journal entry:

<table>
<thead>
<tr>
<th>Dr Income Taxes Payable</th>
<th>$40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Current Income Tax Benefit</td>
<td>$10</td>
</tr>
<tr>
<td>Cr Liability for Unrecognized Tax Benefit</td>
<td>$30</td>
</tr>
</tbody>
</table>

The journal entry above records (1) the reduction of a $40 income taxes payable for the $100 maintenance deduction ($100 at a 40 percent tax rate), (2) a current tax benefit for the tax effect of the deduction taken on the tax return that meets the recognition and measurement criteria of ASC 740 ($25 at a 40 percent tax rate), and (3) a liability for the tax effect of the amount deducted on the tax return that did not meet the recognition and measurement criteria of ASC 740 ($75 at a 40 percent tax rate).

The following additional journal entry records the deferred tax asset (DTA) for the expected future deductible amount associated with the repairs and maintenance costs ($75 at a 40 percent tax rate) as determined pursuant to ASC 740’s recognition and measurement criteria (i.e., straight-line amortization over four years, with three years remaining as of the end of the current year).

<table>
<thead>
<tr>
<th>Dr Deferred Tax Asset</th>
<th>$30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Deferred Income Tax Benefit</td>
<td>$30</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Financial Statement Presentation</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Repairs and Maintenance Expense</td>
</tr>
<tr>
<td>Current Tax Benefit</td>
</tr>
<tr>
<td>Deferred Tax Benefit</td>
</tr>
<tr>
<td>Total Tax Benefit</td>
</tr>
<tr>
<td>Deferred Tax Asset</td>
</tr>
<tr>
<td>Liability for Unrecognized Tax Benefit</td>
</tr>
</tbody>
</table>

Finally, Company A would also need to consider whether interest should be accrued on the liability for the unrecognized tax benefit.
16.3.2.10 Amended Returns and Refund Claims

Although an uncertain tax position is most commonly associated with a tax reserve or the decrease of a tax asset, it can also be associated with cases that result in an increase of a tax asset (e.g., a tax receivable recorded as a result of the filing or the intent to file an amended return).

An entity may be in the process of preparing amended returns to claim refunds on taxes paid in prior periods, but may be unable to file the amended returns before the end of the accounting period or before it files the current-period financial statements. If this is the case, all significant tax positions expected to be included in the amended returns or refund claims should meet the recognition threshold before the expected tax benefit (i.e., the refund receivable) can be recognized in the financial statements.

There may be instances in which an entity’s expectations and intentions regarding an amended return or refund claim are unclear. Such situations may require the use of professional judgment to determine whether, or to what extent, the amended return or refund claim is within the scope of ASC 740’s recognition and measurement criteria.

ASC 740 is applicable to all tax positions that were included on previously filed returns and are expected to be included on returns that have not yet been filed (e.g., amended returns or refund claims that have not yet been filed). The timing of the filing of a tax return is irrelevant, as long as a tax position taken or expected to be taken ends up on an original, amended, or so-called “protective” return.

Therefore, when a refund claim or an amended return fails the requirement for recognition, the expected tax benefit (i.e., refund receivable) cannot be recognized in the financial statements. A refund receivable that is recognized in the financial statements in a prior period, but is determined to fail the recognition threshold in the current period would be derecognized in the financial statements (i.e., the tax receivable asset would be eliminated or reversed). That is, because the recognition threshold has not been met, nothing would be recognized in the balance sheet for this refund claim. However, the amount of the refund claim would still be included as an unrecognized tax benefit in the disclosures required under ASC 740-10-50-15.

Moreover, courts in some jurisdictions require payment of taxes in question as a prerequisite to petition the court. In the past, some entities may have viewed the potential recovery of such amounts as a gain contingency under ASC 450 and may have consequently expensed any amounts paid. However, it should be noted that ASC 740 applies to this type of tax payment. If the taxpayer’s position meets the recognition threshold (and no reserve is required in the measurement step), the taxpayer should record an asset for the prepaid tax and accrue interest income (if applicable).

Furthermore, in the U.S., during an IRS examination, taxpayers may present claims for additional tax benefits that were not reported on the original tax return under examination. Such claims generally arise from new information that was not available when the original return was filed. The IRS policy allows for claims to be directly submitted without requiring the filing of an amended return. However, documentation supporting the basis for the claims and the resulting impact on tax liability must be presented to the IRS during the examination process.
Such claims constitute tax positions subject to ASC 740’s recognition and measurement principles. If the application of ASC 740 would result in no or partial benefit being reported for the claims, an uncertain tax benefit must be disclosed in the rollforward tabular reconciliation until the tax benefits can be recognized or the statute closes. The disclosure requirement begins when a taxpayer decides to present claims for additional tax benefits (refer to Section TX 15.5 for additional discussion on disclosure requirements for uncertain tax benefits).

16.3.2.11 Interaction with Valuation Allowance Assessment

The recognition of an additional tax liability as a result of an uncertain tax position and its impact on deferred taxes must be distinguished from the assessment of the need for a valuation allowance under ASC 740-10-30-16 through 30-25. The recognition of a liability for an unrecognized tax benefit stems from uncertainty about the sustainability of a tax position taken or expected to be taken on a tax return. The recognition of a valuation allowance stems from uncertainties related to whether taxable income will prove sufficient to realize sustainable tax positions. That is, uncertainties about sustaining tax positions relate to whether a tax liability or deferred tax asset exists. Uncertainties about sufficient taxable income relate to the realization of recorded deferred tax assets. Therefore, valuation allowances may not be used to reserve for uncertain tax positions.

Example 16-6: Establishing a Liability Upon Adoption of the ASC 740 Guidance for Unrecognized Tax Benefits When a Company Has a NOL with a Valuation Allowance

Background/Facts:
Company A is a non-public entity that has a full valuation allowance on all of its deferred tax assets, including its NOL. On January 1, 2009, the company adopted the ASC 740 guidance for unrecognized tax benefits and appropriately determined that certain tax positions do not meet the recognition and measurement thresholds. As a result, the company recognized a liability of $1,000. The company did not take these tax positions in the years in which the NOLs were created, but instead it took these tax positions, which relate to the liability, in years that generated taxable income (i.e., taxable income before NOL utilization). Accordingly, the company recorded the liability separately from the DTA associated with the NOLs (i.e., gross, as opposed to net, of the NOL-related DTA). Upon adoption, Company A also determined that $1,000 of the valuation allowance on existing DTAs will no longer be necessary because the incremental taxable income would be a source of income for the existing DTAs if the tax position is not sustained.

Question:
How should Company A account for the release of the valuation allowance on its existing deferred tax assets due to the creation of a liability for the unrecognized tax benefits upon adoption?

Analysis/Conclusion:
In general, the release of the valuation allowance caused by the establishment of the liability should be accounted for as part of the adoption process as an adjustment
to beginning retained earnings. This means that there will not be a net effect to retained earnings because the reduction in opening retained earnings associated with establishing the liability will be offset by an increase in opening retained earnings associated with the release of the valuation allowance. This accounting is consistent with ASC 740-20-45-11(a), which states, in part, that tax effects such as “adjustments of the opening balance of retained earnings for certain changes in accounting principles” should be charged or credited directly to the related components of shareholder’s equity.

There is, however, an exception to this general approach if the valuation allowance was originally established in a business combination (i.e., if it relates to acquired NOLs or temporary differences) or in a reorganization subject to “fresh start” accounting under ASC 852 Reorganizations. In these instances, we believe that the release of a valuation allowance, even though it is a direct effect of the change in accounting principle, is subject to “backwards tracing” pursuant to ASC 740-20-45-3 (i.e., as an adjustment to the acquisition accounting or reorganization accounting).

Although ASC 805 amended the guidance for subsequent changes in valuation allowances and uncertain tax positions related to prior business combinations, the pre-ASC 805 guidance was still applicable as of December 31, 2008. The cumulative-effect adjustment upon adoption of the ASC 740 guidance for unrecognized tax benefits should be the difference between the net amount of assets and liabilities recognized in the statement of financial position as of December 31, 2008, prior to the application of the guidance and the net amount of assets and liabilities recognized as a result of applying the guidance. Therefore, the guidance that was in effect prior to adoption of ASC 805 should be considered.

When determining the amount of valuation allowance to release, companies should also consider whether the NOLs were the result of windfall tax benefits (e.g., from stock options accounted for prior to the effective date of ASC 718). In this circumstance, the amounts would need to reduce taxes payable before any valuation allowance reversal can be recognized (as discussed in ASC 718-740-25-10). That is, in the case of NOLs that represent windfall tax benefits, even though the offsetting income from the uncertain tax position would constitute a source of income for the NOL, no valuation allowance reversal could be recorded until such NOLs were utilized currently on a tax return.

It should be noted that the accrual of interest on the liability for the unrecognized tax benefit may prove unnecessary to the extent that increased tax on positions that are unsustainable can be offset by existing NOLs.

**16.3.2.11.1 Tax-Planning Strategies**

<table>
<thead>
<tr>
<th>Excerpt from ASC 740</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASC 740-10-30-20:</strong> 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.</td>
</tr>
</tbody>
</table>
If an entity uses a tax-planning strategy (as defined in ASC 740-10-30-19) that is considered to be a possible source of future taxable income, the entity must apply ASC 740's recognition and measurement criteria to the tax-planning strategy to determine whether the expected tax consequence can be recognized in the financial statements. Tax-planning strategies that, based on their technical merits, do not meet the more-likely-than-not recognition threshold upon examination cannot be used to reduce the valuation allowance on deferred tax assets. Only a tax-planning strategy that meets the more-likely-than-not recognition and measurement criteria should be considered a source of future taxable income in a valuation allowance assessment (ASC 740-10-55-98).

16.4 Measuring the Tax Benefit to Be Recorded

Excerpt from ASC 740

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 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).

After concluding that a particular filing position has a more-likely-than-not chance of being sustained, ASC 740-10-30-7 requires that an entity measure the amount of benefit to be recognized using a measurement methodology that is based on the concept of cumulative probability. Under this methodology, the amount of benefit recorded represents the largest amount of tax benefit that is greater than 50 percent likely to be realized upon settlement with a taxing authority that has full knowledge of all relevant information.

The analysis that needs to be performed and the level of documentation that needs to be created will vary based on the significance and complexity of the issue, as well as the degree of perceived uncertainty in the tax law. In some cases, this may require entities to develop a cumulative probability table. In other cases, this may not be necessary. Whether documentation is considered sufficient will depend on whether one can conclude, based on existing documentation, that the benefit recorded is the outcome that represents the largest amount of tax benefit that is greater than 50 percent likely to be realized upon effective settlement.

PwC Observation: Depending on an entity's profile, this analysis could prove to be a significant undertaking for preparers who must perform the analysis with enough precision to meet the requirements of ASC 740. It may also pose challenges for tax advisors, who often advise management in areas that require the use of judgment, and auditors, who must assess management's judgments/estimates and the underlying internal control process.
16.4.1 The Cumulative Probability Approach

ASC 740 does not define “cumulative probability,” however, the term is included in the measurement examples provided in ASC 740-10-55-102 through 55-107. When more than two outcomes may alternatively resolve an uncertain tax position (i.e., resolution may occur other than on an “all-or-nothing” basis), the measurement step requires that each potential outcome be assigned a probability to determine the greatest amount of tax benefit whose probability of being realized is greater than 50 percent.

The outcome that provides the greatest tax benefit should be assessed first. If that outcome’s individual probability is greater than 50 percent, the individual probabilities of the remaining less beneficial outcomes need not be considered. The measurement step is concluded because the greatest amount of benefit was obtained from the most favorable outcome. Alternatively, if the individual probability of the greatest tax benefit is less than 50 percent, the next most beneficial outcome should be assessed. If that outcome’s individual probability coupled with the individual probability of the greatest tax benefit is greater than 50 percent, the second most beneficial outcome should be selected for measurement. If the cumulative probability of the second most beneficial outcome is not greater than 50 percent, the entity should continue the process until the probability of the selected outcome (added to the more beneficial outcomes previously assessed) is greater than 50 percent on a cumulative basis.

The concept of cumulative probability is best understood through an example that is similar to the example provided in ASC 740-10-55-102 through 55-104. Assume that a tax return includes a position that results in an as-filed benefit of $100. The position is considered to be more-likely-than-not sustainable based on its technical merits and thus meets the requirement for recognition.

<table>
<thead>
<tr>
<th>Amount of the “As Filed” Tax Benefit Sustained</th>
<th>Individual Probability of a Particular Outcome</th>
<th>Cumulative Probability that the Tax Position Will Be Sustained</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>$75</td>
<td>20%</td>
<td>60%</td>
</tr>
<tr>
<td>$50</td>
<td>15%</td>
<td>75%</td>
</tr>
<tr>
<td>$25</td>
<td>15%</td>
<td>90%</td>
</tr>
<tr>
<td>$0</td>
<td>10%</td>
<td>100%</td>
</tr>
</tbody>
</table>

In this case, $75 is the amount of tax benefit that would be recognized in the financial statements because it represents the largest amount of benefit that is more than 50 percent likely to be sustained upon settlement, based on the outcome’s cumulative probability.

16.4.1.1 Calculation of Individual Probability and Possible Outcomes

There is no prescribed method for determining the individual probability of each possible outcome. By necessity, such assessments will require management to exercise judgment. Probabilities can be based on factors such as (1) the perceived weight of the tax law in the taxpayer’s favor, (2) the extent of precedent of the tax law being applied to the particular position or transaction, (3) expectations regarding how aggressively the taxing authority might pursue a particular position or, alternatively, its willingness to reach a negotiated compromise, and (4) the entity’s willingness
to defend the position in tax court (as opposed to conceding to a negotiated compromise to avoid the hazards of litigation). In the latter case, comparable and resolved exposures that the entity or similar entities have experienced will often be relevant to the development of measurement estimates and the assignment of individual probabilities. In this regard, it is expected that a history of negotiating and settling the same or similar tax positions would provide strong evidence in support of individual probabilities.

Furthermore, while all potential outcomes should be considered to determine possible measurement outcomes and their individual probabilities (e.g., litigation, negotiated compromise, etc.), detection risk cannot be considered. That is, measurement must be performed under the assumption that the taxing authority has full knowledge of the uncertain tax position.

16.4.1.2 Consideration of Past Audit Experience

A taxpayer’s past audit results can be considered in measuring the most likely amount of tax benefit that can be recorded for an uncertain tax position. If past audit results are the consequences of negotiation and settlement between a taxpayer and a taxing authority, for measurement purposes, the recent settlement of the same or similar position can be considered a reliable indication of the expected tax benefit that will be sustained on an audit of the same or a similar tax position, as long as no new information has arisen to suggest that the previously negotiated outcome would no longer be acceptable (ASC 740-10-55-109). That said, a taxpayer's history of negotiating and settling with a taxing authority on the same or similar tax positions is only one source from which expected outcomes may be derived.

A taxpayer's unique experience and resolution of a tax position with a taxing authority generally cannot be viewed as an acceptable administrative practice and precedent for the purposes of meeting the recognition threshold in ASC 740-10-25-6, unless the treatment is “widely understood” by other taxpayers (e.g., taxpayers in the same industry). Using past negotiations and settlements with a taxing authority as a “widely understood” practice for recognition purposes should not be confused with relying on past experience with the taxing authority, which remains a viable source from which possible outcomes may be derived for measurement (i.e., assuming that a particular position satisfies the recognition threshold).

Furthermore, a taxpayer’s lack of or limited audit history should not be taken into account when determining the expected outcome for measurement of a recognized tax benefit. As discussed previously, ASC 740-10-25-7 prohibits consideration of detection or tax examination risks. Therefore, when determining expected outcomes, a taxpayer must assume that the taxing authority has full knowledge of the uncertainty, even if a taxpayer has limited (or no) audit history demonstrating that a taxing authority will ultimately examine uncertain positions taken by the taxpayer. When a taxpayer has limited or no audit experience, other taxpayers’ experience with negotiating and settling the same or similar positions can be used as a source of expected outcomes. Relevant law (e.g., statute, regulations, rulings, case laws, etc.) that provides an indication as to the expected amount of tax benefit that may be sustained can also be used as a source of expected outcomes.

16.4.1.3 Use and Documentation of Cumulative Probability Table

Although ASC 740-10-30-7 requires the consideration of a range of possible outcomes, as well as their individual and cumulative probabilities (when appropriate), it does not mandate the use of cumulative probability tables (i.e., using a format that
is the same or similar to the format included in ASC 740-10-55-103 and reproduced in Section TX 16.4.1 of this chapter). As explained below, some tax positions that meet the requirement for recognition may have one expected outcome that is clearly more than 50 percent likely to be sustained if challenged by the relevant taxing authority. A cumulative probability table for measuring such positions would not be needed to determine the greatest amount of tax benefit that can be recorded.

A circumstance that may not require a cumulative probability table, for example, is measurement of a tax position after settlement of a similar position. This is illustrated in ASC 740-10-55-109:

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.

**PwC Observation:** The example in ASC 740-10-55-109 assumes that the taxing authority will provide the same settlement options for future audit cycles. In practice, however, a position should be continually reassessed for any new information (e.g., changes in tax laws, regulations, or rulings) that may have an impact on the entity’s assessment of the relevance of the prior settlement.

However, if various outcomes are reasonably possible and if the tax-benefit amount that straddles the more-likely-than-not cumulative probability is not readily apparent, it might be appropriate to develop a cumulative probability table.

**PwC Observation:** It is important to note that a virtually identical tax position could be measured differently by two different preparers based solely on management’s appetite for risk and willingness to compromise. For example, an entity might determine that if it is challenged, it would litigate the tax position until it is ultimately sustained and the individual probability of sustaining the full amount of the benefit is greater than 50 percent likely. In that fact pattern, the entity would record the full amount of the benefit. However, another entity might believe that upon challenge, it would be willing to settle for 80 percent of the tax benefit. That entity would record 80 percent of the benefit for that tax position, assuming that expectation of settlement for this amount is greater than 50 percent likely.

### 16.4.1.4 Highly Certain Tax Positions

The tax treatment of certain tax positions is based on clear and unambiguous tax law. For these positions, the amount of benefit that is expected to be sustained is near certain. ASC 740-10-55-99 refers to these positions as highly certain tax
positions. The measurement of highly certain tax positions in the financial statements represents the amount of benefit either expected to be claimed or actually claimed in the tax return. The following example is taken from ASC 740-10-55 and illustrates the measurement of a highly certain tax position.

**Exhibit 16-5: Measurement of Highly Certain Tax Positions**

**ASC 740-10-55-100 through 55-101**

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.

**16.4.1.5 Binary Tax Positions**

A taxing authority may not always be willing (or in certain cases legally permitted) to accept a compromise on a position. Additionally, there may be positions taken by an entity that are so significant (e.g., status of the entity) that the entity cannot negotiate with the taxing authority. This subset of uncertain tax positions are considered binary. This means there are two possible outcomes:

1. If the position is sustained, the entire as-filed tax return amount (i.e., 100 percent of the benefit) will be accepted.
2. If the position is lost upon challenge, none of the as-filed tax return amount (i.e., zero benefit) will be accepted.

That is, the expected tax benefit of an uncertain tax position that has a binary outcome is either sustained or denied in its entirety. When a binary tax position qualifies for recognition, the measurement of the largest amount of tax benefit would generally cause 100 percent of the expected benefit (i.e., the as-filed amount) to be recorded.

**16.4.2 Measurement and Transfer Pricing**

Certain situations, such as transfer pricing, might produce a number of different outcomes. Absent a reasonable number of comparable and resolved exposures that the entity or similar entities have experienced, there might not be sufficient information to develop a probability assessment of every possible outcome. Yet,
the entity must develop and support a conclusion as to which possible outcome represents the one that provides for the greatest benefit that has a greater than 50 percent cumulative probability of being sustained. The assignment of probabilities to a particular outcome is not an exact science. This exercise depends heavily on the facts and circumstances that are specific to the particular transaction in question, management’s experience and knowledge of the tax authority’s position on particular transactions, and the experience and knowledge of industry peers with respect to settlements and strategies. Consideration should be given to the requirement to defer tax consequences in accordance with ASC 740-10-25-3(e) when an uncertain tax position relates to an intra-entity transfer of assets (see Section TX 16.5.6.1).

As mentioned in Section TX 16.3.1.2, entities measuring the amount of an uncertain tax position should evaluate any offsetting transaction separately on a gross basis, and record the corresponding tax payable (or receivable) on a gross basis on the balance sheet. Uncertain tax positions related to transfer pricing are no exception. Specifically, unrecognized tax benefits from one jurisdiction may not be netted against a deferred tax asset or potential tax overpayment receivable from another jurisdiction. Interest calculations for the respective tax liabilities and assets should also be performed on a separate jurisdictional basis.

PwC Observation: Transfer pricing professionals can help entities identify the factors that should be considered by sharing their experience and knowledge of settlements with respect to a particular transaction in that geography or industry. However, it is management’s responsibility to determine the individual probabilities of alternative outcomes.

16.4.2.1 Contemporaneous Documentation

The existence of contemporaneous documentation, which covers an entity’s intercompany transactions, is not sufficient to conclude that there are no uncertain tax positions associated with intercompany transactions. Contemporaneous documentation typically helps determine whether an entity appears to have met the standards of reasonableness with respect to transfer pricing penalties as set forth in IRC Regulation §1.6662-6, but does not determine the likelihood that a position will be sustained, whether a particular position has a greater than 50 percent cumulative probability of being sustained, or whether there are particular alternative outcomes that might be asserted by the respective taxing authorities.

Accordingly, entities may need to consider alternative transfer pricing methods or profit-level indicators in their analysis of alternative settlement positions. The best method for transfer pricing documentation is not necessarily the only method that should be considered. The best method analysis contained in transfer pricing documentation may describe only why an entity did not choose other methods (and should be protected from penalty exposure). Entities may need to review other methods and their respective results more closely.

16.4.3 Interrelationship of Measurement and Recognition

Generally, the individual and cumulative probabilities that are considered relevant to the measurement step would not have a direct impact on the recognition step. Once a tax position has satisfied the more-likely-than-not requirement for recognition, the position should be evaluated to determine the measurement of the largest amount of tax benefit that can be recorded in the financial statements. However, when the tax benefit amount that is recorded under the measurement step is insignificant
in relation to the total position taken or expected to be taken on a tax return, the more-likely-than-not conclusion reached in the recognition step may need to be reevaluated.

16.4.4 The Implications of “Should” Level Tax Opinions

The recognition and measurement of a tax position are two separate steps in the ASC 740 accounting model. A tax opinion issued by outside counsel or another tax service provider can constitute external evidence supporting management’s assertions in relation to the recognition of a tax position. A tax opinion (with no significant caveats) that concludes that a tax position should be sustained may indicate that the recognition threshold has been met, but may not be sufficient to justify recording 100 percent of the expected tax benefit, especially if the opinion addresses the sustainability of the position without identifying the amount that can be sustained. Furthermore, if an entity knows or has reason to believe that the relevant taxing authority expects some concession and the entity does not intend to litigate, it would suggest that less than 100 percent of the expected tax benefit might be the largest amount of benefit that has a cumulative probability greater than 50 percent, notwithstanding the existence of a should level opinion.

16.5 Changes in Recognition and Measurement in Subsequent Periods

Excerpt from ASC 740

ASC 740-10-25-8:
If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

a. The more-likely-than-not recognition threshold is met by the reporting date.

b. The tax position is effectively settled through examination, negotiation, or litigation.

c. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

Accordingly, a change in facts subsequent to the reporting date but prior to the issuance of the financial statements shall be recognized in the period in which the change in facts occurs.

ASC 740-10-25-9:
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.

(continued)
ASC 740-10-25-10:
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.

ASC 740-10-25-11:
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.

ASC 740-10-25-12:
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 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.

ASC 740-10-25-14:
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.

(continued)
ASC 740-10-40-2:
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.

ASC 740-10-40-3:
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.

ASC 740-10-40-2:
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.

ASC 740-10-40-3:
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.

The assessment of an uncertain tax position is a continuous process, which does not end with the initial determination of a position's sustainability. As of each balance sheet date, unresolved uncertain positions must be reassessed. Management must determine whether the factors underlying the sustainability assertion have changed and whether the amount of the recognized tax benefit is still appropriate.

ASC 740-10-25-14 specifically states that an uncertain tax position does not need to be legally extinguished nor does its resolution need to be certain to be recognized, derecognized or measured. Furthermore, ASC 740-10-25-14 requires that changes in the expected outcome of an uncertain tax position be based on new information, and not on a mere reevaluation of existing information. New information can relate to developments in case law, changes in tax law, new regulations issued by taxing authorities, interactions with the taxing authorities, or some other development. Such developments could potentially change the estimate of the amount that is expected to eventually be sustained or to cause a position to cross over the recognition threshold (i.e., either the position's sustainability becomes more-likely-than-not or the position ceases to meet the recognition threshold).

New information would exist if management's previous evaluation was fully informed and based on all relevant facts and if, in the intervening period, legislative developments or developments in case law gave rise to the different interpretation of outside counsel. New information requires a new judgment on whether the recognition threshold has been met.

The following example illustrates a fact pattern whereby an entity is evaluating whether a proposed settlement with the taxing authority provides new information.
Example 16-7: Consideration of a Tentative “Global” Settlement with a Taxing Authority in Measuring Uncertain Tax Positions

Background/Facts:
Company A has multiple uncertain tax positions, all of which have been assessed under ASC 740. Some tax positions met the recognition threshold of ASC 740, while other positions did not. The individual tax positions are not similar, nor interdependent. Positions that did not meet the recognition threshold were fully reserved (i.e., no benefit has been recognized). The taxing authority is conducting an audit of three years in which the positions were taken.

The Company has been in negotiations with the taxing authority and, as of the end of the current reporting period, the parties have reached a tentative “global” settlement agreement. The agreement would settle all positions within the three tax years under examination, and close out the audit for those years. While the Company believes they have reached an agreement with the taxing authority’s examination team, the agreement is subject to another level of governmental review before it becomes final and binding.

Company A determined that the additional level of review is substantive, and could result in the agreement being changed or withdrawn (by either party). As a result, the Company determined that the uncertain tax positions that have not met the recognition threshold are not considered “effectively settled” as described in ASC 740-10-25-10. In addition, no new information came to light during the examination process that would cause Company A to change its assessment of the technical merits of any of the individual uncertain tax positions. Therefore, no adjustment will be made to the tax positions that have not met the recognition threshold.

Question:
For positions that have met the recognition threshold, should Company A adjust its measurement of the related benefit of those positions based upon the tentative global settlement agreement?

Analysis/Conclusion:
It depends. Company A must determine whether the proposed global settlement changes their assessment of the expected outcome for each tax position that has met the recognition threshold. In making this determination, the Company should consider its expected course of action, and related expected outcome, if the global settlement proposal is withdrawn or changed in the review process.

While ASC 740-10-25-14 requires companies to continually remeasure tax positions “based on management’s best judgment given the facts, circumstances, and information available at the reporting date,” subsequent changes must be based on “new information.”

In this case, Company A determined that the global settlement proposal was merely a part of the on-going examination and negotiation procedures and that it did not constitute “new information” that changed their assessment of the outcome of any individual tax position. Negotiations with the taxing authority appear to have been conducted on a global basis which aggregated all positions, rather than on an individual position-by-position basis. Consequently, the Company concluded there was no new information with respect to any of the individual tax positions that caused management to change their previous assessment (i.e., no adjustment to the measurement of the related benefit is necessary).
16.5.1 Considering the Impact of a Jurisdiction's Dispute-Resolution Process

In addition to monitoring developments in the technical merits of a position, entities must monitor the progress of the dispute-resolution process to determine whether a tax position is effectively settled through examination, negotiation, or litigation.

There may be phases in the taxing authority’s examination process that provide new information, which would result in recognition or remeasurement of a tax position or, in some cases, de-recognition of a previously recognized tax position. Entities must also consider this key question: Is recognition of tax benefits or remeasurement of previously recognized tax benefits appropriate when a tax examination is closed, even if the relevant statute of limitation for assessing taxes is still open? This determination is critical because, in many cases, a taxing authority completes its examination of a tax year before the statute of limitations expires.

16.5.2 Effective Settlement of a Tax Position

In analyzing whether a tax position meets the three conditions of ASC 740-10-25-10 (as referenced above) and can therefore be considered effectively settled, the following key considerations should be noted:

- A tax position not specifically examined: As stated in ASC 740-10-25-11, a tax position does not need to be specifically reviewed or examined by the taxing authority during the examination of a tax year in order for it to be considered effectively settled through examination.

PwC Observation: In cases where the position has not been specifically reviewed or examined by the taxing authority, additional judgment may be necessary to conclude whether the likelihood that the taxing authority would subsequently examine the position is remote. It is also important to remember that this conclusion must be reached under the presumption that the taxing authority has full knowledge of all relevant information.

- Completion of examination and other procedures: When evaluating the requirement of ASC 740-10-25-10(a), a unique challenge may arise with respect to NOL and tax credit carryforwards. To illustrate, assume that a U.S. entity generated an NOL carryforward of $500 on its tax return for a particular year, but only $400 of that amount was recognizable in the financial statements because of an uncertain tax position that totaled $100. The uncertain position is not examined by the IRS in the subsequent examination, and the examination is later closed. In this case, it is unlikely that the entity would be in a position to conclude that the unrecognized benefit of $100 was effectively settled upon closure of the examination for the year in which the NOL first arose. This is because the IRS not only has the ability to examine or reexamine the positions that led to the generation of NOL and tax credit carryforwards, but in many cases will examine or reexamine those positions when assessing whether a benefit from the utilization of those items should be allowed on a future year’s tax return. The IRS can perform the reexamination even if the year in which the items were generated was already subjected to examination and the statute of limitations for the year of generation has since expired. Other jurisdictions may have the same or a similar ability based in tax law, regulations, or judicial doctrine.
Remote likelihood of reexamination: Evaluating whether the requirement of ASC 740-10-25-10(c) has been met is likely to involve the most difficult judgments. This is due in part to the differing practices of taxing authorities and to the lack of experience that entities may have in evaluating these practices. Entities may find it particularly difficult to evaluate whether it is remote that the taxing authority would examine or reexamine the position (assuming that the taxing authority has full knowledge of all relevant information).

PwC Observation: We understand that the meaning of the term “remote” as used in this context is intended to be consistent with the use of the term as defined in ASC 450-20-25-1 (i.e., “the chance of the future event or events occurring is slight”).

ASC 740-10-40-3 requires the continuous reevaluation of tax positions that were already determined to be “effectively settled.” An entity should reevaluate a tax position that was “effectively settled” if the entity believes that a taxing authority may examine or reexamine a tax position, or if the entity intends to appeal or litigate any aspect of the tax position. Under these circumstances, the tax position would no longer be considered “effectively settled.”

ASC 740-10-25-12 acknowledges that an entity may obtain information during an examination that would enable it to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. However, the fact that a position has been effectively settled for a given year should not be used as a basis for concluding that similar tax positions taken in future years can be recognized. For example, consider an entity that took a tax position for which a tax benefit was not recognized because it did not meet the ASC 740-10-25 recognition criteria. The fact that this position was effectively settled for a particular year does not constitute new information that would allow the entity to recognize the benefit from similar positions taken in subsequent years.

In many jurisdictions, the resolution process for a challenged tax position can potentially involve several stages and various government departments, each of which might be empowered to overturn or modify another department’s ruling. The appropriate stage in the resolution process that provides sufficient evidence for recognition of the reserved tax benefit is reached when an entity concludes that a tax position is “effectively settled.”

Under the U.S. federal income tax system, Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, is used upon completion of an IRS examination to indicate the taxpayer’s agreement with the revenue agent’s proposed adjustments and agreement to pay the deficiency. The Revenue Agent’s Report accompanies the Form 870. By signing the Form 870, the taxpayer waives the right to a notice of deficiency and thus permits the IRS to assess the tax immediately. In effect, this represents the closing of the IRS examination upon acceptance by the IRS. Generally, the IRS will only reopen a closed case if (1) there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact, (2) the closed case involves a clearly defined, substantial error based on an established service position existing at the time of the examination, or (3) other circumstances exist which indicate that a failure to reopen the case would be a serious administrative omission.
We would generally expect the closing of an IRS examination to constitute effective settlement of a position taken in the examined year(s) when not being appealed, other than cases involving continued governmental review (e.g., Joint Committee) or years in which there was no tax payable (e.g., NOL years). PwC engagement teams are encouraged to consult with the Accounting Services Group within PwC’s National Professional Services Group if it is concluded that effective settlement has not occurred other than in circumstances as described above.

The following discussions are based on our understanding of the U.S. federal income tax system. However, they can also be applied in concept to other taxing authorities.

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**Example 16-8: Impact of Closing an Appeal on Recognition**

The effectively settled guidelines may also affect the determination as to whether the recognition threshold is met for a tax position after an appeal. For example, an uncertain tax position that does not initially meet the recognition threshold is not measured, and a full liability for the expected benefit is recorded. The audit is closed and the tax position is examined by the IRS appeals division, which issues a Form 870-AD, *Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment*, related specifically to the position. Form 870-AD is used almost exclusively by Appeals and differs from Form 870. Specifically, Form 870-AD states that the case will not be reopened by the IRS unless, among other things, there was “fraud, malfeasance, concealment or misrepresentation of a material fact,” “an important mistake in mathematical calculation,” or “excessive tentative allowance of a carryback.”

We would generally expect the closing of an audit through a Form 870-AD would constitute effective settlement by having met the three conditions outlined in ASC 740-10-25-10.

In addition, an IRS review at the appeals level could provide new information to support initial recognition under ASC 740-10-25-10. The nature and extent of the IRS examination process at the appeals level may validate or strengthen the merits of the position. Accordingly, new information resulting from an appeals-level review could lead to the conclusion that the position is more-likely-than-not to be sustained based on its technical merits.

**PwC Observation:** Even if the tax position had not been examined, the likelihood that the IRS would challenge a position after receiving a Form 870-AD would generally be remote. The instructions for Form 870-AD make it clear that once the form is signed by both parties, the taxpayer will not reopen the respective tax year(s) and the IRS will only reopen the tax year(s) in very limited circumstances.

As illustrated in the following example, the unit-of-account for purposes of analyzing the requirements for effective settlement is a tax position and not the tax return period under audit.
Example 16-9: Determining when a Tax Position is “Effectively Settled” with the IRS

Background/Facts:
Company A has three uncertain tax positions (UTPs) in its 20X7 federal tax return; none of which met the more-likely-than-not recognition threshold under ASC 740-10-25-6. The individual tax positions are neither similar nor interdependent.

During 20X9, the IRS audited the 20X7 tax return. After specifically examining UTP1, in Q3 20X9 the examining agent informed Company A that there would be no adjustment to UTP1. The examination of UTP1 did not, however, yield any information that changed Company A’s view that the position failed the recognition threshold based upon its technical merits. UTP2 was not specifically examined.

The audit was concluded in Q4 with the issuance of the Revenue Agent’s Report (RAR) and Form 870 which disallowed only UTP3. Company A intends to appeal the disallowance of UTP3. The status of the UTPs is summarized as follows:

<table>
<thead>
<tr>
<th>UTP</th>
<th>Specifically Examined</th>
<th>Additional Information/Insight on Technical Merits</th>
<th>Revenue Agent Report Accepts UTP</th>
</tr>
</thead>
<tbody>
<tr>
<td>UTP1</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>UTP2</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>UTP3</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Question:
When can Company A assert “effective settlement” of UTP1 and UTP2?

Analysis/Conclusion:
Effective settlement of a tax position is dependent upon whether the facts and circumstances satisfy the three requirements in ASC 740-10-25-10.

UTP1:
To satisfy the first requirement, Company A should consider the respective taxing authority’s policies and procedures for completing an examination.\(^5\) The policy of the IRS indicates that an examination is closed when the examining agent presents written notification of either (1) adjustments to the company’s tax liability or (2) acceptance of the company’s tax return without change. Although the examining agent verbally indicated acceptance of UTP1 in Q3, the examination was not concluded until the RAR and Form 870 was issued in Q4. Since Company A does not intend to appeal or litigate any aspect of UTP1, the second requirement is satisfied.

In evaluating whether the third requirement has been met, Company A should consider the IRS policy and historical practices with respect to the appeals process. Specifically, Company A must assess whether there is a more than remote likelihood of the IRS reexamining UTP1 during the appeal of UTP3. The IRS policy for the appeals process is to resolve specific issues in dispute rather than extend the examination, absent unusual circumstances. The policy limits the circumstances in which a “new issue” may be introduced by the IRS during the appeals process. The

\(^5\) Policies, procedures and historical practices of taxing authorities should be considered at the relevant jurisdictional level (i.e., U.S. federal, U.S. state and local, foreign, etc.) in determining whether a position is effectively settled.
policy defines a new issue effectively as an issue not being appealed, and applies regardless of whether the issue was specifically examined. In effect, the appeals process policy is aligned with the IRS audit policy which provides that an audit will be reopened only in narrowly defined circumstances.\(^6\)

Unless Company A’s facts suggest circumstances which would support reopening an exam, in accordance with IRS policies, UTP1 would be effectively settled in Q4 20X9.

UTP2:

Similar to UTP1, the first and second requirements are satisfied with respect to UTP2 upon the issuance of the RAR in Q4. ASC 740-10-25-11 states that a tax position does not need to be specifically examined in order for it to be considered effectively settled. Thus, UTP2 could potentially be effectively settled in Q4 unless the likelihood of the IRS examining UTP2 during the appeal of UTP3 is more than remote. Similar to the above analysis of UTP1, UTP2 would also likely be considered effectively settled in Q4 20X9.

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**Example 16-10: Tax Audit under a “LIFE Exam” Program**

In the U.S. federal tax jurisdiction, certain entities may agree to participate in IRS tax audit programs that provide for exam scope pre-determination. In IRS audits, such programs are termed “Limited Issue Focused Exams” (LIFE exams). Although an uncertain tax position may initially meet the recognition threshold, the measurement process may result in less than the full benefit being recorded in the financial statements. Additionally, the position may not be included in the documented pre-determined scope.

Based on discussions with the FASB staff, if the recognition threshold is initially met, but only a partial benefit is recorded in the financial statements, the status of a tax examination should be considered in the reevaluation of the benefit measured. If the taxing authority provides an indication that the tax position will not be examined and that the examination will be limited to pre-agreed issues, then such an indication may be viewed as new information in support of a reevaluation of the measured benefit.

However, for the purposes of remeasuring the tax position, the entity must consider the status of the examination, as well as the likelihood that the taxing authority would challenge the position (assuming the taxing authority has all of the relevant information). That is, a company would remeasure the tax position if it is unlikely that the tax position would be challenged, even if the taxing authority were presented with all of the relevant information. It should be noted that the IRS is able to alter the LIFE exam scope because such an exam is considered a memorandum of understanding, not a legally binding agreement.

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**16.5.3 Other Considerations in the Tax Examination Process**

**16.5.3.1 Amended Return/Tax Receivable**

Section TX 16.3.2.10 discusses the application of ASC 740’s recognition and measurement criteria to refund claims. Generally, filing an amended return results in a tax receivable. When the filed, or expected to be filed, amended return includes

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\(^6\) Refer to Section TX 16.5.2.
an uncertain tax position, the recognition, derecognition, and remeasurement of the receivable should apply ASC 740’s recognition and measurement criteria. We believe that the threshold for the recognition of the associated tax benefit should be the same, regardless of whether the accounting entry results in a tax receivable, a decrease in a liability for an unrecognized tax benefit, or a current tax payable. However, obtaining the tax benefit might involve additional procedural steps (e.g., in the U.S. federal tax jurisdiction, approval by additional government authorities, such as the Joint Committee on Taxation that serves under the U.S. Congress), which might affect the risk that an advantageous lower-level decision could be reversed.

16.5.3.2 Competent Authority

Competent Authority (“CA”) resolution is a formal agreement between the taxing authorities of two countries interpreting provisions in a bilateral income tax treaty for the elimination of double taxation. A resolution by a CA is applicable to entity-specific facts and circumstances. Section TX 16.3.2.2 specifies that a CA resolution can be considered authoritative tax materials used in recognition. A CA resolution is handled by designated representatives of both countries who are charged with the task of clarifying and interpreting the provisions of international income tax treaties for the elimination of double taxation. Entities can invoke the CA process when they believe that the actions of the taxing authorities cause a tax situation that was not intended by a treaty between two countries (e.g., double taxation), or when they need specific treaty provisions to be clarified or interpreted. The fact that the CA has agreed with an entity’s position would presumably provide sufficient evidence to meet the recognition threshold. However, this might still be subject to further approvals in certain tax jurisdictions (e.g., the approval of the Joint Committee on Taxation for U.S. federal tax refunds over a defined amount).

16.5.3.3 Relevance of Resolution Experience to Future Periods

The resolution of an uncertain position in a given audit cycle should also be assessed for its relevance to future periods. For example, the resolution of an uncertain tax position in a given audit cycle might involve the new or additional interpretation (or clarification) by the taxing authority of the relevant authoritative tax materials and their applicability to the uncertain tax position. This new or additional information might provide evidence supporting the technical merits of a similar position in subsequent periods and therefore may allow recognition of a similar position pursuant to ASC 740-10-25-8(a). However, the resolution of an uncertain position in a given audit cycle may arise from an uncertain tax position that satisfies the three conditions that must be met to be considered effectively settled pursuant to ASC 740-10-25-10. In such circumstance, management’s assessment that the effectively settled conditions with respect to an uncertain tax position have been met in a given audit cycle does not provide any basis on which management may change its assessment of the technical merits of the same or a similar position taken in other periods (ASC 740-10-25-12). That is because the taxing authority may not examine the uncertain tax position in a given audit cycle (and thus may not provide any technical insight), even though the effectively settled conditions have been met in that audit cycle.

Additionally, the resolution might not provide any technical insight if it is the result of a negotiated settlement that involves many issues and so-called “horse-trading” without respect to the technical merits of the resolved position. Management will have to consider the factors that could change the taxing authority’s stance in subsequent periods (e.g., the level at which a resolution was reached, the substance of communication and argumentation during the resolution process, and the materiality and importance of the position relative to the tax return).
16.5.3.4 Entities Not Subject to Audit by a Taxing Authority

Although the Board clarified that finality of outcome is not required to recognize a benefit, the Board made its rejection of any consideration of detection risk equally clear. Hence, an entity that is not subject to the taxing authority’s audit and subsequent resolution process will have to delay recognizing a tax benefit that did not meet the recognition and measurement criteria of ASC 740 until the statute of limitations runs its course or until subsequent changes in the technical merits of the tax position permit a change in judgment about the position’s sustainability.

16.5.4 Subsequent Derecognition

ASC 740-10-40-2, states that a previously recognized tax position should be derecognized in the first period in which the position no longer meets the more-likely-than-not recognition threshold. New information resulting in derecognition must be considered and accounted for even if that derecognition results in a deferred tax asset that would require a valuation allowance to be recorded against it. As noted in ASC 740-10-40-2, the “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.”

16.5.5 Subsequent Events

Relevant developments occurring after the balance sheet date but before issuance of financial statements (which would include the discovery of information that was not available as of the balance sheet date) should be considered a nonrecognized subsequent event for which no effect would be recorded in the current-period financial statements. Only an explanatory disclosure of the event (if it is significant) is required.

Exhibit 16-6: New Information Received After the Reporting Date

ASC 740-10-55-118 through 55-119

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. Subsequent to the reporting date, but prior to the issuance of the financial statements, 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 (continued)
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.

**PwC Observation:** Entities will need to implement processes and controls that are specifically designed to identify all contemporaneous information relevant to material changes in the assessment of open positions on each balance sheet date. As with any other case in which an accounting decision might be affected by subsequent facts, management will need to carefully assess whether changes are the result of new information or information that was already available. We also expect that the requirement to regularly review the sustainability of all material positions and the measurement of associated tax benefits will require significant coordination between an entity’s tax and financial reporting personnel. Management should consider the potential financial reporting consequences of tax developments and should be aware of ASC 740-10-50-15's requirements regarding “early warning” disclosures.

### 16.5.6 Recording the Effects of Changes in Recognition and Measurement During the Year

**Excerpt from ASC 740**

**ASC 740-10-25-15:** 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.

**ASC 740-270-35-6:** 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.

When new information causes a change in judgment about recognition, derecognition, or a change in measurement of an uncertain tax position (including any related interest and penalty) that was taken in a prior year, the effect should be recorded discretely in the period in which the change in judgment occurs (ASC 740-10-25-15). Changes in judgment related to uncertain tax positions taken in a prior interim period but within the same current fiscal year are an integral part of an annual period, and should be accounted for in accordance with the principles of ASC 740-270-35. Section TX 17.1.1.4.1 includes a discussion about which tax effects are
included as part of the consolidated annual effective tax rate and which ones are recorded based on year-to-date activity.

16.5.6.1 Interaction with Intra-entity Transactions (ASC 740-10-25-3(e))

Certain aspects of an intra-entity transaction, such as transfer pricing, might result in uncertain tax positions taken by a company. Such uncertain tax positions should be recognized and measured in accordance with the guidance in ASC 740 similar to all other uncertain tax positions. However, as further discussed in Section TX 2.3.4, no immediate tax impact should be recognized in a company’s consolidated financial statements as a result of an intra-entity transfer of assets. As illustrated in the example below, this exception is also applicable to subsequent changes in the recognition and measurement of unrecognized tax benefits resulting from such transactions.

Example 16-11: Considering the Effects of Changes in Measurement of Uncertain Tax Positions When Accounting for Intra-entity Transactions Under ASC 740-10-25-3(e)

Background/Facts:
Company A is a multinational corporation that developed intellectual property (IP) in the U.S. In the previous year, the U.S. parent entered into an arrangement to transfer the IP to its foreign subsidiary in exchange for a lump sum payment. At the time that the arrangement was executed, the Company determined that there was no uncertainty in the tax position and therefore no liability for an unrecognized benefit was recorded. The Company accounted for the IP transfer as a sale of an asset and therefore deferred the taxes paid on its transfer under ASC 740-10-25-3(e). This deferred charge is being amortized over the economic life of the IP.

During a subsequent reporting period in which the deferred charge continues to be amortized, the IRS performs an audit of the IP transfer and challenges the valuation of the IP. As a result, the IRS contends that the taxes paid by Company A should have been greater.

Question:
Assuming a liability must be recorded as a result of new information arising from the IRS audit, should the amount of the unrecognized tax benefit be deferred pursuant to ASC 740-10-25-3(e)?

Analysis/Conclusion:
Yes. Pursuant to ASC 740-10-25-3(e) no immediate tax impact should be recognized in the financial statements as a result of intra-entity transfers of assets. This includes all taxes incurred by the seller including any unrecognized tax benefit associated with the transaction.

Similar to the tax the Company originally calculated on the transfer, the incremental tax effect of the uncertain tax position should also be deferred and amortized over the economic life of the IP. We believe that one acceptable approach would be to account for the additional tax charge through a cumulative catch-up adjustment. That is, the Company would adjust the remaining balance of the deferred charge to the amount that would have been recorded had the benefit been unrecognized the IP was originally transferred.
16.6 Interest and Penalties

Generally, taxing authorities assess interest on any underpayment of tax, but only assess penalties if a disallowed position fails to meet certain minimum thresholds of support.

16.6.1 Interest

Excerpt from ASC 740

ASC 740-10-25-56:
When the tax law requires interest to be paid on an underpayment of income taxes, an entity shall begin recognizing interest expense in the first period the interest would begin accruing according to the provisions of the relevant tax law.

ASC 740-10-30-29:
Paragraph 740-10-25-56 establishes the requirements under which an entity shall accrue interest on an underpayment of income taxes. The amount of interest expense to be recognized shall be computed by applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with the requirements of this Subtopic for tax positions and the amount previously taken or expected to be taken in a tax return.

As noted above, the Board believes that if a benefit claimed on a tax return does not qualify for financial reporting recognition, the benefit essentially constitutes a loan from the government and therefore results in an interest charge. Consequently, the Board concluded that the basis for an interest accrual should be the difference between the tax position recognized in the financial statements and the amount claimed (or expected to be claimed) in the tax return. The commencement of an interest accrual should be in accordance with the relevant tax law. For example, in the U.S. federal tax system, a calendar-year corporation generally starts accruing interest two and one-half months after the end of the tax year for which the position was taken on a tax return. Interest should be accrued each period prior to ultimate resolution of the uncertainty.

16.6.1.1 Interest Income on Uncertain Tax Positions

While ASC 740 does not reference interest income specifically, we believe that interest income related to uncertain tax positions should be accounted for in the same manner as interest expense. That is, interest income should be recognized over the time period in which it accrues under the applicable tax law.

Example 16-12: Recording Interest Income on a Transfer Pricing Tax Position

Background/Facts:
Assume that Company XYZ has taken a position related to transfer pricing. In Jurisdiction A, Company XYZ has recorded a liability for an unrecognized tax benefit for $100, and will record interest expense under ASC 740-10-25-56 at a rate of 5 percent per year. However, under competent authority between Jurisdiction A and

(continued)
Jurisdiction B, Company XYZ believes that it is more-likely-than-not that it will be able to amend its tax return for Jurisdiction B to reduce its taxable income for the related tax position that was not sustained in Jurisdiction A. In addition, Company XYZ would be entitled to interest income on the overpayment of tax for the amended return in Jurisdiction B at a statutory interest rate of 6 percent.

Analysis/Conclusion:
We believe that Company XYZ should record interest expense on the liability of $5 ($100 x 5%) in Jurisdiction A and also record interest income of $6 ($100 x 6%) in Jurisdiction B.

Example 16-13: Recording Interest Income on Overpayments of Tax

Background/Facts:
In applying the recognition criteria of ASC 740-10-25, Company A has determined that a tax position resulting in a $1,000 tax benefit qualifies for recognition and should be measured. After considering all relevant information, management believes that there is a greater than 50 percent chance that 100 percent of the benefit will be realized. To stop interest charges from accumulating in the event that it loses the issue, Company A makes a payment to the taxing authority for the $1,000. Under the laws of the jurisdiction in which this uncertainty exists, Company A will receive interest income from the taxing authority if the position is ultimately sustained.

Analysis/Conclusion:
Because $1,000 is the largest amount of benefit that is greater than 50 percent likely to be realized upon settlement, the $1,000 payment would be considered a pre-payment to the taxing authority and recorded as an asset. Given that the settlement of the amount recorded in the financial statements would entitle Company A to interest income on the $1,000 pre-payment, this interest income should be accrued by Company A.

PwC Observation: ASC 740 does not address the classification of interest income. We believe that it would be consistent to classify interest income and interest expense in the same manner as either a component of tax or a pretax income line item. Note that tax deposits are essentially equivalent to advance tax payments and therefore should not be included as an offset to unrecognized tax benefits in the annual tabular reconciliation disclosure.

Example 16-14: ASC 835-20 Capitalization of Interest Expense on the Underpayment of Income Taxes

Background/Facts:
Company A has taken an uncertain tax position that reduces taxes payable by $100. In assessing the uncertain tax position, Company A has determined that it is more-likely-than-not that the position, based on its technical merits, will be sustained upon examination. In performing the measurement step in ASC 740-10-30-7, Company A determined that $60 is the largest tax benefit that is greater than 50 percent likely to be realized upon settlement with the taxing authority. Therefore, Company A has recorded a $40 liability for the unrecognized tax benefit.
Company A has an ongoing significant capital project that was financed through the issuance of debt. A portion of this interest expense is being capitalized to the project under ASC 835-20. Company A is also required to accrue interest on the unrecognized tax benefit ($40 in this example) under the provisions of ASC 740-10-25-56. Further, in accordance with ASC 740-10-45-25, it has elected to classify the interest on the underpayment of income taxes as interest expense in the income statement.

**Question:**
Does ASC 835-20, require Company A to capitalize the interest expense on their liability for unrecognized tax benefit?

**Analysis/Conclusion:**
No. ASC 835-20-30-2 indicates that the amount of interest to be capitalized is the portion of interest cost that theoretically could have been avoided (by avoiding additional borrowings or paying down existing borrowings) if the expenditures for an asset had not been made. Interest costs arising from liabilities for unrecognized tax benefits are not borrowings contemplated by ASC 835-20. Rather, a liability for an unrecognized tax benefit is recognized for tax positions that do not meet the recognition and measurement criteria of ASC 740. In addition, the underlying liability is not treated as debt in other areas of the financial statements.

**16.6.2 Penalties**

<table>
<thead>
<tr>
<th>Excerpts from ASC 740</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASC 740-10-25-57:</strong></td>
</tr>
<tr>
<td>If a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 740-10-25-7), an entity shall recognize an expense for the amount of the statutory penalty in the period in which the entity claims or expects to claim the position in the tax return. If penalties were not recognized when the position was initially taken, the expense shall be recognized in the period in which the entity's judgment about meeting the minimum statutory threshold changes.</td>
</tr>
<tr>
<td><strong>ASC 740-10-40-5:</strong></td>
</tr>
<tr>
<td>A tax position that did not meet the recognition requirements of paragraph 740-10-25-6 may have resulted in the accrual of interest and penalties under the requirements of paragraphs 740-10-25-56 through 25-57. Previously recognized interest and penalties associated with tax positions that subsequently meet one of the conditions in paragraph 740-10-25-8 shall be derecognized in the period that condition is met.</td>
</tr>
</tbody>
</table>

In its deliberations, the Board considered whether penalties should be accrued in the period for which management expects to take a position that is below the applicable minimal statutory threshold to avoid penalties or, alternatively, whether penalties should be accrued in the period in which the entity files the tax return that reflects the position. Although only the filing actually creates a legal obligation, the Board concluded that it would be more appropriate to record a penalty in the period for which a tax position is expected to be taken.
PwC Observation: It is likely that the FASB’s conclusion will be considered academic in nature because entities generally will not be expected to take positions in a tax return that are below the statutory thresholds for avoiding penalties. The provisions are more likely to be relevant as the assessment about uncertain transactions and other exposures changes and as the sustainability decreases below (or increases above) such thresholds, at which time applicable penalties should be accrued (or reversed).

Example 16-15: Considering a Taxing Authority's Past Practices to Determine Whether a Tax Penalty Should Be Accrued

Background/Facts:
Company X has filed tax returns in Jurisdiction Y and has determined that after the application of ASC 740's recognition and measurement criteria, $100 of a tax benefit claimed on its tax return in Jurisdiction Y cannot be recognized for financial reporting purposes.

The relevant tax law in Jurisdiction Y provides for a 50 percent penalty assessment on any unpaid balance that exists after the original due date of the tax return (this amount is in addition to the requirement for interest to be paid on the unpaid balance). It is widely known that in Jurisdiction Y, the taxing authority routinely charges interest for underpayments, but historically has only assessed the 50 percent penalty if fraud is suspected or if the expectation that the tax position will be sustained based upon its technical merits is remote.

Company X has concluded that the tax position at issue did not constitute fraud and that the position has more than a remote chance of being sustained based on its technical merits.

Question:
How should Company X account for the penalty under the relevant tax law in Jurisdiction Y? Specifically, can ASC 740 be interpreted to infer a penalty threshold in a particular jurisdiction as a matter of administrative practice or precedent if such a threshold does not statutorily exist?

Analysis/Conclusion:
In this instance, the taxing authority appears to have established a de facto minimum statutory threshold for assessment through its historical administrative practice of not assessing the 50 percent penalty unless fraud is present or there is only a remote chance that the position will be sustained based on its technical merits.

ASC 740-10-25-57 states, “If a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 740-10-25-7), an entity shall recognize an expense for the amount of the statutory penalty in the period in which the entity claims or expects to claim the position in the tax return.”

Although it could be argued that the administrative practice accommodation as highlighted in ASC 740-10-25-7 should not be considered in deciding whether penalties should be accrued, it does not appear that the FASB contemplated situations where there is no stipulated minimum statutory threshold to avoid a penalty (e.g., certain jurisdictions outside the Unites States).
Consistent with ASC 740-10-25-7 which provides that “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,” we believe that the existence of a widely understood administrative practice in regard to penalties should be considered when applying ASC 740-10-25. By virtue of its practice of applying penalties in only instances of fraud and circumstances where the expectation of the tax position being sustained upon challenge is remote, the taxing authority has created a de facto minimum threshold for assessing penalties. Company X should consider this administrative practice when determining whether a position fails to meet an implied threshold to avoid a payment of penalties in Jurisdiction Y. Thus, under the fact pattern presented above, the 50 percent penalty should not be accrued because it is widely understood that Jurisdiction Y’s taxing authority will not assess the 50 percent penalty.

16.6.3 Accounting Policy Election for Classification of Interest and Penalties

Excerpt from ASC 740

740-10-45-25: Interest recognized in accordance with paragraph 740-10-25-56 may be classified in the financial statements as either income taxes or interest expense, based on the accounting policy election of the entity. Penalties recognized in accordance with paragraph 740-10-25-57 may be classified in the financial statements as either income taxes or another expense classification, based on the accounting policy election of the entity. Those elections shall be consistently applied.

ASC 740-10-45-25 gives entities the option, by means of an accounting policy election, to classify interest and penalties as components of either income tax expense or as part of pretax income, depending on the entity’s accounting policy. As a result, any change in classification for either interest or penalties would be treated as a change in accounting principle subject to the requirements of ASC 250, Accounting Changes and Error Corrections. If upon adoption of ASC 740’s guidance related to uncertain tax positions, an entity adopts a new financial statement classification of interest and penalties, it should disclose that it has adopted a new accounting principle and disclose its new policy for classification of interest and penalties. Because the FIN 48 transition provision precludes any form of retroactive application, financial statements for periods presented prior to adoption of FIN 48 should not be retroactively restated or reclassified to conform to the newly adopted accounting principle.

However, an entity should disclose its policy for the classification of interest and penalties for prior periods. If an entity has changed its classification policy, the entity should disclose (in its annual financial statements that include any period prior to adoption of the ASC 740 guidance related to uncertain tax positions) both the classification and amount of interest and penalties on uncertain income tax positions reflected in each income statement. If the entity cannot determine the amount of interest and penalties for periods prior to the adoption of the guidance due to its inability to disaggregate the interest or penalties portion of the accrual from the underlying tax exposure, it should disclose that fact.
At the AICPA conference, the SEC staff stated that they believe the accounting policy for interest and penalties should be applied consistently throughout the financial statements. That is, the policy should be applied consistently in the balance sheet, the income statement, the statement of cash flows, and any related disclosure requirements.

When the accounting policy election is to classify interest and penalties as “above the line” income statement items (i.e., included in pretax income or loss), the accrued balance sheet amounts should not be included with the balance sheet tax account (as either deferred tax liabilities or liabilities for unrecognized tax benefits), but should instead be included with accrued interest and other accrued expense (for penalties). Conversely, when the accounting policy is to classify interest and penalties as income tax expense, they should be included with the liabilities for unrecognized tax benefits. It should also be noted that classifying accrued interest and penalties as part of the liability for unrecognized tax benefits does not mean that the amount accrued should also be included in the annual tabular reconciliation disclosure because accrued interest and penalties are not considered unrecognized tax benefits.

### 16.7 Balance Sheet Classification

Excerpts from ASC 740

**ASC 740-10-25-16:**
The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of this Subtopic.

**ASC 740-10-45-11:**
An entity that presents a classified statement of financial position shall classify a liability associated with an unrecognized tax benefit as a current liability (or the amount of a net operating loss carryforward or amount refundable is reduced) to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, if longer. The liability for unrecognized tax benefits (or reduction in amounts refundable) shall not be combined with deferred tax liabilities or assets.

**ASC 740-10-25-17:**
A tax position recognized in the financial statements may also affect the tax bases of assets or liabilities and thereby change or create temporary differences. A taxable and deductible temporary difference is a difference between the reported amount of an item in the financial statements and the tax basis of an item as determined by applying this Subtopic's recognition threshold and measurement provisions for tax positions. See paragraph 740-10-30-7 for measurement requirements.

*(continued)*
ASC 740-10-45-12:
A liability recognized for an unrecognized tax benefit shall not be classified as a deferred tax liability unless it arises from a taxable temporary difference. Paragraph 740-10-25-17 explains how the recognition and measurement of a tax position may affect the calculation of a temporary difference.

16.7.1 Background

ASC 740-10-45-11 indicates that the balance sheet classification of a liability for an unrecognized tax benefit as current versus long term is determined based on the expected timing of cash payments, if any. That is, to the extent that cash payments are anticipated within 12 months of the reporting date, a liability for an unrecognized tax benefit is classified as a current liability. Otherwise, such amounts are reflected as noncurrent liabilities or, in some cases, as reductions of refundable amounts or carryforwards. Additionally, ASC 740-10-45-11 states that the liability for unrecognized tax benefits shall not be combined (i.e., netted) with deferred tax liabilities or assets.

In determining balance sheet classification, management’s “real world” expectation of future cash payments should be used. For example, if $40 of a $100 liability for an unrecognized tax benefit is anticipated to be paid within 12 months, only $40 should be classified as a current liability, while the remaining $60 should be classified as a noncurrent liability. Similarly, if management’s expects that its liability for an unrecognized tax benefit will reverse without cash consequences within 12 months (e.g., because the statute of limitation will expire or the taxing authority will concede the position taken), the associated liability should be classified as noncurrent because no cash payments are anticipated to settle the liability.

The liability that an entity records for uncertain positions is not a component of deferred taxes. Therefore, it is inappropriate to use a valuation allowance to recognize a liability for an unrecognized tax benefit. Rather, the liability must be classified separately from other tax balances based on the expected timing of cash payments to taxing authorities.

See Section TX 15.5.1.5 for additional guidance related to disclosure of unrecognized tax benefits.

16.7.1.1 SEC Required Balance Sheet Display of Liabilities for Unrecognized Tax Benefits

Rule 5-02 of Regulation S-X provides the SEC’s requirements as to what should appear on the face of the balance sheet and in the related notes (i.e., balance sheet line items and certain related disclosures). The SEC staff has indicated that for the purposes of complying with the balance sheet display requirements, a registrant should display potential future obligations to taxing authorities as “Other Current Liabilities” (“taxes” are specifically referenced in paragraph 20 of Rule 5-02) or “Other Liabilities” (as per paragraph 24 of Rule 5-02), in addition to any other disclosures required on the face of the balance sheet or in footnotes (e.g., separately presenting an item in excess of 5 percent of current liabilities or in excess of 5 percent of total liabilities).
Example 16-16: Classifying a Liability for an Unrecognized Tax Benefit When No Cash Payment Is Expected and Statute of Limitations Will Expire Within the Next Twelve Months

Background/Facts:
In applying the recognition criterion of ASC 740-10-25, Company A has determined that a tax position resulting in a $1,000 tax benefit does not qualify for recognition. Company A is not currently under examination and does not expect to be examined by taxing authorities. The statute of limitations on assessment is set to expire in less than one year.

Question:
How should the liability related to this exposure be classified on the balance sheet?

Analysis/Conclusion:
Since the statute of limitations on the uncertain tax position is set to expire in less than one year and Company A believes that it will reverse without a cash payment (i.e., they expect to keep the $1,000 benefit), none of the liability attributable to this issue should be classified as “current.”

Example 16-17: Classifying the Current Portion of a Liability for an Unrecognized Tax Benefit With Some Cash Payment Expected

Background/Facts:
In applying the recognition criterion of ASC 740-10-25, Company A has determined that a tax position resulting in a $1,000 tax benefit does not qualify for recognition (and thus no benefit is recorded). Company A is currently under examination and expects to settle the issue with a cash payment of $600. The statute of limitations on assessment is set to expire in less than one year.

Question:
How should the liability related to this exposure be classified on the balance sheet?

Analysis/Conclusion:
Even though the entire liability is expected to reverse within the next year, only $600 (i.e., the expected cash payments to settle the issue) of the $1,000 liability should be reclassified from noncurrent to current on the balance sheet. To determine the amount of cash payment expected, all information should be considered, including the likelihood that the tax position will (or will not) be identified by taxing authorities.

PwC Observation: Because the process leading from a tax return to an audit and finally to a resolution will often span several years, most of the liabilities recorded for unrecognized tax benefits will be classified as long-term, at least during the period(s) in which they are initially established.
16.7.2 Classification/Presentation of an Unrecognized Tax Benefit When NOL or Tax Credit Carryforwards Exist

If an entity has NOL carryforwards and an unrecognized tax benefit, should the unrecognized tax benefit be presented as a liability or a reduction of the NOL carryforward? The answer to this question depends on the specific facts and circumstances surrounding the carryforwards and the unrecognized tax benefit.

16.7.2.1 NOL (or Tax Credit Carryforwards) Directly Attributable to the Unrecognized Tax Benefit

For balance sheet purposes, NOLs, capital loss carryforwards, and tax credit carryforwards that are created or increased because of an unrecognized tax benefit should be recorded at the amount that is recognizable under the ASC 740 recognition and measurement model. Consistent with ASC 740-10-25-16, if a carryforward is created or increased as a result of an unrecognized tax benefit taken (or expected to be taken) on the tax return, the balance sheet should not reflect the DTA for the carryforward or the liability for the unrecognized tax benefit. However, the unrecognized tax benefit should be disclosed for the purposes of applying ASC 740-10-50-15.

The example below illustrates a specific fact pattern in which presentation of an unrecognized tax benefit as a reduction of a tax credit carryforward would be the appropriate accounting treatment.

Example 16-18: NOL/Tax Credit Carryforwards Should Be Recorded Net of Unrecognized Tax Benefits

**Background/Facts:**
Company A is a public company and has generated $1,000 of research-and-experimentation (R&E) credits that it plans to claim in its current-year income tax return. The company is in an NOL position even before the R&E credit is considered. The company has concluded that a full valuation allowance against the DTA related to the R&E credits (and NOLs) is necessary, as it does not expect to have sufficient taxable income to recognize the benefit from these items.

Under ASC 740-10-25, the R&E credit meets the more-likely-than-not criteria. Applying ASC 740-10's measurement criteria results in $800 as the maximum benefit that is more than 50 percent likely to be realized. Therefore, $200 constitutes an unrecognized tax benefit.

**Question:**
How should Company A record the recognition of the R&E benefit?

**Analysis/Conclusion:**
Company A should record a DTA of $800, and no liability for the unrecognized benefit. Consistent with ASC 740-10-25-16, if a carryforward is created or increased as a result of an uncertain tax benefit taken (or expected to be taken) on the tax return, the balance sheet should not reflect the DTA for the carryforward or the liability for the unrecognized tax benefit. In this case, since the unrecognized tax benefit of $200 increased the R&E credit carryforward in the current year, it would not be recognized as part of the DTA and a liability would not be recognized for it.

(continued)
Company A would record the following entries:

**Journal Entry #1**—This entry illustrates how to record the deferred tax benefit for the R&E benefit.

Dr Deferred Tax Asset $800  
Cr Deferred Income Tax Benefit $800

**Journal Entry #2**—This entry illustrates how to record the valuation allowance on the R&E benefit recognized.

Dr Deferred Income Tax Expense $800  
Cr Valuation Allowance $800

In this case, Company A’s tabular reconciliation of unrecognized tax benefits would include the $200 unrecognized tax benefit, even though the footnote disclosure will not relate to the liability recorded on the balance sheet (In fact, in this case, no liability is recorded). Additionally, in the overall income tax disclosure, the credit carryforward amount disclosed would be $800 (i.e., the portion that satisfies ASC 740’s recognition and measurement threshold).

### 16.7.2.2 NOL (or Tax Credit Carryforwards) Not Directly Attributable to the Unrecognized Tax Benefit

An unrecognized tax benefit might not directly create or increase an NOL or tax credit carryforward. For example, an NOL or tax credit carryforward might exist from a previous period and be unrelated to an unrecognized tax benefit attributable to a current period tax position, or vice versa. In such cases, the financial statements will report a liability for unrecognized tax benefits for tax positions that fail to meet the recognition threshold, or that meet the recognition threshold but for which measurement causes partial benefits to be recorded in the financial statements. If settled with the taxing authority on the basis recognized and measured, the positions’ resolution effectively amounts to additional taxable income. Therefore, unrecognized tax benefits are effectively viewed as an additional source of taxable income that should be considered in the assessment of whether a DTA is realizable.

For example, if settled in the taxing authority’s favor, an uncertain tax position would result in additional taxable income for the prior period that may be absorbed by a carryback of an unutilized NOL that has a full valuation allowance. That is, the NOL would require a full valuation allowance absent the unrecognized tax benefits relating to the liability. It is important to evaluate the attributes and timing of the unrecognized tax benefit when considering it as a source of income (e.g., an uncertain tax benefit for ordinary income would not be a source of income for a capital loss carryforward in a U.S. tax jurisdiction).

The liability for an unrecognized tax benefit that is unrelated to a DTA, but allows for the realization and utilization of a DTA, is recorded separately. That is, even though the NOL can be applied to the liability if the uncertain tax position is not sustained, the NOL and the liability would be recorded separately on the balance sheet. (Refer to the PwC Observation below for recent standard setting developments on this topic). It should be noted, however, that interest on the liability would not generally require accrual, as long as the taxpayer is able to offset the exposures with NOLs.
The examples below illustrate specific fact patterns in which the recognition of a liability for an unrecognized tax benefit would be the appropriate accounting treatment.

**PwC Observation:** On February 21, 2013, the FASB issued an exposure draft of a proposed Accounting Standards Update to ASC 740 (Exposure Draft). The Exposure Draft acknowledges that current U.S. GAAP does not include explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward or a tax credit carryforward exists. The EITF believes that diversity in practice exists and is, therefore, proposing specific guidance on the subject to eliminate that diversity. The proposed guidance would require that an unrecognized tax benefit (or a portion thereof) be presented in the statement of financial position as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward. This requirement would not apply when the carryforward attribute is not available (under the jurisdictional tax law) to settle additional income taxes that would result from the disallowance of a tax position. In such a case, the unrecognized tax benefit would be presented as a liability.

This proposed guidance departs from the original guidance provided by the FASB staff and what is currently reflected in this Section TX 16.7.2.2. The EITF reached a final consensus on June 11, 2013 on the proposed guidance described above. The changes will be effective for public entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2013, and for nonpublic entities for annual periods beginning after December 15, 2014. The guidance is required to be applied to all unrecognized tax benefits at the effective date (and after); however, entities may also choose to apply the new guidance retrospectively, to all periods presented. The guidance will also allow for early adoption.

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**Example 16-19: NOL/Tax Credit Carryforwards Recorded Gross of Unrecognized Tax Benefits**

**Background/Facts:**
As of December 31, 20X7, Company A has $100 of NOL carryforwards that have been fully recognized under ASC 740-10-25 (i.e., as of December 31, 20X7, Company A has on its books a DTA of $40, assuming a 40 percent tax rate). The DTA does not require a valuation allowance. During 20X8, Company A has $0 taxable income after taking a deduction of $80 that does not meet the more-likely-than-not recognition criteria under ASC 740-10-25 for financial statement purposes.

**Question:**
Since the $100 NOL from 20X7 would be available to Company A if the 20X8 position were ultimately disallowed, should Company A net the $80 unrecognized tax benefit (UTB) resulting from 20X8 activity against the $100 NOL carried forward from 20X7? This would leave a gross NOL of $20 ($8 deferred tax asset) as of December 31, 20X8.

**Analysis/Conclusion:**
No. As of December 31, 20X8, Company A should record a liability of $32 ($80 x 40%) for the uncertain tax position expected to be taken on the 20X8 return and should leave the $40 (40% x $100) NOL carryforward previously recognized as a deferred tax asset. The rationale for gross presentation in this circumstance is (continued)
premised on the fact that the NOLs from 20X7 continue to be valid tax attributes and may be used to offset another source of taxable income in a future period (prior to the final resolution of the uncertain position from 20X8). We understand that this conclusion is consistent with the view of the FASB staff.

In this case, interest typically would not be recorded on the liability for the unrecognized tax benefit, as the availability of the NOL would be considered in determining the amount of interest, if any, to accrue. That is, in many jurisdictions, such as the United States, the taxing authority would allow the tax preparer to amend its tax return and apply the NOL carryforward toward the liability. In this case, as there are sufficient NOLs to cover the liability, no interest would be recorded.

It is important to note that the balance sheet guidance above would only be applicable if the NOL and the uncertain tax positions arose in different tax years. If the uncertain tax position were entered into in the same tax year in which the NOL arose (i.e., absent the uncertain tax position, there would not have been a loss generated in a particular year), a net presentation would be required as described in Section TX 16.7.2.1. That is, the NOL DTA would be presented net of the unrecognized tax benefit, as described in ASC 740-10-25-16.

Example 16-20: NOL/Tax Credit Carryforwards in a Full Valuation Allowance Position Should Be Recorded Gross of Unrecognized Tax Benefits

**Background/Facts:**
As of December 31, 20X7, Company A has $800 in NOL carryforwards that have been fully recognized under ASC 740-10-25. These DTAs have attracted a full valuation allowance as a result of the significant negative evidence that exists.

In 20X8, Company A expects to report taxable income of $30 on its tax return. This taxable income of $30 includes a $10 deduction that does not meet the ASC 740-10-25 recognition threshold and therefore constitutes an unrecognized tax benefit. Assume that the tax rate is 40 percent and that the assessment of the need for a full valuation allowance has not changed as of December 31, 20X8.

**Question:**
Should Company A reduce the NOL carried forward from 20X7 on its balance sheet for the unrecognized tax benefit recorded in 20X8?

**Analysis/Conclusion:**
No. The Company should recognize the NOL carryforwards separately from the liability of $4. The $4 liability would be a source of income for the purposes of assessing whether a valuation allowance is necessary for the NOL carryforwards. The rationale for gross presentation in this circumstance is premised on the fact that the NOLs from 20X7 continue to be valid tax attributes and may be used to offset another source of taxable income in a future period (prior to the final resolution of the uncertain position from 20X8). This view is also consistent with the FASB staff view.

(continued)
Journal Entries are summarized as follows:

**Journal Entry #1**—This entry illustrates how to record the realization of the NOL carryforward and the release of the valuation allowance due to 20X8 taxable income on tax return of $30 ($30 x 40% = $12).

\[
\begin{align*}
\text{Dr Deferred Income Tax Expense} & \quad \$12 \\
\text{Cr DTA-NOL Carryforward} & \quad \$12 \\
\text{Dr Valuation Allowance on DTA} & \quad \$12 \\
\text{Cr Deferred Income Tax Expense} & \quad \$12
\end{align*}
\]

**Journal Entry #2**—This entry illustrates how to record the liability on the unrecognized tax benefit of $10 ($10 x 40% = $4) taken in 2008.

\[
\begin{align*}
\text{Dr Income Tax Expense} & \quad \$4 \\
\text{Cr Liability for Unrecognized Tax Benefit} & \quad \$4
\end{align*}
\]

**Journal Entry #3**—This entry illustrates how to reverse a valuation allowance of $4 due to the existence of a liability for the unrecognized tax benefit of $4, which can be used as a source of taxable income in the valuation allowance assessment.

\[
\begin{align*}
\text{Dr Valuation Allowance on DTA} & \quad \$4 \\
\text{Cr Deferred Income Tax Benefit} & \quad \$4
\end{align*}
\]

Balance sheet reporting as of December 31, 20X8, is as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA-NOL Carryforward</td>
<td>$308&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>(304)&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>Net DTA</td>
<td>4</td>
</tr>
<tr>
<td>Liability for Unrecognized Tax Benefit</td>
<td>$ (4)</td>
</tr>
</tbody>
</table>

<sup>1</sup> $800 – $30 = 770; $770 x 40% = $308.

<sup>2</sup> $308 – $4 (liability for unrecognized tax benefit).

**16.7.2.3 Unrecognized Tax Benefits and Windfall Tax Benefits That Have Not Yet Reduced Taxes Payable**

As further described in Section TX 18.14, an entity cannot recognize the excess tax benefit that results from the settlement of a stock-based compensation award until it reduces income taxes payable. In such cases, NOL carryforwards for which a deferred tax asset is recognized will differ from the amount of NOL carryforwards available to the entity (as disclosed in the entity's tax return). While a liability for unrecognized tax benefits may provide a source of income when assessing the realizability of deferred tax assets attributable to NOL carryforwards (see Section TX 16.7.2.2), the liability does not create or increase taxes currently payable on a tax return. Therefore, unrecognized tax benefits do not provide a basis to recognize excess tax benefits that have not otherwise reduced taxes payable.
Example 16-21: Recognition of ASC 718, Stock Compensation Windfall Tax Benefits Upon Recording a Liability for the Unrecognized Tax Benefit of an Unrelated Tax Position

Background/Facts:
Company A has taken a position on its tax return that is considered an uncertain tax position. In its assessment of ASC 740-10-25, Company A has determined that the position does not meet the more-likely-than-not criteria for recognition. Thus, Company A has recorded a liability for the full amount of the deduction taken. However, Company A has available but unrecognized windfall tax benefits from the exercise of nonqualified stock options that are available to offset any amounts that might be payable if the uncertain tax position is not sustained on the tax return. These windfall tax benefits meet the recognition and measurement criteria of ASC 740, but have not yet reduced taxes payable and thus have not been recognized pursuant to ASC 718-740-25-10.

Question:
Since the windfall tax benefits would reduce taxes payable if the uncertain tax position is not sustained, should Company A recognize the APIC credit for the windfall tax benefits that would offset any tax due (if the position is not sustained) and remove the liability for the unrecognized tax benefit?

Analysis/Conclusion:
No. Recording a liability for the unrecognized tax benefit does not create or increase taxes currently payable on a tax return. Therefore, consistent with ASC 718-740-25-10, the windfall tax benefits have not yet reduced taxes payable and should not be recognized. If and when the liability becomes currently payable on a tax return and the windfall benefits are expected to reduce what would otherwise have been a currently payable income tax, the windfall tax benefits should be recorded as an adjustment to APIC.

16.8 Disclosures

16.8.1 Annual Disclosures
Disclosures for uncertain tax positions are often regarded as highly sensitive and, as such, require the use of professional judgment. Although management might be concerned with including information in the financial statements that could be advantageous to a taxing authority examining its uncertain tax positions, it is important to recognize that stakeholders base their investment decisions on those same financial statements. ASC 740-10-50-15 addresses this tension in part by requiring a qualitative discussion of only those positions that management expects will change significantly within the next twelve months. Further, for public entities, the quantitative rollforward of unrecognized tax benefits is prepared on a worldwide aggregated basis. The required disclosures are further discussed in Section TX 15.5.

16.9 Intraperiod Allocation

16.9.1 Backwards Tracing
We believe that pursuant to ASC 740-20-45-3 “backwards tracing” for the tax effects of the equity items listed in ASC 740-20-45-11(c) through (f) also includes both favorable and unfavorable adjustments resulting from changes in the assessment
of uncertain tax positions. For example, pursuant to ASC 740-20-45-11(d), a reduction in recognized tax benefits relating to excess deductions from share-based compensation should be recorded in equity to the extent there is a pool of windfall tax benefits (this accounting treatment is also discussed in Section TX 18.16).

But what about items previously recorded in discontinued operations or other comprehensive income (e.g., foreign currency translation adjustments and unrealized gains/losses from available-for-sale securities)? It would appear that under these circumstances, backwards tracing would be prohibited; however, ASC 740-20 only addresses backwards tracing within the context of initial recognition (i.e., release of a valuation allowance).

For example, suppose that in a prior period a liability was established for an unrecognized tax benefit that related to and was reported as a component of discontinued operations. In a subsequent year in which there were no pretax discontinued operations, the previously unrecognized benefit would be able to be recognized. In this circumstance, the FASB staff has confirmed that there are two acceptable alternatives, depending on a company’s accounting policy, that can be used to account for current-period recognition of tax benefits associated with previously recorded discontinued operations.

A backwards tracing alternative is based on provisions in ASC 205-20-45-4 which requires that subsequent adjustments to contingencies recorded as part of prior-year discontinued operations be classified as discontinued operations in the period in which the subsequent adjustment is made. Thus, when applying ASC 205-20-45-4 to tax uncertainties, these uncertainties are interpreted as contingencies, whose subsequent resolution is reflected in that year’s financial statements as discontinued operations even in the absence of current-period pretax income or loss from discontinued operations (i.e., the income statement line item “income or loss from discontinued operations” would show a tax benefit, but no pretax income or loss).

The other alternative is based on the principle in ASC 740-10-45-20 under which the tax effects of any changes to the beginning of the year valuation allowance (as a result of a change in judgment) is generally recorded in continuing operations. Therefore, by analogy, the tax effects of a change in the opening balance of unrecognized tax benefits (including unrecognized tax benefits related to prior-period discontinued operations) should be recorded in current-period income/loss from continuing operations.

Therefore, with respect to uncertain tax positions from discontinued operations, as well as uncertain tax positions associated with both extraordinary items and items included in other comprehensive income, both alternatives are acceptable. The alternative selected, however, is an accounting policy and should therefore be applied consistently.

16.10 Indemnification Arrangements

Income tax indemnifications are contractual arrangements established between two parties whereby one party will reimburse the other for income taxes paid to a taxing authority related to tax positions that arose, typically, prior to the transaction. Income tax indemnifications can arise from a number of circumstances including business
combinations, spin-offs and IPOs. Common scenarios including the general direction of indemnification arrangements are summarized below:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Seller</th>
<th>→</th>
<th>Buyer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of a subsidiary that previously filed a separate tax return</td>
<td>Seller</td>
<td>→</td>
<td>Buyer</td>
</tr>
<tr>
<td>Sale of a subsidiary that previously filed as part of a consolidated tax return</td>
<td>Seller</td>
<td>→</td>
<td>Buyer</td>
</tr>
<tr>
<td>Spin-off, IPO or carve-out of an entity that previously filed a separate tax return</td>
<td>Previous Owner</td>
<td>→</td>
<td>New Entity or Shareholders</td>
</tr>
<tr>
<td>Spin-off, IPO or carve-out of an entity that previously filed as part of a consolidated tax return</td>
<td>Previous Owner</td>
<td>←</td>
<td>New Entity or Shareholders</td>
</tr>
</tbody>
</table>

The accounting for indemnification arrangements described below differs from the accounting that would result if the entity purchased insurance coverage from a third party to mitigate its exposure. In that situation, the entity should consider the guidance in ASC 720-20, Insurance Costs. Indemnification arrangements may also arise in a number of commercial or financing transactions such as leases; however, the accounting for such arrangements is not addressed below.

16.10.1 Accounting Considerations from the Indemnifying Party's Perspective

16.10.1.1 Determining the Applicable Accounting Model

When determining which accounting to apply, consideration should be given to the relationship with the taxing authority and the relationship between the parties to the arrangement.

The indemnifying party must determine whether it is a primary obligor to the taxing authority. In situations when an entity that previously filed a separate tax return is sold to a third party or spun-off to shareholders, the determination may be clear. For example, when a U.S. company sells its interest in a foreign subsidiary, the consolidated entity generally has no legal obligation to pay back taxes in the foreign jurisdiction subsequent to the sale.

In situations when the transferred entity was previously included as part of a consolidated return, the determination may be less clear and more than one party may be considered a primary obligor. If a company is a primary obligor to the taxing authority, it should account for the tax risk pursuant to the provisions within ASC 740, Income Taxes (ASC 740) dealing with accounting for uncertain tax positions. Sections TX 16.3 and 16.4 discuss in detail the two-step recognition and measurement approach set out in ASC 740.

If an indemnifying party is not a primary obligor to the taxing authority, it should account for the tax risk pursuant to ASC 460, Guarantees (ASC 460), which requires

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7 If the tax is determined to be a non-income based tax, a similar analysis will need to be performed; however, the guidance in ASC 740 should not be followed. Rather, accounting guidance such as ASC 450 may need to be applied.
use of fair value based upon the guidance in ASC 820, *Fair Value Measurements and Disclosures* (ASC 820). The scope of ASC 460 does not apply to an indemnification issued between a parent and its subsidiary or between companies under common control. When considering whether ASC 460 applies, companies should note that the SEC staff has indicated that the above scope exception applies only during the parent-subsidiary relationship. For example, if a parent indemnifies a subsidiary prior to a spin-off, a decision to retain the guarantee post-spin-off is the same as issuing a new guarantee at the date of the transaction when the parent-subsidiary relationship no longer exists. As a result, ASC 460 would apply subsequent to the spin-off.

If the ASC 460 (parent-subsidiary) scope exception applies, a company should account for the indemnification pursuant to ASC 450, *Contingencies* (ASC 450). ASC 450 requires a company to accrue a liability when it is probable that the liability has been incurred and the amount of loss can be reasonably estimated.

The following summarizes the paths to the relevant accounting guidance:

Is the company a primary obligor to the income taxing authority?

a. Yes. ASC 740 applies.

b. No. Is the arrangement between a parent and subsidiary or companies under common control?
   i. Yes. ASC 450 applies.
   ii. No. ASC 460 applies.

A change in circumstances causing a change in the applicable principle may result in adjusting or recognizing (and possibly reclassifying) a liability. For example, a company that was previously a primary obligor may have recorded a liability for unrecognized tax benefits pursuant to ASC 740. Following a disposition, the company is no longer a primary obligor to the taxing authority but agrees to indemnify the buyer. The company would need to adjust its liability to reflect an ASC 460 approach.

16.10.1.2 Unique Considerations for Entities That Previously Filed as Part of a Consolidated Return

The situation may arise when a wholly owned subsidiary that was previously included as a member of a consolidated federal income tax return is spun off from its parent. In such a case, the subsidiary (Company B) may agree to indemnify the parent (Company A) for any income taxes that Company A may be assessed related to the resolution of Company B’s pre-spin uncertain tax positions. Further, because the entities were previously included as part of a consolidated return, under current U.S. tax law both Company A and Company B may be considered a primary obligor.

- Indemnification—In general, when considering the subsidiary’s indemnification of the parent, we do not believe it would be appropriate for Company B to record a liability for the income taxes related to Company A’s operations. Although legally Company B may be liable for the taxes of Company A (i.e., because it is liable for the taxes of the entire pre-spin consolidated group), the convention under U.S. GAAP is that each entity should recognize income taxes related to its own operations. However, if Company A becomes insolvent (and, therefore, the taxing authority’s only recourse is to seek recovery from Company B), it may be appropriate for Company B to account for the potential liability related to Company A’s tax uncertainties as a contingent liability in accordance with ASC 450.
• Primary obligor—As described in Section TX 16.10.1.1, if a company is a primary obligor to the taxing authority, it should account for the tax risk pursuant to the provisions within ASC 740, *Income Taxes (ASC 740)* dealing with accounting for uncertain tax positions.

16.10.2 Accounting Considerations from the Indemnified Party’s Perspective

The indemnified party must also begin its analysis by determining whether they are a primary obligor to the taxing authority and, if so, recognize and measure a liability in accordance with ASC 740. If the indemnifying and indemnified parties are both liable for the exposure, both parties should apply the guidance in ASC 740. The indemnified party must then determine the amount to recognize for the indemnification receivable.

The relevant accounting guidance for the indemnified party may differ depending on whether the transaction is accounted for as a business combination.

16.10.2.1 Business Combinations (ASC 805)

ASC 805 provides guidance on the recognition and measurement of an indemnification asset and requires what is sometimes referred to as “mirror image” accounting for indemnifications. The indemnified party recognizes an indemnification asset at the same time that it recognizes the indemnified item and measures the asset on the same basis as the indemnified item. Accordingly, an indemnification asset related to an uncertain tax position is recognized at the same time and measured on the same basis as the related liability, subject to collectability or contractual limitations on the indemnified amount. The liability is recognized and measured using the ASC 740 guidance. Indemnification assets recognized on the acquisition date continue to be measured on the same basis as the related indemnified item until they are collected, sold, cancelled, or expire.

Mirror image accounting assumes that the terms of the indemnification arrangement fully cover the related exposure. Where that is not the case, there can be accounting differences, such as in the following scenarios:

• An income tax uncertainty relates to the timing of a deduction. For example, a tax deduction was claimed in year 1, but there is risk that the deduction should be taken over 15 years. Where the indemnification covers the implied interest cost associated with spreading the deduction over a longer period, the indemnification asset would not equal the related liability. Rather, in this case, the indemnification receivable would presumably equal only the outstanding interest accrual.

• The indemnification covers any tax exposure that exceeds a specified dollar amount. In this situation, the mirror image will apply only to the excess over the specified amount.

There may also be scenarios where the terms of the indemnification fully cover the tax exposure, but the related amounts recorded for accounting purposes appear to differ, such as in the following scenarios:

• A company does not classify interest and penalties in the same line as the liability for an income tax exposure. In this situation, mirror image accounting may apply.

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8 If the tax is determined to be a non-income based tax, a similar analysis will need to be performed; however, the guidance in ASC 740 should not be followed. Rather, accounting guidance such as ASC 450 may need to be applied.
(assuming that interest and penalties are covered by the indemnification); however, the indemnification asset would mirror the total of the tax liability and the related interest and penalty accruals.

- The company records a reserve against the indemnification asset due to collection risk.

There may also be scenarios where the seller provides a blanket indemnification for taxes owed in prior years, but no specific tax positions are reserved. If no liability is required under the uncertain tax position guidance in ASC 740, an indemnification asset should not be recognized. Accordingly, the indemnification asset would be zero, which is the mirror image of the tax liability.

Another scenario to consider is when the income tax uncertainty increases a loss carryforward. In this situation, the guidance in ASC 740 requires a net presentation (i.e., the company should not record a deferred tax asset for the loss carryforward and a liability for the tax uncertainty). However, if the tax liability is covered by an indemnification, the indemnification asset would mirror the tax liability even though no tax liability is recorded. For example, assume that a buyer acquires a $100 loss carryforward (tax-effected). The buyer determines that $20 of the loss carryforward is an unrecognized tax benefit and, therefore, reduces the loss carryforward to $80. If the seller indemnifies the buyer for the related tax exposure, the buyer would record a $20 indemnification asset.

16.10.2.2 Transactions Other Than Business Combinations

The guidance in ASC 805 is limited to business combinations and, therefore, does not apply to transactions such as spin-offs or asset acquisitions. Accordingly, the question arises whether mirror image accounting should be applied to transactions other than business combinations.

In connection with the implementation of ASC 740’s guidance related to uncertain tax positions, certain investment funds approached the SEC for guidance on how to measure an indemnification receivable. In certain situations, in an effort to neutralize the impact of a tax exposure to a fund’s net asset value (NAV), the fund manager was willing to indemnify the fund for the exposure. In a letter to the funds, the SEC staff noted that “an advisor’s (or other relevant party’s) contractual obligation to indemnify uncertain tax positions generally would be sufficient in demonstrating that the likelihood of recovery is probable. The process of obtaining a contractual obligation to indemnify uncertain tax positions may occur simultaneously while the fund is gathering the relevant information to assess whether a liability should be recorded to NAV. In these circumstances, recognition of an indemnification receivable, to the extent of recovery of the tax accrual, generally would be acceptable practice.”

The SEC’s letter provides support for recognizing the indemnification receivable at the same amount as the recorded liability absent any collectability or contractual limitations on the indemnified amount.

A more common indemnification scenario, outside of a business combination, is when a parent spins off a subsidiary. Following the spin-off, the parent may indemnify the new entity for income tax exposures related to the spun-off entity’s prior operations. Assuming that the indemnification fully covers the exposure, we believe that it would be reasonable for the spun-off entity to record an indemnification

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receivable at the same amount as the tax liability. This view is consistent with the SEC's letter described above.

Another scenario to consider, which might occur in an IPO, spin off or in a case involving an investment fund, is when the parent retains a controlling interest and, therefore, the parent-subsidiary relationship continues after the transaction. If the parent indemnifies the subsidiary, consideration should be given to whether the indemnification asset and subsequent changes should be recorded in equity.

16.10.3 Tax Consequences from Indemnification Payments

From a U.S. tax perspective, there are typically no consequences from indemnification payments regardless of whether the acquisition was taxable or nontaxable. For example, assume that an uncertain tax position is not sustained and that the buyer (or acquired company) pays $100 to the taxing authority and collects $100 from the seller. The amount paid to the taxing authority and the amount collected from the seller would generally offset, with no net impact on taxable earnings, tax-deductible goodwill or stock basis.

As a result, in most cases the indemnification receivable recorded in acquisition accounting would not be expected to have a deferred tax effect.

16.10.4 Financial Statement Presentation and Disclosure

An indemnification asset should not be netted against the related liability. Adjustments to the indemnification asset should be recorded in pre-tax income, not as part of income tax expense. The income tax line item is reserved for only those amounts expected to be paid to (or received from) the taxing authorities. Therefore, although dollar-for-dollar changes in an income tax liability and a related indemnification asset will offset on an after-tax basis, pre-tax income measures and a company’s effective tax rate will be impacted.

Companies should ensure that liabilities for unrecognized tax benefits, regardless of whether covered by an indemnification agreement, are included in the company’s annual disclosures. That is, the disclosures required by ASC 740-10-50-15 would reflect the unrecognized tax benefits with no offset or netting for an indemnification. For example, the company would need to include the tax position in its disclosure of gross amounts of increases and decreases in unrecognized tax benefits and amounts that, if recognized, would affect the effective tax rate. However, it may often be necessary to provide additional disclosure in regard to the terms of any indemnification arrangements so that financial statement readers can appropriately assess the net economic exposure to the entity.

16.11 Documentation

The level of effort and documentation that is required as part of the recognition and measurement process is a source of concern for many entities. Because there are an infinite number of possible exposures and several different taxing authorities, it is very difficult to develop guidance that is both specific and directly applicable to uncertain tax positions.

While ASC 740-10-25-6 states that the recognition of a tax benefit represents a positive assertion that an entity is entitled to the benefit, it does not impose specific documentation requirements for all tax positions with respect to the analysis performed for recognition or measurement purposes. However, entities should
have a process in place for reviewing tax returns and other information to identify the position that should be evaluated under the requirements of ASC 740-10-25. In addition, entities should have procedures surrounding decisions and the review of those decisions reached in the recognition and measurement steps. Extensive analysis and documentation may not be necessary to support the recognition and measurement of positions supported by clear and unambiguous tax law. On the other hand, more robust analysis and documentation may be necessary if a position involves a significant amount of uncertainty. The extent of effort that may be required to analyze and document a tax position may depend significantly on the entity’s prior accounting policies and procedures.

Management will need to be able to support its accounting conclusions with an assessment of every material uncertainty and expected outcome. However, judgment will be required to determine how the entity should document those uncertainties. Sometimes, it is obvious that certain positions will be accepted. In those cases, the effort required to document will prove less burdensome. Other times, determining whether certain positions will be accepted requires a greater documentation effort and an in-depth analysis of the position, related tax laws, regulations, and case law. In these cases, the following points may be worth considering:

- Due to the sheer number of positions and the significance of income taxes for the average entity, we believe that identification, assessment, and documentation of uncertain tax positions must be deeply integrated in an entity’s internal control structure.
- Entities should consider beginning assessment and documentation efforts as soon as a significant position is initiated. Assessment and documentation should never be an afterthought in the processing of a transaction for financial reporting purposes.
- The assessment of sustainability for classes of similar exposures or commonly recurring uncertain tax positions might be documented in a standard memo. This would allow transaction-specific criteria or unique issues to be addressed in more concise documentation that references the standard memo.
- Entities might call on their experiences with other areas of GAAP, such as hedge accounting, which requires a diligent and detailed documentation regime.

### 16.11.1 Role and Use of Tax Opinion Letters

A tax opinion letter speaks not only to the merits of the tax position under applicable laws and regulations, but also to whether the related position has been properly structured in accordance with the tax law. A tax opinion letter must take into account all possible lines of attack by tax authorities, including their ability to disregard or re-characterize a transaction for lack of business purpose or economic substance.

In the United States, these possible lines of attack would include the technical aspects of the tax law and the structure of the related transaction (as discussed above), as well as whether the transaction meets the business-purpose test. Furthermore, U.S. federal tax authorities have challenged transactions when they have been able to establish that the transaction was counter to the original intent of the tax law.

We believe that all of these risks should be considered in evaluating whether it is more-likely-than-not that an uncertain tax position will be sustained. Just as a tax opinion letter cannot consider the possibility that the entity’s tax returns might not be
audited or that the tax position might be settled as part of the tax audit for something less than the full benefit, an assessment of whether it is more-likely-than-not that an uncertain tax position will be sustained should not consider these possibilities.

It is also important to note that the terms used in tax opinion letters may have meanings that are different from the meanings of similar or identical terms used in financial accounting guidance. Entities obtaining tax opinions should have a clear understanding of the level of assurance that the advisor intends to convey. Although tax opinions do not need to conform to ASC 740, we would expect that many entities will use them to support conclusions reached on material, complex, and highly technical matters of income tax law.
Chapter 17:
Accounting for Income Taxes in Interim Periods
Chapter Summary

ASC 740-270, *Interim Reporting*, prescribes an estimated annual effective tax rate ("ETR") approach for calculating a tax provision for interim periods. Conventional wisdom might lead one to believe that using such an approach to record an interim period income tax provision simplifies the otherwise laborious process of computing a discrete tax provision for each interim period. However, accounting for income taxes in interim periods is far from simple. The ETR approach presents a number of unique complexities and challenges and, in certain circumstances, can lead to counterintuitive results. This chapter walks through some of the key considerations and complexities in accounting for income taxes during interim periods following this general outline:

- The estimated annual effective tax rate approach should generally be used to determine the tax (or benefit) related to ordinary income, as defined (Section TX 17.2). Certain items do not meet the definition of ordinary income; the tax effects of such items should be computed and recognized as discrete items when they occur (Section TX 17.3).

- There are limited exceptions to the use of the estimated annual effective tax rate approach (Section TX 17.2.2) and also limitations on the amount of benefits that can be recognized for losses, credits and rate differentials in loss periods (Section TX 17.2.1.3).

- There are a number of additional situations that present unique challenges when accounting for income taxes in interim periods (Section TX 17.4 and Section TX 17.5).
Excerpts from ASC 740

ASC 740-270-25-1:
This guidance addresses the issue of how and when income tax expense (or benefit) is recognized in interim periods and distinguishes between elements that are recognized through the use of an estimated annual effective tax rate applied to measures of year-to-date operating results, referred to as ordinary income (or loss), and specific events that are discretely recognized as they occur.

ASC 740-270-25-2:
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.

ASC 740-270-25-3:
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.

ASC 740-270-25-4:
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.

ASC 740-270-25-5:
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.

(continued)
17.1 Method of Computing an Interim Tax Provision

ASC 740-270-25-2 provides the following guidance for calculating an income tax provision in an interim period:

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.
PwC Observation: The language in ASC 740-270-25-2 makes it clear that the estimated annual effective tax rate approach should be used only for recording the tax effect of current-year ordinary income. Throughout the year, other events and/or transactions may occur that relate to continuing operations, but do not represent ordinary income or tax effects thereon. The tax effects of such events (e.g., changes in a valuation allowance due to changes in expectations about income in a future period or the tax effects of settlements of prior-year tax audits) should not be included in the derivation of the company’s estimated annual effective tax rate.

17.1.1 Determining the Elements and Tax Effects of Ordinary Income

17.1.1.1 Definition of Tax (or Benefit) Related to Ordinary Income

Since the tax effects of current-year ordinary income receive different interim accounting treatment than the tax effects of other types of income during the same period, the definition of a tax (or benefit) related to ordinary income becomes important. ASC 740-270-20 defines these terms as follows:

a. Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items. Extraordinary 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 vs. capital gain. The meaning of “unusual or infrequently occurring items” is consistent with their use in the definition of the term, “extraordinary item.”

b. Tax (or benefit) is the total income tax expense (or benefit), including the provision (or benefit) for income taxes both currently payable and deferred.

17.1.1.2 Items Excluded from the Definition of Ordinary Income

17.1.1.2.1 Significant Unusual or Infrequent Items

ASC 270-10-45-11A prescribes that “extraordinary items, gains or losses from disposal of a component of an entity, and unusual or infrequently occurring items shall not be prorated over the balance of the fiscal year.” Deciding whether events should be classified as unusual or infrequent can be challenging. The definition of “ordinary income (or loss)” in ASC 740-270-20 refers to the definition of the term “extraordinary item” in ASC 225-20-20, which provides the following:

- **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 ASC 225-20-60-3).

- **Infrequency of occurrence.** The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (see ASC 225-20-60-3).

While both of these criteria should be met to classify an event or transaction as an extraordinary item, only one of these factors is required for an item to be excluded from the estimated annual effective tax rate.
Additionally, consideration should be given to ASC 740-270-30-12 to 30-13, which provides that the tax effect of significant unusual or extraordinary items that are reported separately within income from continuing operations should be excluded from the estimated annual effective tax rate calculation and instead be recorded on a discrete basis in the period in which the item occurs. ASC 740-270-30-12 also prescribes discrete treatment for items that are required to be reported net of their related tax effect such as other comprehensive income, discontinued operations and extraordinary items.

**PwC Observation:** Companies need to be particularly careful about classifying events as unusual or infrequent. In the past, we have concluded that catastrophe losses (e.g., losses resulting from natural disasters such as hurricanes) incurred by property and casualty insurance companies do not represent a significant unusual or infrequent occurrence because insurance companies in that sector are in the business of insuring customers against those risks. While the magnitude of a loss may be unusual or infrequent, the event itself (e.g., the hurricane) is not.

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**Example 17-1: Impact of Nondeductible-Goodwill Impairment on Interim Period Tax Provisions**

**Background/Facts:**
Company A has recorded a financial statement impairment of nondeductible goodwill during the second quarter.

**Question:**
Would the impairment of nondeductible goodwill be considered an unusual or infrequent item that requires discrete treatment, or should it be considered a component of the estimated annual effective tax rate, which requires recognition throughout the year?

**Analysis/Conclusion:**
ASC 740-270-30-4 through 30-8 indicate that the interim tax provision should be the estimated annual effective tax rate. This rate should then be applied to determine income taxes on a year-to-date basis. ASC 740-270-30-8 also states that, “in arriving at this estimated effective tax rate, no effect shall be included for the tax related to significant, unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.” These items should instead be recognized as a discrete tax event in the period of occurrence.

Judging whether a nondeductible-goodwill impairment should be classified as an unusual or infrequent item requires careful consideration of the relevant facts and circumstances. The definition of an “extraordinary item” in ASC 225-20-20 provides guidance for judging whether a transaction or event qualifies as unusual or infrequent. A history of goodwill impairments or a reasonable expectation that there will be impairments in the future would indicate that the impairment is not unusual and should therefore be included in the estimated annual effective tax rate (i.e., not treated discretely in the period). Conversely, in circumstances where there has been no history of goodwill impairments and there is presently no reasonable expectation of significant goodwill impairments in the future, the tax effect of the impairment might be able to be accounted for discretely in the period in which the impairment is recorded.

(continued)
The following chart compares the year-to-date tax expense of a nondeductible-goodwill impairment classified as a discrete item and a nondeductible-goodwill impairment classified as an item that affects the estimated annual effective tax rate calculation. Company A projected $200 of book and taxable income and an ETR of 40 percent prior to the impairment. In the second quarter, Company A recorded an $80 impairment of its nondeductible goodwill.

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<td>200</td>
</tr>
<tr>
<td>Tax expense if impairment tax effect is treated discretely</td>
<td>20</td>
<td>40(^1)</td>
<td>60(^1)</td>
<td>80(^1)</td>
</tr>
<tr>
<td>Tax expense if impairment tax effect is included in the effective rate</td>
<td>$20</td>
<td>$13.3(^2,3)</td>
<td>$46.7(^3)</td>
<td>$80(^3)</td>
</tr>
</tbody>
</table>

1 Calculated as YTD tax expense on YTD book income using 40% effective rate, plus tax expense on goodwill impairment times 40% tax rate.
2 Revised effective rate is 66.7%—forecasted annual book income of $120 and tax expense of $80 on $200 taxable income.
3 YTD tax expense on YTD book income using 66.7% effective rate.

17.1.1.2.2 Extraordinary Items

ASC 225-20-20 defines the term extraordinary items as “events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence.” Thus, an item must satisfy both criteria (i.e., unusual and infrequent) to qualify as extraordinary while treatment as a discrete item for interim reporting purposes only needs to satisfy one of the criteria.

**PwC Observation:** It is extremely rare for events/transactions to be classified as extraordinary. For example, in discussing the accounting implications of the terrorist attacks of September 11, 2001, the Emerging Issues Task Force concluded that events stemming from the tragedy fell short of extraordinary as defined in ASC 225-20-20.

17.1.1.2.3 Discontinued Operations

See ASC 205-20-45-1 for a discussion of what constitutes a discontinued operation.

17.1.1.2.4 Cumulative Change in Accounting Principle

See ASC 250-10-45-3 through 45-7 for guidance on how to account for the cumulative effect of changes in accounting principles when an accounting pronouncement does not provide specific transition adjustments.

**PwC Observation:** It should be noted that when a cumulative effect adjustment is recognized because retrospective application is not practicable, the adjustment is not considered part of current-period ordinary income because it is recorded as an adjustment to beginning retained earnings (or other appropriate components of equity or net assets).
17.1.1.3 Limited Exceptions for Certain Items

Barring the exceptions presented below in Sections TX 17.1.1.3.1 through TX 17.1.1.4.8, Section TX 17.2.2, and Section TX 17.5.1, ASC 740-270 provides no latitude for treating any other tax effects of ordinary income on a discrete-period basis. Accordingly, the tax effects of items such as dividends-received deductions and capital gains rates on significant fixed asset dispositions that are not considered unusual or infrequent should be incorporated into the estimated annual effective tax rate rather than recorded discretely.

17.1.1.3.1 Tax-exempt Interest

While deliberating the accounting issues related to accounting for income taxes in interim periods, the FASB discussed the historical practice of excluding tax-exempt interest from ordinary income and effectively treating it as discrete income even though interest on tax-exempt securities often forms a portion of ordinary income of an entity that routinely invests in such securities.1 Despite this mention of recording the tax impacts of interest from tax-exempt securities as they are earned, the FASB decided not to provide specific guidance on this issue.

If not for the reference to the then common practice of excluding tax-exempt interest from the estimated annual effective tax rate calculation, tax-exempt interest would be treated like any other rate reconciling item related to current-year ordinary income. Because the FASB did not explicitly object to the exclusion of tax-exempt interest from the ETR calculation, we believe that including or excluding tax-exempt interest from the ETR calculation is acceptable as long as the approach is applied consistently.

17.1.1.3.2 Investment Tax Credits

ASC 740-270-30-14 provides guidance for handling the impact of investment tax credits when applying the estimated annual effective tax rate approach. Whether investment tax credits are included or excluded depends on the accounting treatment selected. ASC 740-270-30-14 states:

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 ASC 740-10-25-46 and 740-10-45-28).

17.1.1.3.3 Leveraged Leases

ASC 740-270-30-15 states:

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 a return on the net investment in the leveraged leases during the years in which the net

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1 FIN 18, par. 80.
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.

We believe that investment tax credits that arise from direct-financing leases and are recognized as additional return on investment should also be excluded.

17.1.1.3.4 After-tax Equity Pickup for Investees Owned 50 Percent or Less

It is typically appropriate to record equity in the net income of a 50-percent-or-less-owned investee based on its interim statements on an after-tax basis (i.e., the investee would provide taxes in its financial statements based on its own estimated annual effective tax rate calculation). For any incremental investor's tax (e.g., the deferred tax liability for unremitted earnings), the incremental tax would not be calculated as part of the investor's overall ETR calculation. Instead, this incremental tax would be calculated based on a separate ETR calculation (i.e., the amount of incremental tax expected to be incurred in the annual period divided by the estimated annual amount of equity method income).

17.1.1.4 Other Items That Do Not Represent Tax Effects Related to Ordinary Income

ASC 740-270-25-2 makes it clear that the only items that should be spread by means of the estimated annual effective tax rate approach are the tax effects of current-year ordinary income (or loss). As a result, many items resulting from actions that occurred during the year, but not representing tax effects related to current-year ordinary income, should be recorded discretely in the interim period in which they occurred (i.e., excluded from the ETR calculation). Examples of these items include the following:

• Subsequent recognition, derecognition, or change in measurement for an uncertain tax position arising in prior periods due to a change in judgment or interpretation of new information (Section TX 17.1.1.4.1)
• Interest and penalties recognized on uncertain tax positions (Section TX 17.1.1.4.2)
• Change in tax law (Section TX 17.1.1.4.3)
• Change in tax status (Section TX 17.1.1.4.4)
• Certain changes in the realizability of deferred tax assets (Section TX 17.1.1.4.5)
• Change in judgment regarding unremitted foreign earnings and other outside basis differences (Section TX 17.1.1.4.6)
• Change in estimate related to a prior-year tax provision (Section TX 17.1.1.4.7)

17.1.1.4.1 Subsequent Recognition, Derecognition, or Change in Measurement for an Uncertain Tax Position Arising in Prior Periods Due to a Change in Judgment or Interpretation of New Information

As discussed in ASC 740-10-25-14 through 25-15, the existence of new information that results in a change in judgment that causes subsequent recognition, derecognition, or a change in measurement of a tax position taken in a prior period shall be recognized as a discrete item (including interest and penalties) in the period.
in which the change occurs. For example, if an event during an interim period (e.g., a court case or tax ruling related to another taxpayer with a similar exposure) prompts a change in the assessment of the sustainability of a tax position taken in a prior year (i.e., based on the technical merits of the tax position), the effect of the change should be recorded discretely in the period in which the assessment changes.

However, as discussed at ASC 740-270-35-6, if the assessment changes with respect to a current-year tax position, the new assessment should generally be incorporated into the revised ETR that will be applied to the year-to-date ordinary income and in each successive quarter (unless the tax uncertainty relates to a pretax item that was accounted for discretely, such as discontinued operations). The requirements for recording changes in unrecognized tax benefits in interim periods can be summarized as follows:

<table>
<thead>
<tr>
<th>Change Related to:</th>
<th>Interim Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior year uncertain tax position</td>
<td>Discrete</td>
</tr>
<tr>
<td>Current year uncertain tax position (related to ordinary income included in ETR)</td>
<td>Included in ETR</td>
</tr>
<tr>
<td>Current year uncertain tax position (related to income excluded from ETR)</td>
<td>Discrete</td>
</tr>
</tbody>
</table>

17.1.1.4.2 Interest and Penalties Recognized on Uncertain Tax Positions

ASC 740-10-25-56 requires that interest be accrued in the first period in which the interest would begin accruing according to the provisions of the relevant tax law. Therefore, interest expense should be accrued as incurred and should be excluded from the ETR calculation. ASC 740-10-25-57 indicates that a penalty should be recorded when a position giving rise to a penalty is taken or anticipated to be taken on the current year’s tax return.

17.1.1.4.3 Change in Tax Law

In accordance with ASC 740-10-25-47 through 25-48, ASC 740-10-45-15, and ASC 740-270-25-5 through 25-6, adjustments to deferred tax assets and liabilities as a result of a change in tax law or rates should be accounted for discretely in continuing operations at the date of enactment. Similarly, the effects of a retroactive change in tax rates should also be accounted for discretely in continuing operations in the interim period in which the law is enacted. However, the prospective effects of a change in tax law or rates on tax expense in the year of enactment should be reflected in the estimated annual effective tax rate calculation. See Section TX 7.4 (including Example 7-4) for more information on the accounting for changes in tax law.

17.1.1.4.4 Change in Tax Status

As specified in ASC 740-10-25-32 through 25-34, the effect of a voluntary change in tax status should be recognized discretely on (1) the date that approval is granted by the taxing authority or (2) the filing date, if approval is unnecessary. The entire effect of a change in tax status should be recorded in continuing operations in accordance with ASC 740-10-45-19. Chapter TX 8 offers more information on the accounting for changes in tax status.
17.1.4.5  Certain Changes in the Assessment of the Realizability of Deferred Tax Assets

As prescribed by ASC 740-270-25-7, the tax effect of a change in the beginning-of-the-year balance of a valuation allowance caused by a change in judgment about the realizability of the related deferred tax asset that results from changes in the projection of income expected to be available in future years should be recognized discretely in the interim period in which the change in judgment occurs. A change in judgment about the realizability of deferred tax assets resulting from changes in estimates of current-year ordinary income and/or deductible temporary differences and carryforwards that is expected to originate in ordinary income in the current year should be considered in determining the estimated annual effective tax rate. The change in judgment should not be recorded discretely in the interim period in which it changes. See Example 17-6 and Section TX 17.4.4 for additional information.

17.1.4.6  Change in Judgment Regarding Unremitted Foreign Earnings and Other Outside-Basis Differences

A company will sometimes change its intentions about whether it will indefinitely reinvest undistributed earnings of foreign subsidiaries or corporate joint ventures that are essentially permanent in duration and thus whether it will record deferred taxes on outside basis differences. In these situations, the tax effect of the change in judgment for the establishment/reversal of the deferred tax liability related to the outside basis difference that had accumulated as of the beginning of the year should be recorded in continuing operations in the interim period during which the intentions changed. A portion of the outside basis difference that accumulated as of the beginning of the year may include the effects of currency movements that (1) had been previously recorded through a cumulative translation adjustment (CTA) as the company had already established a deferred tax liability or (2) were not recorded through CTA as the company did not recognize a deferred tax liability on the CTA portion of the outside basis difference. In either situation, the effect of that currency movement on the outside basis difference as of the beginning of the year is reflected in continuing operations in the period in which the change in judgment occurred. This treatment is consistent with ASC 740-30-25-19, which indicates that the tax effect of a subsidiary’s undistributed earnings (1) should be charged to expense in the period during which the circumstances change and (2) should not be recorded as an extraordinary item.

The tax effect of the change in intentions on unremitted earnings of the current year should be reflected in the determination of the company’s ETR. Accordingly, any tax effect related to currency movements associated with current-year unremitted earnings that increases or decreases the deferred tax liability would be attributed to CTA (i.e., a component of other comprehensive income) for the period. This is consistent with ASC 740-20-45-11(b), subject to the intraperiod allocation process in ASC 740-20-45. Chapter TX 12 offers a detailed discussion of intraperiod allocation.

17.1.4.7  Change in Estimate Related to a Prior-Year Tax Provision

As discussed in Section TX 17.1, the language in ASC 740-270-25-2, makes it clear that the estimated annual effective tax rate approach should only be used to record the tax effect of current-year ordinary income. A change in estimate in the current year that is related to a prior-year tax provision does not constitute a tax effect on current-year income. Therefore, the effects of this change should be recorded discretely in the period during which the change in estimate occurs. The next section presents guidance for determining whether a change in the prior-year tax provision is an error or a change in estimate.
Discerning an Error from a Change in Accounting Estimate in Income Taxes

The following guidance is intended to assist professionals with judgements as to when changes in tax positions reflected in prior periods or changes in income tax amounts accrued in prior periods constitute financial reporting “errors” rather than changes in estimate. The following circumstances are among those intended to be covered by this guidance:

- The discovery that the tax reported in a prior year’s return was either understated or overstated (regardless of whether an amended return has been filed);
- The discovery that a tax return or tax payment filing requirement was not met;
- The discovery of misapplication of ASC 740 or related accounting principles; or
- A change in the amount of tax expense or benefit initially recognized related to a prior reporting period (e.g., via a return-to-provision “true-up”).

Unless specified otherwise, all matters addressed in this section are subject to normal materiality considerations.

The ASC Master Glossary definition of the term change in accounting estimate indicates that a change in accounting estimate results from “new information.” In contrast, the ASC Master Glossary definition of the term error in previously issued financial statements indicates that errors result from “mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.”

As it relates to accruals for income taxes, we believe that, in general, an adjustment of a prior-period tax accrual that results either from new information (including a change in facts and circumstances) or later identification of information that was not reasonably “knowable” at the original balance sheet date and that results in improved judgment would lead to a change in estimate. However, an adjustment that arises from information that was reasonably “knowable” during the prior reporting period (or represents a reconsideration of the same information) may constitute “oversight or misuse of facts” and, therefore, may be an error. In this regard, consideration should be given to whether the information was (or should have been) “readily accessible” from the company’s books and records in a prior reporting period and whether the application of information commonly known by competent corporate tax professionals at that time would have resulted in different reporting.

Examples of Errors

The following would be examples of errors:

- A tax accrual is intentionally misstated (without regard to materiality).
- A mechanical error is made when calculating the income tax provision (e.g., if meals and entertainment expenditures were deducted twice instead of being added back to taxable income or if the wrong disallowance rate was applied).
- Misapplications of ASC 740 and related accounting principles and interpretations are made. For example, the company failed to record a tax benefit or contingent tax liability at the balance sheet date that should have been recognized in accordance with such guidance considering the facts and circumstances that existed at the reporting date and that were reasonably knowable at the date the financial statements were issued.
• The company chose to estimate rather than obtain an amount for tax provision purposes at the balance sheet date that was “readily accessible” in the company’s books and records, and the actual amount differs from the estimate. In assessing whether information was (or should have been) “readily accessible,” consideration should be given to the nature, complexity, relevance and frequency of occurrence of the item. In this regard, it would be expected that companies would develop internal control processes to properly consider relevant information relating to frequently occurring or recurring items that could be significant.

For example, a company would be expected to have an adequate internal control system to track meals and entertainment charges, to the extent such amounts create a material permanent difference in the company’s tax return. If there is a significant difference between the estimate made when closing the books and the actual amount reported on the tax return, this would seem to constitute an error. This is not to suggest that the level of precision is expected to be completely accurate or that all differences between estimates and actual amounts constitute errors. Rather, a relatively insignificant difference between an estimate and the actual amount provides evidence that the company’s control system is adequate and that such an adjustment should be treated as a change in estimate in the period identified.

Conversely, consider a company that had never before repatriated foreign earnings (and had not provided deferred taxes on such amounts in accordance with ASC 740-30-25-17). The company decides late in its fiscal year to repatriate some or all of the foreign earnings. To determine the financial statement impact of the planned repatriation, the company may need to perform complex “earnings & profits” (E&P) computations or assess other data that may only become available after year-end and take considerable time to complete (and thus would not be “readily accessible” as of the balance sheet date). To close its books on a timely basis, the company estimates certain amounts that are not readily accessible based on information available from the company’s books and records. In this case, assuming the company had a reasonable basis for its original estimates, we would be inclined to view any subsequent adjustment as a change in estimate. In this circumstance, to the extent amounts needing to be estimated were material, we would also expect disclosures (e.g., “early warning” disclosures prescribed by ASC 275-10-50-8 through 50-9) if it was reasonably possible that the estimates used could change within the next 12 months, such as when the E&P analysis was completed.

Distinguishing when information was (or should have been) readily accessible will often be judgmental and will be based on the facts and circumstances of each situation.

**Examples of Changes in Estimate**

The following circumstances would constitute changes in accounting estimate:

An event occurs that results in a changed judgment with respect to the sustainability of an uncertain tax position or an amount related thereto.

Examples of events are: (1) a settlement is reached with the taxing authorities related to a previously identified uncertain tax position; (2) a change in interpretation of tax law or new administrative ruling; (3) additional expert technical insight obtained with respect to complex, highly specialized or evolving areas of tax law interpretation and knowledge; and (4) additional information becomes known based on other taxpayers.
with similar situations that provides better insight into the sustainability of the uncertain tax position. For example:

- The company, with the assistance of highly specialized tax experts, obtains a new insight or point of view in relation to the application of the tax law with respect to prior tax return positions involving nonrecurring or complex transactions or technical tax issues. Because of the level of sophistication and expertise required, and recognizing that insight with respect to complex tax laws is continually evolving both on the part of tax professionals and the taxing authorities, these circumstances would typically suggest a change in estimate rather than an error.

- The company makes a retroactive tax election that affects positions taken on prior tax returns (as is sometimes permitted under the tax code), as long as the primary factors motivating such change can be tied to events that occurred after the balance sheet date. For example, based on subsequent-year developments, such as lower than expected operating results in succeeding periods, a company concludes that it is more tax efficient to deduct foreign income taxes paid than to claim a foreign tax credit for foreign taxes paid.

- Due to a change in facts and circumstances, there is an economic basis to pursue a tax credit or deduction retroactively that was previously considered not to be economical. This is premised on the company having evaluated the acceptability of the tax position at a previous balance sheet date and having performed a reasoned analysis of the economics, and reaching a conclusion that it was not prudent to pursue such benefit. For example, a company considered the potential tax savings associated with pursuing tax credits for certain research activities. Based on the company’s lack of current taxable income, it concluded that the additional administrative burden of pursuing such credits was not economical. Then, in a subsequent period, based on a change in the company’s operating results and perhaps due to an increase in the amount of the potential credits, the company decided to put in place the necessary infrastructure to be able to claim the credit, including for retroactive periods.

- Another example of a change in facts and circumstances might be new tax software becoming available that makes it economical to pursue a tax benefit. To the extent it is concluded that a change in estimate has occurred, it should be noted that ASC 250-10-50-4 indicates that disclosure is required if the effect of the change is material.

17.2 Computing the Tax Provision Attributable to Ordinary Income

17.2.1 Estimated Annual Effective Tax Rate

17.2.1.1 Methodology

With limited exceptions, ASC 740-270 requires companies to calculate the estimated annual effective tax rate for current-year ordinary income, including both the current and deferred provisions determined under ASC 740. To project taxable income for the year, which is in turn used to estimate the annual provision for taxes currently payable, it is necessary to estimate temporary differences and rate differentials entering into the current provision. The temporary differences used to estimate the current provision are then included in the projected year-end temporary differences used to estimate the annual provision for deferred taxes, including any change in the valuation allowance. These estimates should be updated on each interim financial reporting date.
As a practical matter, however, there may be circumstances in which the estimated annual effective tax rate can be appropriately estimated by considering only rate differentials. These situations often involve temporary differences that are expected to have offsetting effects in the current and deferred provisions (i.e., the effect on the current provision would be equal in amount but opposite in direction to the effect on the deferred provision). If additional complexities arise (e.g., the enacted tax rate varies between years or a valuation allowance for beginning or ending deferred tax assets changes), separate estimates of the annual current and deferred provisions must typically be made to develop an appropriate estimated annual effective tax rate.

**PwC Observation:** ASC 740-270-55 contains numerous examples of the application of the estimated annual effective tax rate approach to a variety of fact patterns:

- Income fluctuates from quarter to quarter
- Valuation allowance considerations
- Losses projected for the year or incurred on a year-to-date basis and the benefit computed under the ETR approach must be limited
- Multiple jurisdictions
- Tax law changes
- Discontinued operations
- Significant unusual or infrequent items

Use of the ETR approach, as required by ASC 740-270, could yield results that are materially different from a discrete calculation of the year-to-date provision. If a company does not qualify for one of the exceptions and is not using the ETR approach (described in more detail below), the company should ensure that the result it obtains is not materially different.

### 17.2.1.2 Best Current Estimate

#### 17.2.1.2.1 General

The estimated annual effective tax rate should represent the best estimate of the composite tax provision in relation to the best estimate of worldwide pretax book ordinary income. The composite tax provision should include federal, foreign, and state income taxes, including the effects of (1) credits, (2) special deductions (e.g., Internal Revenue Code Section 199 deduction under the American Jobs Creation Act or percentage depletion), (3) capital gains taxed at different rates, and (4) valuation allowances for current-year changes in temporary differences and losses or income arising during the year. The estimated annual ETR is then applied to year-to-date ordinary income to compute the year-to-date interim tax provision on ordinary income. The difference between the year-to-date interim tax provision and the year-to-date interim tax provision as of the preceding interim period constitutes the tax provision for that quarter.

**PwC Observation:** Because the estimate of full-year income may change from quarter to quarter, the ETR for any particular quarter may not have a meaningful relationship to pretax income for the quarter or the current estimated annual effective tax rate.
17.2.1.2.2 Treatment of Nonrecognized Subsequent Events on the ETR

If a significant pretax nonrecognized subsequent event occurs after the interim balance sheet date but before financial statement issuance, an important question arises: Should the company’s best current estimate of annual pretax ordinary income be updated for the nonrecognized subsequent event, or should the best current estimate only use information that existed as of the balance sheet date? For example, assume that, subsequent to the interim balance sheet date, a significant new customer contract was signed. Alternatively, assume a severe hurricane loss was suffered by an insurance company. In both instances, the subsequent event significantly changed the company’s current estimate of its annual pretax ordinary income and thereby its estimated annual effective tax rate.

ASC 740-270-35-3 indicates that, at the end of each interim period during the fiscal year, the estimated annual effective tax rate should be revised, if necessary, to reflect the entity’s best current estimate. Therefore, one could reasonably conclude that the company’s best current estimated annual effective tax rate should be based on information available prior to the date of issuance, even though some of that information might be about influential factors that did not exist or were not relevant until after the interim balance sheet date.

Conversely, AU Section 560.05 indicates that nonrecognized subsequent events should not result in the adjustment of the financial statements. If an entity were to incorporate a significant nonrecognized subsequent event into the development of an updated ETR, some of the subsequent event’s indirect effects would be recorded in the results up until the balance sheet date that preceded the nonrecognized event. Since the effects of nonrecognized subsequent events should not be reflected in the financial statements, one could reasonably conclude that the effects of a nonrecognized subsequent event should be excluded from the interim calculation of the ETR.

Given that either approach can be supported by a reasonable interpretation of existing guidance, we believe that both are acceptable. However, a company must choose one approach and consistently apply it as an accounting policy.

Companies that choose to consider all available information up until the issuance date should be careful to exclude items whose tax effects are required to be recognized discretely in the period that they occur, such as: (1) changes in tax laws or rates (as discussed in Section TX 7.4), (2) new information received after the reporting date related to the assessment of uncertain tax positions (as discussed in Sections TX 16.5.5 and TX 17.1.1.4), and (3) discontinued operations, extraordinary items, and other significant unusual or infrequent items (as discussed in Section TX 17.1.1.2.1).

When there is a significant time lag from the interim date to the date of the issuance of the financial statements (as may be the case with a company reporting on a prior interim period for the first time in connection with a registration statement), it may become increasingly difficult to assert that an event in the extended period should affect the estimated annual effective tax rate applied to the interim period. We generally believe that the delayed issuance of the financial statements should not result in a different assessment of the estimated annual effective tax rate than would have been the case had the financial statements been issued on a timely basis.
17.2.1.3 Limitation on Benefits of Losses, Credits, and Rate Differentials in Loss Periods

The ETR approach is modified by ASC 740-270-30-30 through 30-34, which limit the tax benefit recognized for a loss in interim periods to the amount that is expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year. Those limitations should be applied in determining both separate jurisdiction and worldwide estimated annual effective tax rates and the year-to-date benefit for a loss. We believe that those limitations also apply to rate differentials that would increase the effective benefit rate during loss periods.

In applying the guidance in ASC 740-270-30-30 through 30-34 related to the realizability of deferred tax assets and the need for a valuation allowance, the central issue that a company needs to consider is the valuation allowance that it expects to recognize at year-end, including any expected change in the valuation allowance during the year. The company cannot simply focus on the benefit of losses in the current year.

Example 17-2: Application of ASC 740-270-30-30 through 30-34: Loss Limitation When the Year-to-Date Loss Exceeds the Full-Year Expected Loss and Full Realization of the Tax Benefit of the Loss Is Assured

Background/Facts:
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. A total of $10,000 in tax credits is anticipated for the fiscal year. The company does not anticipate any events that do not have tax consequences.

If there is a recognizable tax benefit for the loss and the tax credits pursuant to the requirements of ASC 740-10, the estimated annual effective tax rate that applies to the ordinary loss would be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax benefit at statutory rate ($100,000 at 50%)</td>
<td>$(50,000)</td>
</tr>
<tr>
<td>Tax credits</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net tax benefit</td>
<td>$(60,000)</td>
</tr>
<tr>
<td>Estimated annual effective tax rate ($60,000 ÷ $100,000)</td>
<td>60%</td>
</tr>
</tbody>
</table>

The entity has the following year-to-date ordinary income and losses for the following interim periods:

<table>
<thead>
<tr>
<th>Year-to-date Ordinary income/(loss)</th>
<th>First Quarter</th>
<th>Second Quarter</th>
<th>Third Quarter</th>
<th>Fourth Quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income/(loss)</td>
<td>$20,000</td>
<td>$(60,000)</td>
<td>$(140,000)</td>
<td>$(100,000)</td>
</tr>
</tbody>
</table>

The full tax benefit of the anticipated ordinary loss and the anticipated tax credits will be realized through carryback. The full tax benefit of the maximum year-to-date ordinary loss can also be realized through carryback.

Question:
Given these facts, how should the interim reporting guidance be applied?

(continued)
Analysis/Conclusion:
Quarterly tax computations are as follows:

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Quarterly Income/(Loss)</th>
<th>Year-to-Date Income/(Loss)</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Tax (or Benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First quarter</td>
<td>$20,000</td>
<td>$20,000</td>
<td>60%</td>
<td>$12,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$—</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$12,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(80,000)</td>
<td>(60,000)</td>
<td>60%</td>
<td>(36,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(48,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(80,000)</td>
<td>(140,000)</td>
<td>60%</td>
<td>(84,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$(80,000)(^1)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(36,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(44,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>(100,000)</td>
<td>60%</td>
<td>(60,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(80,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$(100,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$(60,000)</td>
</tr>
</tbody>
</table>

\(^1\) 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 loss is limited to the amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the fiscal year. The limitation is computed as follows:

- Year-to-date ordinary loss multiplied by the statutory rate ($140,000 at 50%) = $70,000
- Estimated tax credits for the year = $10,000
- Year-to-date benefit (as limited) = $80,000

Note: Example 17-2 was derived from ASC 740-270-55-16.

Example 17-3: Application of ASC 740-270-30-30 through 30-34: Loss Limitation When the Year-to-Date Loss Exceeds Full-Year Expected Loss and Partial Realization of the Tax Benefit of the Loss Is Assured

Background/Facts:
Assume that the same facts presented in Example 17-2 are applicable to this example except that 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 (i.e., $20,000 of tax at the 50 percent statutory rate) will not be realized. Therefore, the estimated annual effective tax rate is 20 percent (i.e., $20,000 of benefit that is more-likely-than-not to be realized divided by $100,000 of estimated fiscal-year ordinary loss).

Question:
Given these facts, how should the interim reporting guidance be applied?

Analysis/Conclusion:
Quarterly tax computations are as follows:

(continued)
### 17.2.2 Exceptions to the Use of the ETR Approach

ASC 740-270 requires the use of an estimated annual effective tax rate to compute the tax provision for ordinary income in all jurisdictions during an interim period. However, in determining that rate, there are two exceptions to the general rule that requires all jurisdictions (and all the tax effects on current-year ordinary income) to be included in the computation of the consolidated worldwide ETR.

If one of these two exceptions applies and one or more foreign jurisdictions are excluded from the computation of the worldwide ETR, the U.S. tax effects (e.g., remitted or unremit dividend income and related foreign tax credits) of the operations in those foreign jurisdictions are also excluded. State and municipal income tax jurisdictions are subject to the same limitations as foreign jurisdictions with respect to what can be included in the consolidated worldwide ETR.

**PwC Observation:** The estimated annual effective tax rate approach can yield illogical results (such as a negative ETR or an ETR exceeding 100 percent) if a company (1) expects to be in a loss position or near breakeven for the entire fiscal year or (2) has experienced year-to-date losses. Regardless of those seemingly illogical results and apart from the exceptions outlined below, ASC 740-270 provides no relief from the requirement to apply the ETR approach.

### 17.2.2.1 Jurisdictions with Pretax Losses for which No Tax Benefit Can Be Recognized

When a company operates in a jurisdiction that has generated ordinary losses on a year-to-date basis or on the basis of the results anticipated for the full fiscal year and no benefit can be recognized on those losses, ASC 740-270-30-36(a) requires the company to exclude that jurisdiction’s income (or loss) from the overall ETR calculation. A separate ETR should be computed and applied to ordinary income (or loss) in that jurisdiction. In effect, any jurisdictions with losses for which no benefit can be recognized are removed from the base calculation of the ETR. Assuming the reason for no benefit is a full valuation allowance, the separate ETR for that jurisdiction would be zero.

---

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Quarterly Income/(Loss)</th>
<th>Year-to-Date Income/(Loss)</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>Year-to-Date Less Previously Provided</th>
<th>Reporting Period Amount</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>$4,000</td>
</tr>
<tr>
<td>Second quarter</td>
<td>$(80,000)</td>
<td>$(60,000)</td>
<td>20%</td>
<td>$(12,000)</td>
<td>$(16,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>$(80,000)</td>
<td>$(140,000)</td>
<td>20%</td>
<td>$(28,000)</td>
<td>$(12,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>40,000</td>
<td>$(100,000)</td>
<td>20%</td>
<td>$(20,000)</td>
<td>$(20,000)</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$(100,000)</td>
<td></td>
<td></td>
<td>$(20,000)</td>
<td>$(20,000)</td>
</tr>
</tbody>
</table>

Note: Example 17-3 was derived from ASC 740-270-55-20.
PwC Observation: As discussed above, jurisdictions in which a company is unable to recognize a tax benefit for losses are excluded from the ETR calculation. We believe that the same concept should be applied to an individual return (i.e., a separate tax-paying component) within a jurisdiction if multiple returns are filed within the same jurisdiction and the tax provision or benefit resulting from those separate returns is determined without regard for the other returns (e.g., in the United Kingdom, although separate returns may be filed, groups commonly elect “group relief,” the outcome of which is similar to the outcome of filing a consolidated tax return).

We also believe that the use of the term no tax benefit should be interpreted literally. If a company records any benefit (e.g., carryback of current-year losses to offset income in prior years), the ETR approach must be used unless another exception applies.

Example 17-4: Treatment of Withholding Tax in an Interim Period Income Tax Calculation for an Entity with Operations in Multiple Jurisdictions

Background/Facts:
Parent has operations in Country A. Parent also has a wholly owned subsidiary (“Sub”) with operations in Country K. Upon repatriation of earnings, Parent will pay tax in both Country A and Country K on the earnings of Sub. Parent’s tax due to Country K will be paid by Sub on behalf of Parent in the form of a withholding tax for which Parent is the legal obligor. In the instant case, Parent does not consider the earnings of Sub to be indefinitely reinvested, and therefore, records a deferred tax liability on the outside basis difference in its investment in Sub. Such deferred tax liability would consider applicable tax in both Country A and K and would include withholding taxes in Country K as well as incremental taxes, net of realizable foreign tax credits, if any, in Country A.

To determine the tax provision in an interim period, ASC 740-270-30-36 typically requires the use of an overall (or worldwide) effective tax rate (ETR) applied to worldwide income. However, in certain circumstances, a jurisdiction will be excluded from the worldwide ETR calculation. ASC 740-270-30-36(a) requires that if an entity has a year-to-date ordinary loss or expects an annual ordinary loss in a separate jurisdiction for which the benefit will not be realized (i.e., a full valuation allowance (continued)
will be recorded), then the interim tax provision is calculated separately for that jurisdiction, using the principles of ASC 740-270.

At the end of Q2, Sub has year-to-date ordinary income and anticipates ordinary income for the fiscal year. Parent’s operations in Country A have a year-to-date ordinary loss and an anticipated ordinary loss for the fiscal year. Parent has a full valuation allowance on its net deferred tax assets.

**Question:**
Should Parent’s withholding tax obligation to Country K related to Sub’s earnings be included in the worldwide ETR calculation?

**Analysis/Conclusion:**
We believe there are two acceptable alternatives, as long as the method chosen is consistently applied.

**Alternative A:** Include Parent’s obligation in Country K in the worldwide ETR (i.e., look to the tax obligations by jurisdiction). Under this view, the withholding tax is considered separately from Parent’s tax to Country A on the earnings of K.

Each component is analyzed as follows:

*Country A (Parent)*—Country A is excluded from the worldwide ETR calculation due to year-to-date ordinary loss for which no benefit may be recognized (i.e., a full valuation allowance is needed).

*Country K (Parent)*—Parent is recording withholding tax related to Sub’s earnings. Sub has year-to-date ordinary income and anticipates ordinary income for the fiscal year. This jurisdictional component is not in a year-to-date loss situation and should therefore be included in the worldwide ETR calculation.

*Country K (Sub)*—As stated above, Sub has year-to-date ordinary income and anticipates ordinary income for the fiscal year. Therefore, this jurisdictional component should be included in the worldwide ETR calculation.

Alternative A is supported by the jurisdictional discussion in ASC 740-270-30-36, which includes the following language, “an enterprise that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions…” This view is also supported by the general requirements of ASC 740-10-45-6 for financial statement presentation for income taxes by “tax-paying component of an enterprise within a particular tax jurisdiction.” In the case of Parent’s tax obligation to Country K, the identified income is the earnings of Sub on which the tax is levied, and the tax-paying component is Parent, the legal obligor.

**Alternative B:** Include Parent’s withholding tax to Country K in Parent’s separate income tax calculation and therefore exclude it from the worldwide ETR. Under this view, the withholding tax is considered a component of the measurement of Parent’s tax expense on its investment in Sub.

Each component is analyzed as follows:

*Parent (Country A and K)*—For the reasons previously discussed, Country A is excluded from the worldwide ETR calculation. Parent’s obligation to Country K would follow the treatment for Country A and also be excluded from the worldwide ETR calculation.

(continued)
Sub (Country K)—For reasons previously discussed, this jurisdictional component is included in the worldwide calculation.

As discussed in ASC 740-10-55-24, the withholding tax due to Country K is merely a component of the Parent's measurement of taxes on its investment in Sub. ASC 740-10-55-24 provides that measurement should be based on expectations regarding tax consequences (e.g., capital gains or ordinary income). The computation of a deferred tax liability for undistributed earnings based on dividends should reflect any related dividends received, deductions or foreign tax credits, and taxes that would be withheld from the dividend.

In measuring deferred taxes on Parent’s investment in Sub, Parent would incorporate withholding tax. The withholding tax would therefore be associated with Parent for purposes of calculating interim tax.

This analysis is further supported by ASC 740-270-30-36(b), which states that “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, etc.” While ASC 740-270-30-36(b) is not the exception being applied in the present fact pattern, it is related.

17.2.2.1.1 Zero-Rate Jurisdictions

ASC 740-270 does not specifically address whether a zero-rate jurisdiction should or should not be included in the ETR computation. As there is conceptual support for either inclusion or exclusion of a zero-rate jurisdiction, we believe this is an aspect of accounting for income taxes for which diversity in practice can be expected. The following are four acceptable approaches:

Approach A: Always exclude pre-tax ordinary income or loss from a zero-rate jurisdiction from the ETR computation. This view is premised on the theory that the income in a zero-rate jurisdiction is effectively tax-exempt. The exclusion of pre-tax income from a zero-rate jurisdiction is analogous to the optional treatment of tax-exempt income discussed in TX 17.1.1.3.1.

Approach B: Exclude pre-tax ordinary income or loss from a zero-rate jurisdiction from the ETR computation if there is a year-to-date loss in that jurisdiction. The rationale for this view is based on the notion that a loss ultimately will not provide a tax benefit. Support for this view can be found in ASC 740-270-30-36(a) which requires the exclusion of jurisdictions with year-to-date losses if no tax benefit can be recognized for the year-to-date loss or for an anticipated full-year loss.

Approach C: Exclude pre-tax ordinary income or loss from a zero-rate jurisdiction from the ETR computation only if a loss is anticipated for the full fiscal year. This view concludes that ASC 740-270-30-36(a) is not directly applicable because it addresses positive tax rate jurisdictions in circumstances where a loss would be offset with a valuation allowance. This view would not exclude income or loss when a year-to-date loss is anticipated to reverse in subsequent periods. This view in effect represents a modified analogy to the principle in ASC 740-270-30-36(a).
Approach D: Always include pre-tax ordinary income or loss from a zero-rate jurisdiction the ETR computation because the underlying principle in ASC 740-270 is that, absent a specific requirement or exception, all current-year ordinary income or loss should be included in the ETR computation. This view differentiates the exception in ASC 740-270-30-36(a) as only applying to taxable jurisdictions for which a valuation allowance may be necessary. This view is premised on the notion that the ETR approach is known to yield, at times, seemingly illogical results in particular periods, yet there are only two narrowly drawn exceptions to full-inclusion, both of which are described with reference to an entity that “is subject to tax.”

The approach used should be considered an accounting policy election to be applied consistently to all zero-rate jurisdictions of the reporting entity. If it is clearly evident that the approach applied to zero-rate jurisdictions has reporting consequences that would be significantly different than had one or more of the other acceptable approaches outlined above been applied, appropriate disclosure should be considered.

17.2.2.2 Jurisdictions for Which a Reliable Estimate Cannot Be Made

17.2.2.2.1 General Overview

ASC 740-270-30-36(b) provides the following two situations in which a company should exclude a jurisdiction from the overall computations of the estimated annual effective tax rate:

1. If a company operates in a foreign jurisdiction for which a “reliable estimate” of the annual effective tax rate in terms of the parent entity’s functional currency cannot be made.

2. If a reliable estimate of ordinary income for a particular jurisdiction cannot be made.

Presumably the first situation would arise when the exchange rate between the parent company’s functional currency and the foreign currency is highly volatile (this does not commonly occur in practice).

With respect to the second situation, the FASB acknowledged that determining whether an estimate is reliable requires the use of professional judgment and may involve the assessment of probability. For example, in some cases, a small change in an entity’s estimated ordinary income could produce a significant change in the ETR. In such cases, an estimate of the ETR would not be reliable if a small change in ordinary income were likely to occur.

PwC Observation: Entities should refrain from asserting an inability to make a reliable estimate if they do so merely to escape the requirement to follow the ETR approach. However, exceptional circumstances can exist in which a genuine inability justifies a discrete-period computation. This might be the case for a company that is anticipating marginal profitability for the year, but has significant

(continued)

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2 FIN 18, par. 82.
permanent differences that could result in wide variability in the ETR. In all such cases, management’s assertion must be supported by sufficient evidence. A quantitative analysis (such as a sensitivity analysis) supports a company’s assertion that a reliable estimate cannot be made by demonstrating the potential variability in the estimated annual effective tax rates that would result across a range of likely scenarios. A company’s assertion that it cannot develop a reliable estimate should be consistent with its other disclosures and communications to investors. We believe that a company’s assertion that it cannot reliably estimate its ETR should be prominently disclosed to financial statement readers so that they can understand the manner in which the interim tax provision was determined.

Example 17-5: Interim Period Calculation of the ETR Involving a Jurisdiction That Anticipates an Ordinary Loss for the Fiscal Year

Background/Facts:
Company X operates in and is subject to tax in two different jurisdictions. Management has projected for the fiscal year that Jurisdiction A will have ordinary income, but Jurisdiction B will have an ordinary loss. Because Company X is a seasonal business, operating results are expected to vary from quarter to quarter.

Assume that the losses in Jurisdiction B will be benefited fully and that any resulting end-of-year deferred tax asset will not require a valuation allowance. Assume also that Company X is able to make reliable estimates of ordinary income and loss for Jurisdictions A and B.

The applicable tax rate for Jurisdiction A is 40 percent and the applicable tax rate for Jurisdiction B is 50 percent. No significant rate differentials are anticipated in either jurisdiction.

Company X develops for each jurisdiction the following budget of pretax income and loss and the related tax expense and benefit:

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Pretax Income (Loss)</th>
<th>Tax Expense (or Benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jurisdiction A</td>
<td>B</td>
</tr>
<tr>
<td>First quarter</td>
<td>$100</td>
<td>$ (20)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>100</td>
<td>(20)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>20</td>
<td>(80)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>20</td>
<td>(80)</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$240</td>
<td>$(200)</td>
</tr>
</tbody>
</table>

Based on the above forecasts, Company A determines that the estimated annual effective tax rate is negative 10 percent (i.e., $4 of total tax benefit on $40 of consolidated income). Assuming that the actual results mirror the projected results, application of the estimated annual effective tax rate as calculated would yield the following results:
Because the losses in Jurisdiction B are benefited at a higher tax rate than the income in Jurisdiction A is being taxed, Company X’s management believes that application of a global estimated annual effective tax rate produces counterintuitive results. For this reason, management proposes calculating a separate estimated annual effective tax rate for each individual jurisdiction (i.e., 40 percent for Jurisdiction A and 50 percent for Jurisdiction B). Management's proposed approach would yield the following results:

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Consolidated Pretax Income (Loss)</th>
<th>Consolidated Tax Expense (Benefit)</th>
<th>Calculated Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Quarterly</td>
<td>Year-to-Date</td>
<td>Quarterly</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ 80</td>
<td>$ 80</td>
<td>(10)%</td>
</tr>
<tr>
<td>Second quarter</td>
<td>80</td>
<td>160</td>
<td>(10)%</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(60)</td>
<td>100</td>
<td>(10)%</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>(60)</td>
<td>40</td>
<td>(10)%</td>
</tr>
<tr>
<td>Fiscal year</td>
<td>$ 40</td>
<td></td>
<td>(10)%</td>
</tr>
</tbody>
</table>

**Question:**
Is the alternative approach proposed by Company X’s management acceptable?

**Analysis/Conclusion:**
No. If a company is subject to tax in multiple jurisdictions, ASC 740-270 requires that the interim period tax related to consolidated ordinary income be computed using one overall estimated annual effective tax rate.

The application of the estimated annual effective tax rate approach may produce a result that could appear illogical from a consolidated perspective. However, ASC 740-270 provides only two exceptions to the overall computation of the estimated annual effective tax rate, as described in TX 17.2.2.1 and 17.2.2.2.
17.2.2.2 Computing a Tax Provision When a Reliable Estimate Cannot Be Made

ASC 740-270-30-17 through 30-18 reads as follows:

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. 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 ETR.

This excerpt clarifies that the estimated annual effective tax rate is an estimate that is inherently subject to changes. However, this fact alone does not justify a departure from the ETR approach.

Whether a reliable estimate of ordinary income or loss or the related tax can be made is a matter of judgment. If management is unable to estimate only a portion of its ordinary income, but is otherwise able to reliably estimate the remainder, the tax applicable to that item should be reported in the interim period in which the item occurs. An estimated annual effective tax rate must be applied to the remainder of ordinary income and the related tax that can be reliably estimated.

17.2.2.3 Effects of “Naked Credits” on the Estimated Annual Effective Tax Rate

When a company is incurring losses and has a full valuation allowance, the increase of a deferred tax liability that does not serve as a source of income for the recognition of a deferred tax asset will trigger an estimated tax for the current year. The impact of this “naked credit” should be included in a company's ETR calculation. This inclusion would be required whether the jurisdiction with the “naked credit” is included in an entity’s worldwide ETR calculation or excluded from the worldwide ETR calculation and treated as a separate jurisdiction with a stand-alone estimated annual ETR under ASC 740-270-30-36(a).

However, discrete treatment is appropriate when the annual estimate of the tax rate is not considered a reliable estimate. This may happen when a company determines a wide range of potential estimated annual effective tax rates because pretax income is at or near breakeven and it has significant permanent items such as the deferred tax effect from a “naked credit.” In such circumstances, consideration should be given to whether the company has the ability to estimate its ETR, given the range of possible outcomes. The inability to estimate the ETR in a jurisdiction would cause the tax provision for that jurisdiction to be calculated on a discrete basis under ASC 740-270-30-36(b).

17.3 Tax Effects Other Than the Tax on Current-Year Ordinary Income

ASC 740-270-25-2 requires that the entire tax (or benefit) related to all items other than the tax effect on ordinary income should “be individually computed and recognized when the items occur.”

Examples of these items include the tax effects related to discontinued operations, other comprehensive income, additional paid-in capital and items in continuing operations that represent tax effects not attributable to current-year ordinary income.
The tax effects represented by these items should be computed and reflected in accordance with the intraperiod allocation rules discussed below in Section TX 17.4.

17.4 Intraperiod Allocation in Interim Periods

17.4.1 General Overview

ASC 740-270-45 indicates that the intraperiod allocation rules (ASC 740-20-45) should be used to allocate the interim provision throughout the interim financial statements. Although the “with-and-without” model is basically the same for interim and annual periods, as discussed in ASC 740-270-45-2, the allocation of tax expense or benefit for interim periods should be performed using the estimated fiscal year income and tax for “ordinary income (or loss)” as defined by the ASC Master Glossary and the year-to-date income and tax for (1) an infrequent, unusual, or extraordinary item, (2) the gain or loss on disposal of a discontinued operation, or (3) another component of the financial statements (e.g., other comprehensive income). If more than one of the above items is present, the computation should reflect the order of precedence that will be assumed in annual financial statements. Thus, unusual or infrequent items that are included in continuing operations will ordinarily be considered before any items that are excluded from continuing operations.

If more than one item is excluded from continuing operations, the process outlined in ASC 740-20-45-14 should be used to apportion the remaining provision after the tax expense or benefit allocated to continuing operations is considered. This allocation process should be consistent with the process used in the annual calculation, which is illustrated in Chapter TX 12, Example 12-12.

17.4.2 Subsequent Revisions

Tax attributed to financial statement components that are reported in an early quarter can be subsequently revised to reflect a change in the estimate of tax related to annual ordinary income or changes in year-to-date income or loss in other components. ASC 740-270 requires the computation of the interim provision to be performed on a year-to-date basis. As a result, the tax provision for a given quarter equals the difference between the provision recorded cumulatively for the year (via the estimated annual effective tax rate approach) less the amount recorded cumulatively as of the end of the prior interim period. Changes in circumstances from quarter to quarter might make it necessary to record the tax effects in a financial statement category that differs from the one in which the company recorded the tax effects during a previous quarter. The goal of the ASC 740-270 model is to treat the interim periods as components of the current annual period. As a result, the intraperiod allocation, like the estimated annual effective tax rate, must be updated and recomputed each quarter.

17.4.3 Intraperiod Allocation That Reflects Discontinued Operations Prior to the Date on Which They Are Classified as Held for Sale or Disposed of

Once operations are classified as discontinued, prior periods are restated to reflect the now discontinued operations as discontinued. With respect to operating results of discontinued operations prior to the date on which those operations are first reported as discontinued operations, ASC 740-270-45-6 through 45-8 provides detailed rules for taking the tax previously assigned to ordinary income and allocating it between the recomputed ordinary income and the discontinued operations. In addition, ASC 740-270-55-29 provides an illustration of accounting for income taxes applicable to income or (loss) from discontinued operations at an interim date. See
Section TX 12.2.3.2.4 for a more detailed discussion about intraperiod allocation issues related to discontinued operations.

17.4.4 Changes in Valuation Allowance

The need for a valuation allowance must be reassessed at each interim reporting date. Pursuant to ASC 740-270-25-4, and depending on the circumstances that lead to a change in valuation allowance, the change may be reflected in the estimated annual effective tax rate or recognized discretely in the interim period during which the change in judgment occurred, or both.

Any change in valuation allowance that results from a change in judgment about the realizability of the related deferred tax assets resulting from changes in the projection of income expected to be available in future years is reported in the period during which the change in judgment occurs. No portion of the effect should be allocated to subsequent interim periods through an adjustment to the estimated annual effective tax rate for the remainder of the year.

The following changes in valuation allowance should be considered in determining the ETR for the year:

- A change in the valuation allowance related to deductible temporary differences and carryforwards that are expected to originate in ordinary income in the current year.

- A change in the valuation allowance for beginning-of-year deferred tax assets that results from a difference between the estimate of annual ordinary income (which includes the year-to-date amount) for the current year and the estimate that was inherent in the beginning-of-year valuation allowance.

If there is a reduction in the valuation allowance for beginning-of-year deferred tax assets that results from income other than ordinary income (e.g., discontinued operations), the benefit should be reflected discretely in year-to-date results (presuming, of course, that current-year continuing operations and projections of future income could not have supported the realization).

PwC Observation: ASC 740-270 requires different treatments in interim statements of changes in the valuation allowance for beginning-of-year deferred tax assets depending on whether the change results from a change in estimate of the current year’s ordinary income or future years’ income. To apply the ASC 740-270 rules, the deferred tax assets, net of the valuation allowance, must be divided between those which are expected to be realized in the current year and those expected to be realized in future years.

Example 17-6: Change in Assessment of the Realizability of Beginning-of-Year Deferred Tax Assets as a Result of Changes in Projections of Future Income

Background/Facts:
At the end of the second quarter, a company determines that future taxable income for the current year and for future years will be higher than estimated at the end of the previous year due to an increase in sales orders. This will permit a decrease in the valuation allowance against deferred tax assets related to net operating loss (NOL) carryforwards that existed at the beginning of the year.
The company has $3,000,000 of NOL carryforwards available at the beginning of the year. At that time, the enacted tax rate was 33.5 percent. Because of uncertainty related to realizability, management established a valuation allowance of $1,005,000 for the full amount of the deferred tax asset related to the NOL carryforward at the end of the prior year. Although the company broke even for the first three months of the current year, a second quarter increase in net income and sales orders has prompted the company to (1) revise its estimate of current-year income from zero to $200,000 and (2) change the expectation regarding income in future years to be sufficient to allow recognition of the entire deferred tax asset. This will permit a full reversal of the valuation allowance for NOL carryforwards that existed at the beginning of the year.

**Question:**
Should this change in judgment be recorded as a discrete event that is accounted for in the second quarter, or should the change be allocated to subsequent interim periods as part of the estimated annual effective tax rate calculation?

**Analysis/Conclusion:**
As indicated above, the decrease in the valuation allowance has two components: (1) the portion related to a change in estimate regarding current-year income and (2) the portion related to a change in estimate about future years’ income.

A company takes the first component into income by adjusting the estimated annual effective tax rate for the current year (i.e., spread over the third and fourth quarters through the revised ETR). The second component is taken into income as a discrete event in the second quarter.

As a result of revising the estimate of future profitability to reflect sales orders, the company calculates current-year income taxes as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated full-year pretax income</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Tax expense:</td>
<td></td>
</tr>
<tr>
<td>Tax on current-year income at 33.5%</td>
<td>67,000</td>
</tr>
<tr>
<td>Reversal of valuation allowance related to current-year income</td>
<td>(67,000)</td>
</tr>
<tr>
<td>Total current tax based on ETR</td>
<td>$0</td>
</tr>
<tr>
<td>Reversal of valuation allowance based on future-years income</td>
<td>(938,000)</td>
</tr>
<tr>
<td>Total tax provision</td>
<td>(938,000)</td>
</tr>
<tr>
<td>Net Income</td>
<td>$1,138,000</td>
</tr>
<tr>
<td>Estimated ETR at end of second quarter [($0) / $200,000]</td>
<td>(0)%</td>
</tr>
</tbody>
</table>

The required journal entry at the end of the second quarter would be:

Dr Valuation allowance $938,000
Cr Income tax expense $938,000

The $938,000 would be accounted for as a discrete event in the second quarter. The tax benefit associated with the remaining valuation allowance of $67,000, along with a similar amount of tax expense tied to the reduction in the NOL deferred tax asset, would be released to income as profits are earned during the remainder of the year, including the second quarter. At the end of the year, the deferred tax asset account would have a balance of $938,000, and there would be no valuation allowance. The following is a summary of activity by quarter, which demonstrates the release of the valuation allowance.

(continued)
### Initial Recognition of Source-of-Loss Items

The initial recognition of source-of-loss items (see a discussion of source-of-loss items in Section TX 12.2.2.2.3.2) are generally excluded from recognition in income but rather recorded back to the source of the prior year loss/benefit. For example, the initial recognition of a tax benefit of a windfall tax deduction related to stock-based compensation would be recognized in additional paid-in capital. Accordingly, tax benefits related to source-of-loss items would not enter into the ETR calculation.

### Exception to the Basic Intraperiod Allocation Model

ASC 740-20-45-7, which describes the exception to the basic “with-and-without” approach to intraperiod allocation, must also be considered in interim periods. If a company has a valuation allowance and expects (1) pretax losses from continuing operations and (2) income in other components of the financial statements, ASC 740-20-45-7 may have an effect on the presentation of the interim period financial statements and may possibly result in the reporting of a tax benefit (which would
be incorporated in the estimated annual effective tax rate) in continuing operations, even though no such benefit would be computed using the basic “with-and-without” approach.

Example 17-7: Mechanics of Applying ASC 740-20-45-7 to Interim Periods

**Background/Facts:**
Assume the following:

- There are only two categories of pretax income/loss (continuing operations and discontinued operations), which are summarized below for each interim period during the year.
- Continuing operations includes no significant unusual or infrequent items.
- There was a full valuation allowance at the beginning of the year, and a full valuation allowance is expected at the end of the year.
- There are no permanent differences.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Ordinary Income (Loss)</th>
<th>Discontinued Operations Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reporting Period Amount</td>
<td>Year-to-Date</td>
</tr>
<tr>
<td>First quarter</td>
<td>$(10,000)</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(10,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(40,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>20,000</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

**Question:**
How should the tax provision be computed during interim periods?

**Analysis/Conclusion:**
As discussed in Section TX 12.3, the FASB concluded that all categories of income for the current period (e.g., discontinued operations and other comprehensive income), excluding continuing operations, should be considered to determine the amount of tax benefit that results from a loss in continuing operations and that should be allocated to continuing operations. To apply ASC 740-20-45-7 in an interim period, the estimated annual effective tax rate must reflect the effect of ASC 740-20-45-7 using the full-year plan for ordinary income and the year-to-date amounts for all other items.

Based on the amounts above, the estimated pretax ordinary loss for the full year is $40,000 and the year-to-date gain for discontinued operations is $20,000. Under the intraperiod allocation rules of ASC 740, the $20,000 of income from discontinued operations will allow the company to realize a benefit from $20,000 of current-year ordinary loss. Assuming a 40 percent tax rate, the company will realize a tax benefit of $8,000 on the ordinary loss, which will result in an estimated annual effective tax rate of 20 percent (tax benefit of $8,000 divided by the expected full-year ordinary loss of $40,000).

This calculation of the estimated annual effective tax rate to be applied in the interim period should be performed at each interim balance sheet date. The amount of
tax expense (benefit) recorded in each period is presented in the table below. For simplicity’s sake, the example assumes no change in planned full year income.

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Continuing Operations</th>
<th>Discontinued Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year-to-Date Computed</td>
<td>Less Previously Provided</td>
</tr>
<tr>
<td>First quarter</td>
<td>$ (2,000)</td>
<td>$ (8,000)</td>
</tr>
<tr>
<td>Second quarter</td>
<td>(4,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Third quarter</td>
<td>(12,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Fourth quarter</td>
<td>(8,000)</td>
<td>(8,000)</td>
</tr>
</tbody>
</table>

Amount of ordinary tax benefit is limited to amount of tax expense on discontinued operations.

Since the effect on ordinary income is accounted for through the ETR approach, and the tax in discontinued operations is recorded discretely in the period, the total tax provision for each quarter will not be zero (even though it will be at year-end). The amount recorded in discontinued operations will be $8,000, but the tax benefit on the year-to-date Q1 continuing operations loss of $10,000 is $2,000 (i.e., 20 percent ETR derived above multiplied by the $10,000 pretax loss). This is accomplished through the following entry:

Dr Income tax provision—discontinued operations (I/S) $8,000
Cr Accrued income tax provision—(B/S) 6,000
Cr Income tax provision—continuing operations (I/S) $2,000

The accrued income tax provision recorded in the balance sheet does not represent a deferred tax liability or income tax payable.

Assuming that the full-year plan for the year’s ordinary income did not change, the following cumulative entry would be recorded in the second quarter:

Dr Income tax provision—discontinued operations (I/S) $8,000
Cr Accrued income tax provision—(B/S) 4,000
Cr Income tax provision—continuing operations (I/S) $4,000

Assuming that the full-year plan for the year’s ordinary income did not change, the following cumulative entry would be recorded in the third quarter:

Dr Income tax provision—discontinued operations (I/S) $8,000
Cr Income tax provision—continuing operations (I/S) $8,000

In this case, the application of the ETR approach would have resulted in the allocation of a net benefit of $12,000, which exceeds the benefit expected for the full year. Therefore, the amount recognized is limited to $8,000.
17.4.6 Tax Accounting Considerations of Stock-Based Compensation During Interim Periods

When an entity calculates its estimated annual effective tax rate, it should not anticipate or estimate the incremental effects of windfalls or shortfalls that may occur over the balance of the year. For example, if an option is due to expire in the current year, the entity should not anticipate that it will be exercised and that a windfall will be recognized, even though the fair value of the underlying stock exceeds the exercise price of the option. Similarly, if an entity had disqualifying dispositions for incentive stock options (ISOs) or employee stock purchase plans (ESPPs) in the past, it should not anticipate future disqualifying dispositions. Instead, the entity should recognize windfalls and shortfalls discretely in the period in which they occur.

For example, if an entity does not have a sufficient pool of windfall tax benefits at the beginning of the year, any shortfall should be recorded in the income statement in the period in which the shortfall occurred. If a windfall is recognized later in the year, the shortfall that was recognized earlier in the year should be reversed in the subsequent quarter to the extent that it can be offset against the windfall (because the pool of windfall tax benefits is determined on an annual basis).

Example 17-8 illustrates how an entity should record windfalls and shortfalls during interim periods.

Example 17-8: Windfalls and Shortfalls During Interim Periods

Assume the following:

- The company has a calendar year-end.
- No pool of windfall tax benefits is available at December 31, 20X8.
- The company’s taxable income is sufficient for the stock option tax deductions to reduce income taxes payable.
- The company has no other windfall or shortfall activity during the year.

(continued)
Exercise Date | Tax Benefit | Deferred Tax Asset | Shortfall | Windfall | Timing and Calculation of Tax Effect of Shortfall or Windfall
--- | --- | --- | --- | --- | ---
1/2/20X9 | $300 | $400 | $(100) | | In the first quarter: Recognize income tax expense of $100.
4/2/20X9 | 1,200 | 900 | | $300 | In the second quarter: Record $100 of income tax benefit to reverse income tax expense recognized during the first quarter. Credit $200 (year-to-date net windfall) to APIC.
7/2/20X9 | 200 | 560 | (360) | | In the third quarter: Offset $200 of the shortfall against the pool of windfall tax benefits by a debit to APIC. Recognize income tax expense for the remaining $160.
10/2/20X9 | 1,440 | 900 | | 540 | In the fourth quarter: Record $160 of income tax benefit to reverse income tax expense recognized during the third quarter. Credit $380 (year-to-date net windfall) to APIC.

Totals | $3,140 | $2,760 | $(460) | $840 | 

1 The tax benefit is calculated by multiplying the intrinsic value of the option by the tax rate of 40 percent.
2 The deferred tax asset is calculated by multiplying the compensation cost by the tax rate of 40 percent.

Entities should also consider the guidance in ASC 718-740-25-10, which states that a windfall tax benefit should not be recognized until it reduces taxes payable. When applying this guidance on a quarterly basis, we believe that entities should consider their estimated annual income taxes payable. If an entity incurs a net loss for the period and experiences a windfall tax benefit in the early quarters of a fiscal year, the entity should still be able to recognize the windfall tax benefit from those exercises as long as the entity expects to have taxable income for the full year. We believe that the requirements of ASC 718-740-25-10 should be applied within the context of a fiscal year, not just an interim period. This is consistent with the requirement to determine the tax provision on an annual basis.

Example 17-9: Recognition of Prior Year Windfall Tax Benefits in Interim Periods

Background/Facts:
Company A, a calendar year-end public company, grants nonqualified stock option awards to its employees. In the past, a U.S. federal windfall tax deduction was generated (i.e., an excess tax deduction to Company A) as the intrinsic value of the options exercised exceeded the cumulative compensation cost for those awards. In accordance with ASC 718-740-25-10, none of the windfall tax benefits were recognized as an increase to additional paid-in capital (APIC) because Company A had a net operating loss carryforward (NOL) in prior years which resulted in the windfall deductions merely increasing the NOL instead of reducing taxes payable.

(continued)
Company A has no valuation allowance on its deferred tax assets and forecasts, as of the first quarter, taxable income for the current fiscal year which will allow for utilization of all of the off-balance sheet NOLs that arose from the windfall deductions claimed in prior years. There are no unrecognized tax benefits for uncertainties related to the deductions.

**Question:**
When should Company A recognize the increase in APIC related to windfall tax benefits that are expected to reduce taxes payable in the current fiscal year?

**Analysis/Conclusion:**
We believe there is diversity in practice with respect to recognizing, in interim periods, windfall tax benefits that originated in prior years and are expected to reduce taxes payable in the current year. Two acceptable alternatives are as follows:

**Alternative 1:** Company A should recognize the prior year windfall tax benefits as the related income occurs during the current year. This view effectively assumes that estimated tax payments would generally be reduced by the windfall tax deduction at applicable quarterly intervals throughout the year. The windfall tax benefits should generally be sequenced as the last benefits to be recognized against year-to-date taxes payable. So, for example, if there were $120 of NOLs that included $20 of windfall tax deductions, and current full year income of $120 is expected to occur ratably ($30 per quarter), this would mean that no windfalls would be recognized in APIC until the fourth quarter. Recognizing windfall tax benefits on this basis appears consistent with the intent of ASC 718-740-25-10, which provides that the credit to APIC not be recognized until it reduces taxes payable.

**Alternative 2:** Company A should recognize the prior year windfall tax benefits that are expected to reduce taxes payable for the entire current year in the first quarter. This view is premised on the notion that the requirements of ASC 718-740-25-10 should be applied in the context of a fiscal year and is consistent with the general treatment of recording windfalls in APIC on a discrete basis in the interim period in which the windfall deduction occurs. In this case, since Company A is now in an annual period in which it anticipates being able to reduce taxes payable with NOLs that arose from windfall deductions, the prohibition on recognition of the windfalls in APIC no longer applies and the estimated amount of windfall benefits that will be used in the current year would be recognized in its entirety.

The view chosen represents an accounting policy that, once established, would be consistently applied. Company A should also consider the impact of the accounting policy on its statement of cash flows. ASC 230-10-45-14e requires that the windfall tax benefits from stock-based compensation awards be classified as cash inflows from financing activities while ASC 230-10-45-17c requires the same amount to be shown as cash outflows from operating activities.

Note: In cases where only a portion of the tax attributes will be used, the accounting policy elected by the company would determine the order in which the tax attributes are utilized. Section TX 12.2.2.2.3.3 indicates that either the with-and-without approach or the tax law ordering approach would be acceptable to determine the order in which tax attributes should be considered.
17.5 Other Complexities

17.5.1 Business Combinations

The acquisition of a business can significantly impact the acquiring company's estimated annual effective tax rate. Because a business combination is a transaction that is not typically accounted for in periods prior to the acquisition date, no effect should be given to a business combination in the estimated annual effective tax rate before the interim period in which the business combination is consummated.

Beginning with the interim period in which the purchase is consummated, the estimated annual effective tax rate for the year would be calculated to reflect the expected results, including the results of the acquired company. That rate would be applied to the consolidated year-to-date ordinary income/loss to compute the year-to-date tax provision/benefit on ordinary income/loss.

Alternatively, a second acceptable approach would be to divide the annual period into pre-acquisition and post-acquisition periods and determine an estimated annual effective tax rate for each of the two periods. After the acquisition is consummated, the tax provision would be the sum of the tax provision for the pre-acquisition period plus the tax computed by applying the ETR for the post-acquisition period to the year-to-date, post-acquisition ordinary income. This method may not be appropriate if rate differentials that do not relate to the acquired operations occur disproportionately in the post-acquisition period.

Example 17-10: Application of the ETR Calculation When a Business Combination Impacts the Rate

Background/Facts:
Assume that a company has cumulative losses in recent years that result in a deferred tax asset with a full valuation allowance recorded against it. During the year, the company experienced losses of $1,000 in each of the first two quarters (Q1 and Q2). These losses cause an increase in the company's net operating loss (NOL) carryforward. Consequently, the deferred tax assets and corresponding valuation allowance were increased by equivalent amounts. The company's estimated annual effective tax rate was zero percent for both Q1 and for the six-month, year-to-date period ending in Q2.

On July 1, the company acquired the stock of another company in a non-taxable transaction. The business combination was accounted for under ASC 805, Business Combinations. As a result of the acquisition, the company has determined that it will be able to reverse its existing valuation allowance, as the taxable temporary differences relating to the amortizable intangible assets exceed the NOL carryforwards and are expected to reverse during the NOL carryforward period. Although the company expects to lose $750 for each of the remaining two quarters (Q3 and Q4), it will be able to recognize a deferred tax benefit of $600 ([$750 x 2] x 40%) on such a loss because of the existence of its net deferred tax liability.

Accordingly, for some period of time subsequent to this acquisition, the company anticipates that its effective tax rate will be 40 percent, even though it expects to incur operating losses for the near term.

(continued)
Question(s):
1. When should the business combination first impact the estimated annual effective tax rate calculation?
2. How should the release of the valuation allowance as a result of the business combination be recorded in the interim period financial statements?
3. How should the business combination be incorporated into the estimated annual effective tax rate calculation?

Analysis/Conclusion:

Question 1:
The acquisition of a business should first impact the estimated annual effective tax rate calculation in the period in which the business combination is consummated. Accordingly, in this example, while disclosure of the future impact may be necessary, the effects of the business combination should not be considered in the calculation of the income tax provision for the six months ended June 30. Rather, the impact should be reflected in the period ended September 30.

Question 2:
In accordance with ASC 805-740-30-3, the reduction of an acquirer’s valuation allowance as a result of a business combination is not accounted for as part of the business combination, but is recognized in the income tax provision (subject to intraperiod allocation as discussed in ASC 740-10-45-20). For purposes of this example, assume that the valuation allowance release should be recorded in continuing operations.

ASC 740-270 indicates that the estimated annual effective tax rate approach should be applied (with limited exceptions) to compute the tax effects related to ordinary income (or loss). However, ASC 740-270 indicates that ordinary income (or loss) excludes significant “unusual or infrequently occurring items” and provides that the tax effects of such items should not be pro-rated over the balance of the fiscal year. In this fact pattern, we believe there are two acceptable alternatives:

Alternative 1: In the period that the business combination is consummated, the acquired business should be incorporated in Company A’s estimated annual effective tax rate calculation—that is, to consider the inclusion of the expected results of Company B subsequent to the acquisition to represent a change in estimate regarding the future income of Company A. Under this view, the valuation allowance release would follow the general approach used when releasing a valuation allowance at an interim period as described in Example 17-6 in Section TX 17.4.4. Specifically, the decrease in the valuation allowance would comprise two components: (1) the portion related to a change in estimate regarding current-year income and (2) the portion related to a change in estimate about future years’ income. The portion of the valuation allowance release that relates to current-year income would be reflected in the estimated annual effective tax rate for the current year (i.e., it would be recognized through the remainder of the year). The portion of the valuation allowance release that relates to future years’ income would be recorded as a discrete item in the period of the business combination.

Alternative 2: Because a business combination is a transaction that cannot be anticipated in the estimated annual effective tax rate calculation prior to the acquisition date, a business combination, by its nature, could be considered an unusual or infrequent item as discussed in Section TX 17.1.2 and ASC 740-270-20. Under this view, the entire release of an acquirer’s valuation allowance as a result of a business combination would be recorded as a discrete item at the acquisition date.

(continued)
When determining which alternative to apply, a company should consider the approach it will use for its interim tax provision calculations subsequent to the business combination (as discussed in question 3 below). The approach used for incorporating a business combination into the estimated annual effective tax rate calculation may influence the determination of which of the above alternatives to apply.

The alternative chosen is an accounting policy election that should be applied consistently. In addition, the company should provide transparent disclosures in the interim financial statements to enable readers to understand the impacts of the business combination and the related release of the valuation allowance.

In this example, because the company is forecasting losses for the remainder of the year, it does not matter which alternative is chosen because the results will be the same under either method (i.e., the full valuation allowance release will be reflected as a discrete item in the period of the business combination under either alternative). However, the approach adopted for incorporating the business combination into the estimated annual effective tax rate calculation will have an impact as demonstrated below.

**Question 3:**
A business combination can be incorporated into the ETR calculation in two ways: (1) a pure ASC 740-270 approach or (2) a bifurcated rate approach.

**A Pure ASC 740-270 Approach:**

Under this approach, the tax provision/benefit for the interim period including the consummation date will include a catch-up for pre-acquisition interim periods.

Based on the above facts, under either Alternative 1 or Alternative 2, the estimated annual effective tax rate for the year, as of Q3, would be 17.1 percent. This would be computed as follows:

\[
\text{Expected tax provision / <benefit> for the year} / \text{Expected pretax income for the year} = \frac{<600>}{[(<1,000> \times 2) + (<750> \times 2)]} = 17.1\%
\]

The year-to-date loss, as of Q3, would be $2,750 \((\$1,000 \times 2) + \$750\). The deferred tax benefit to be recognized as part of the estimated annual effective tax rate calculation would be $472 in Q3 \((\$2,750 \times 17.1\%)\) and $128 in Q4 \((\$750 \times 17.1\%)\). In addition, the release of the valuation allowance that was accounted for as a discrete item would provide a deferred tax benefit in Q3 (i.e., the period the business combination was consummated).

**A Bifurcated Rate Approach:**

Under this approach, in addition to the release of the valuation allowance that was accounted for as a discrete item in Q3 (i.e., the period the business combination was consummated) the deferred tax benefit of $600 would be recognized at the rate of $300 \((\$750 \times 40\%)\) during each of the last two quarters.
Example 17-11: Interim Period Tax Accounting for Acquisition-Related Transaction Costs

Background/Facts:
Company A, an SEC registrant, has incurred during the first interim period of the current year certain transaction costs (mainly legal and accounting) in connection with a planned acquisition of all of the stock of Company B, which is expected to close in the fourth quarter. Company A expects to incur additional accounting and legal fees in the remaining interim periods. These costs will be incurred regardless of whether the business combination is consummated; however, certain other costs, such as “success-based” fees payable to investment bankers, will only be incurred if the acquisition closes.

Company A follows an accounting policy under which it records the tax effects of transaction costs based upon an assumption that the business combination will not be consummated (presuming they would be deductible on that basis). Accordingly, it recognizes a U.S. federal deferred tax benefit in the period it incurs the costs and only revisits that accounting if and when the business combination is ultimately consummated (i.e., the first accounting alternative described in Section TX 10.4.6).

Question:
Company A has had several prior acquisitions and as a result considers acquisition-related costs to be a component of its ordinary income (i.e., the costs are not viewed as “unusual or infrequent”). Should Company A include the tax effect of all anticipated transaction costs in calculating its estimated annual effective tax rate (AETR) as of the end of the first quarter?

Analysis/Conclusion:
It depends. For purposes of calculating its AETR, Company A should include only the tax effects of transaction costs that are not dependent on successful completion of the acquisition. The tax effects of anticipated success-based fees should not be included since those fees are contingent on successful completion of a business combination. In general, no effect should be recognized in the financial statements for a business combination until the period in which the business combination occurs.

Note: We believe likewise that the anticipated tax benefit from success-based fees should not be included in the AETR calculation even when the entity elects an accounting policy that considers the likely form of a transaction were it to be consummated (i.e., the second accounting alternative described in Section TX 10.4.6).

17.5.2 Different Financial Reporting and Tax Year-End

If a corporation’s tax year-end date differs from its financial reporting year-end date, the basis for its tax computation and the application of the estimated annual effective tax rate approach in interim statements are impacted.
The essential question is this: Should the tax provision be based on the tax year or on the financial reporting year? In either case, the tax provision included in the annual financial statements will comprise:

The annual provision for the tax year-ended within the financial reporting year + The provision accrued at the financial reporting year-end for the period subsequent to the latest tax year-end - The tax provision accrued at the preceding financial reporting year-end date for the period subsequent to the preceding tax year-end

If the tax provision is based on the tax year, the ETR calculation will spread the annual provision for the tax year to interim periods within that tax year, and the provision accrued at the financial reporting year-end will be an interim provision based on the estimated annual effective tax rate for the tax year that ends after the financial reporting year-end. If the tax provision is based on the financial reporting year, the provision accrued at the financial reporting year-end will be a discrete-period computation, and the tax credits and permanent differences recognized in that accrual will be those generated between the tax year-end date and the financial reporting year-end date. The ETR calculation in the latter case will be based on spreading the annual provision included in the financial reporting year’s income statement over the interim periods included within that year. It will also entail estimating at the interim periods of the financial reporting year (1) the provision for the tax year (if it has not occurred by the interim date) and (2) the results of the discrete computation at the financial reporting year-end.

The approach based on the financial reporting year is attractive because the credits and rate differentials recognized are those generated during the financial reporting year.

Since ASC 740 and the authoritative literature do not address how to account for the tax provision if a corporation’s tax year and financial reporting year do not coincide, we believe that both of the approaches described above are acceptable. See Section TX 10.5.3 for considerations in computing temporary differences as of an interim date.

Example 17-12: Calculation of an Income Tax Provision for Short-Period Financial Statements Due to a Change in Fiscal Year

Background/Facts:
On July 15, Company A sold 100 percent of the stock of Company B to an unrelated third-party. In its accounting for the acquisition, Company B will record its net assets at fair value in accordance with ASC 805, Business Combinations. For tax purposes, the net assets will be recorded at carry-over basis.

Company A has a December 31 year-end for both financial reporting and income tax purposes. Historically, Company B was included in the consolidated income tax return of Company A. After the sale, Company B changed its year-end to June 30 for both financial reporting and income tax purposes to coincide with its new parent’s year-end. Company A will be required to include the taxable income for Company B through July 15 in its tax return for the year-ended December 31.

In connection with the sale transaction, Company B is required to prepare stand-alone financial statements. Company B has historically calculated its income tax (continued)
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provision using the separate return method. Company B anticipates that it will file a registration statement in the near future and, therefore, is preparing its financial statements in accordance with SEC reporting requirements. Accordingly, the Company will be required to report audited results for the transition period from January 1—June 30 (see the SEC reporting requirements for transition periods at SEC 3185).

**Question:**
How should Company B calculate its income tax provisions for the six-month transition period ended June 30? In particular, (1) should the Company use an interim approach in accordance with ASC 740-270 or (2) should the Company use a discrete-period approach?

**Analysis/Conclusion:**
We believe there are two acceptable approaches:

**Approach A:** For the six-month period ended June 30, Company B could treat the period as an interim period and calculate its income tax provision using an estimated annual effective tax rate in accordance with ASC 740-270. The basis for this approach is that, as of June 30, there has been no change in the tax reporting period (that is, Company B’s tax year-end is still December 31). Accordingly, the income tax provision would be based on the tax reporting period.

**Approach B:** For the six-month period ended June 30, Company B could treat the period as a discrete period and calculate its income tax provision as if it would be filing a short-period return as of June 30. The basis for this approach is that, for financial reporting purposes, the six-month period ended June 30 is treated as a discrete period (i.e., a six-month annual period). Accordingly, the income tax provision would be based on the financial reporting period.

Under either approach, Company B would need to prepare footnote disclosures as of June 30 for audited financial statements as required by ASC 740 and Regulation S-X, Rule 4-08. Accordingly, if Approach A is selected, Company B would need to estimate its individual temporary differences using one of the methods described in Section TX 10.5.3, which provides guidance for determining temporary differences in an interim period.

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**17.5.3 When Disclosure of Components of Interim Tax Expense Is Required**

If interim statements are used in lieu of annual statements (i.e., in a registration statement), companies need to disclose the components of interim income tax expense in the same way that companies present the disclosures required in annual statements by SEC FRP 204, *Disclosures Regarding Income Taxes*. To that end, companies must perform the following tasks:

- Divide the aggregate interim income tax expense calculated using the estimated annual effective tax rate approach between jurisdictions.
- Determine the current and deferred portions of the interim income tax provisions.

It is our view that allocating the computed interim tax to U.S. and foreign operations should usually be based on the ratio of each jurisdiction’s estimated tax to the consolidated worldwide tax used to calculate the worldwide estimated annual effective tax rate. In this situation, we would expect a company’s disclosure to explain how the interim disclosures are prepared differently than the year-end disclosures, which would also be presented.
17.6 Disclosures

Financial statement disclosures required during interim periods are generally prepared under the assumption that financial statement users have read or can access the audited financial statements for the preceding year. For this reason, tax-related disclosures are not expected to be as robust as the disclosures required at year-end.

SEC Regulation S-K, Item 303, requires that a company include in MD&A detailed disclosure of material changes in financial condition and the results of operations. If a company’s MD&A for the preceding annual period disclosed the company’s critical accounting policies, as required by FRR 60, *Cautionary Advice Regarding Disclosure about Critical Accounting Policies*, the disclosures need not be repeated in subsequent quarterly periods. However, if material changes have occurred, the discussion of critical accounting policies should be updated. A similar analysis is required under FRR 67, *Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*.

Detailed footnote disclosure required by Regulation S-X, Rule 4-08 (h), and by other rules under Regulation S-X, do not apply to interim reporting on Form 10-Q. However, the SEC rules require companies to make sufficient disclosures to ensure that the financial information is not misleading to financial statement users. Material events that occur subsequent to the end of the most recent fiscal year should be disclosed.

If important developments occur during the year or if the amounts reported for the interim periods do not adequately represent future results, disclosure of these matters should be considered. Interim period disclosures about items associated with income tax often relate to the following:

- Tax effects of significant unusual or infrequent items that are recorded separately or items that are reported net of their related tax effect (ASC 740-270-30-12)
- Significant changes in estimates or provisions for income taxes (ASC 270-10-50-1(d)) (e.g., changes in the assessment of the need for a valuation allowance that occur during the period)
- Significant variations in the customary relationship between income tax expense and pretax accounting income, unless they are otherwise apparent from the financial statements or from the nature of the entity’s business (ASC 740-270-50-1)
- Impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period (SAB No. 74)\(^3\)
- Material changes to (1) uncertain tax benefits (UTBs), (2) amounts of UTBs that if realized would affect the estimated annual effective tax rate, (3) total amounts of interest and penalties recognized in the statement of financial position, (4) positions for which it is reasonably possible that the total amount of UTBs will significantly increase or decrease within the next 12 months and (5) the description of tax years that remain open by major tax jurisdiction

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\(^3\) SAB 74 requires disclosure of the impact on financial position and the results of operations of accounting standards that have been issued but not yet adopted. The objectives of the disclosure should be (1) to notify the reader of the issuance of a standard that the registrant will be required to adopt in the future and (2) to assist the reader in assessing the impact that the standard will have on the registrant’s financial statements after it is adopted. See PwC SEC Volume 6200.21 for more details.
**PwC Observation:** A company should continually assess the requirements of ASC 275, *Risks and Uncertainties*, and monitor the status of events and circumstances that underlie all significant estimates. This will allow a company to alert its financial statement readers to estimates that could change in the near term (generally considered about one year). The threshold for disclosure in ASC 275 is “reasonably possible,” which covers much of the continuum (i.e., anything greater than remote but less than likely, as required in ASC 450, *Contingencies*). The idea is that a significant one-time charge or benefit due, for example, to a settlement with a taxing authority or to a change in the assessment of the need for a deferred tax asset valuation allowance should not come as a surprise. This is particularly true for public companies because of their quarterly reporting requirements. The more significant the change in estimate and the closer the proximity to the release of the financial statements, the more difficult it may be to justify that the change wasn't reasonably foreseeable when a company last filed Form 10-K or 10-Q.
Chapter 18:
Income Tax Accounting for Stock-Based Compensation
Chapter Summary

This chapter discusses the income tax accounting effects related to stock-based compensation and the reporting of those effects in an entity’s financial statements. This chapter also covers other income tax accounting topics related to modifications of awards, transition provisions when adopting the stock-based compensation standard for income taxes, net operating loss carryforwards, valuation allowances, intraperiod tax allocation, multinational entities, and income tax disclosures. Unless otherwise noted, the discussion in this chapter addresses the income tax implications of stock-based compensation under U.S. tax law. Refer to PwC’s Guide to Accounting for Stock-based Compensation for further guidance on topics related to accounting for stock-based compensation under ASC 718, Compensation—Stock Compensation.
18.1 Background and Basics of Accounting for Stock-Based Compensation under ASC 718 and ASC 740

The fundamental premise of ASC 718 requires that entities recognize the fair value of employee stock-based-compensation awards as compensation cost in the financial statements, beginning on the grant date. Compensation cost is based on the fair value of the awards the entity expects to vest, recognized over the vesting period, and adjusted for actual forfeitures that occur before vesting.

ASC 718 provides specific guidance on income tax accounting and clarifies how ASC 740, Income Taxes, should be applied to stock-based compensation. Guidance also has been provided by the FAS 123(R) Resource Group (the “Resource Group”), an advisory group to the FASB staff that was created after the issuance of ASC 718 to discuss specific implementation issues. The objective of the Resource Group was to identify potential implementation issues, discuss such issues, reach a consensus (if possible), and elevate issues that could not be resolved to the FASB’s attention. Consensuses reached by the Resource Group on significant issues related to the accounting for income taxes for stock-based compensation have been incorporated into this chapter. These consensuses do not represent authoritative guidance, but the FASB staff has publicly stated that it would not expect diversity in practice to develop in regard to a particular issue if the Resource Group was able to reach consensus on that issue.

For awards that are expected to result in a tax deduction under existing tax law, the general principle is that a deferred tax asset is established as the entity recognizes compensation cost for book purposes. Book compensation cost is recognized over the award’s requisite service period, whereas the related tax deduction generally occurs later and is measured principally at the award’s intrinsic value. For example, in the U.S., an entity’s income tax deduction generally is determined on the exercise date for stock options and on the vesting date for restricted stock. For equity-classified awards under ASC 718, book compensation cost is determined at the grant date and compensation cost is recognized over the service period. The corresponding deferred tax asset also is measured on the grant date and recognized over the service period. As a result, there will almost always be a difference in the amount of compensation cost recognized for book purposes versus the amount of tax deduction that an entity may receive. If the tax deduction exceeds the cumulative book compensation cost that the entity recognized, the tax benefit associated with any excess deduction will be considered a “windfall” and will be recognized as additional paid-in capital (APIC). If the tax deduction is less than the cumulative book compensation cost, the resulting difference (“shortfall”) should be charged first to APIC (to the extent of the entity’s pool of windfall tax benefits, as described later), with any remainder recognized in income tax expense.

Example 18-1 summarizes the key accounting events (from the grant date to the settlement date) that relate to a typical equity-classified, nonqualified stock option that generates the employer’s tax deduction upon the option’s exercise.
Example 18-1: Key Income Tax Accounting Events for an Equity-Classified, Nonqualified Stock-Based Compensation Award

<table>
<thead>
<tr>
<th>When</th>
<th>Step</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the option’s grant date</td>
<td>Measure the option’s fair value.</td>
</tr>
<tr>
<td>Over the option’s requisite service period</td>
<td>Recognize compensation cost and the deferred tax asset, adjusted for pre-vesting forfeitures.</td>
</tr>
<tr>
<td>Potentially adjust the deferred tax asset to reflect circumstances such as a change in an entity’s applicable tax rate and employee relocations to jurisdictions with different tax rates, but do not record adjustments to the deferred tax assets to reflect increases or decreases in the entity’s stock price.</td>
<td></td>
</tr>
<tr>
<td>On the option’s settlement date (e.g., exercise or post-vesting cancellation)</td>
<td>Compare the tax deduction with the cumulative book compensation cost. To the extent that the tax deduction exceeds the cumulative book compensation cost, the tax benefit of the excess deduction is a windfall tax benefit. Conversely, when the tax deduction is less than the cumulative book compensation cost, a shortfall occurs.</td>
</tr>
</tbody>
</table>

Note that differences between the amount of the book compensation and the tax deduction for an award that result from factors other than increases or decreases in the fair value of an entity’s shares between the grant date (measurement date for accounting purposes) and the exercise date (measurement date for tax purposes) do not receive the same accounting treatment as a windfall or shortfall. This might occur, for example, in certain situations when a company concludes that the fair value of an award at the grant date is different under the applicable tax law than the fair value determined for book purposes at the same date. See Example 18-7 for further discussion.

Example 18-2 illustrates how, from the grant date to the settlement date, an enterprise should calculate a windfall tax benefit and account for the corresponding income tax for a typical equity-classified, nonqualified stock option.

Example 18-2: Recognition of a Deferred Tax Asset and Calculation of the Tax Deduction and Windfall Tax Benefit for an Equity-Classified, Nonqualified Stock Option

On January 1, 2006, a U.S. multinational entity grants to its U.S. employees 1,000 equity-classified, nonqualified stock options that have a fair value of $15 per option. The award has a one-year service condition and it is assumed that all options will vest. The entity has sufficient taxable income for the stock option tax deductions to reduce income taxes payable in all periods.

**Step 1:** Recognize compensation cost and the related deferred tax asset. During 2006, the entity records $15,000 in compensation cost (1,000 options x $15 fair value) and also records the related deferred tax asset of $5,250 (assuming that the applicable tax rate is 35 percent).

**Step 2:** Calculate the tax deduction, windfall, or shortfall. When the stock options are exercised on July 1, 2007, each option has a $20 intrinsic value (i.e., the shares have (continued)
a quoted market price that exceeds the options’ exercise price by $20). The entity will receive a tax benefit of $7,000 (1,000 shares x $20 intrinsic value x the applicable tax rate of 35 percent). The tax benefit of the excess tax deduction is $1,750, ($20,000 tax deduction – $15,000 compensation cost) x 35 percent) and is credited to APIC (rather than to income tax expense) as a windfall tax benefit. The remaining $5,250 of current tax benefit offsets a like amount of deferred tax expense from the elimination of the related deferred tax asset.

The above example illustrates the calculation of an excess tax benefit when an entity is a regular taxpayer. In certain situations, an entity may be subject to the alternative minimum tax (AMT). Section TX 12.2.3.2.5 discusses accounting for windfall benefits when an entity is subject to the AMT.

18.1.1 Income Tax Accounting for Liability-Classified Awards

The income tax accounting for liability-classified awards (e.g., cash-settled stock appreciation rights) is similar to the income tax accounting for equity-classified awards. The difference is that the liability for book purposes is remeasured each reporting period and thus the related deferred tax asset and tax expense also is remeasured to reflect the effects of remeasuring the book liability. Unlike an equity-classified award, a liability-classified award generally will not be expected to generate a windfall or shortfall upon settlement because the ultimate tax deduction will equal the cumulative book compensation cost as a result of the periodic remeasurements.

18.2 Accounting for Income Taxes Related to Various Awards

An understanding of how an entity’s tax deduction for stock-based compensation is measured in the U.S. requires an understanding of the nature of the instrument or award that is being granted to the employee and whether the employee has made any elections with respect to the award.

This chapter gives an overview of an entity’s accounting for income taxes related to stock-based-compensation awards with respect to nonqualified stock options, statutory stock options, restricted stock, restricted stock units, and stock appreciation rights. Under U.S. tax law, the ultimate tax deduction for these awards will almost always differ from the amounts recognized for financial reporting because nonqualified stock options, restricted stock, restricted stock units, and stock appreciation rights generally result in a tax deduction for an entity when the taxable event occurs (e.g., upon exercise or vesting). Statutory options, including incentive stock options (ISOs) and employee stock purchase plan (ESPP) purchases, however, ordinarily do not result in a tax deduction and therefore the tax effects from these awards will not be recorded unless a disqualifying disposition occurs (as described in Section TX 18.4.1).

18.3 Income Tax Accounting for Nonqualified Stock Options

18.3.1 Initial Recognition and Classification of a Deferred Tax Asset

An entity that grants a nonqualified stock option to an employee generally is entitled to a tax deduction equal to the intrinsic value of the option on the exercise date. Entities generally expense stock options for book purposes before a tax deduction arises, thus creating a temporary difference (and a deferred tax asset) under ASC 740. When an award is settled, the deferred tax asset is reconciled with the realized tax benefit.
PwC Observation: The amount of the deferred tax asset will almost always differ from the amount of the entity’s realized tax benefit. This is because the deferred tax asset is based on the compensation cost the entity recorded for book purposes, which is determined based on fair value on the grant date, while the tax deduction is based on intrinsic value on the vesting date for restricted stock or the exercise date for a stock option.

For nonemployees, the fair value of a share-based payment award will generally be remeasured to reflect its current fair value on an ongoing basis until performance is complete (generally when the award is vested) or a performance commitment is reached, as discussed in more detail in SC 2.2 of PwC’s Guide to Accounting for Stock-based Compensation. This differs from equity-classified employee awards, which generally reflect the fair value as of the grant date. The deferred tax asset and income tax expense related to nonemployee awards will likewise reflect the changes in fair value of the award through the final measurement.

Balance sheet classification of a deferred tax asset related to nonqualified stock options as either current or noncurrent depends on whether the stock option is an equity-classified award or a liability-classified award. If the stock option is equity-classified, we believe that the related deferred tax asset generally should be classified as noncurrent. Other approaches to classifying the deferred tax asset based on the expected period of realization of the related tax deduction also may be acceptable. If the stock option is liability-classified, the related deferred tax asset should follow the classification of the stock option (e.g., if the stock option is classified as a current liability, the related deferred tax asset also should be classified as current).

18.3.2 Change in Tax Rates

A deferred tax asset is adjusted when an entity’s applicable tax rate changes. To determine the amount of the new deferred tax asset, an entity should multiply the new applicable tax rate by the amount of cumulative compensation cost that the entity has recorded for all outstanding stock-based compensation awards. The difference between the new deferred tax asset and the existing deferred tax asset should be recorded in the current-period income statement as a deferred tax benefit or expense. For example, if the applicable tax rate increases, the deferred tax asset should increase and the corresponding benefit would be reflected in the income statement in the period that the tax law change was enacted.

18.3.3 Employer Payroll Taxes

A liability for the employer’s portion of payroll taxes on employee stock compensation should be recognized on the date of the event triggering the obligation to pay the tax to the taxing authority (ASC 718-10-25-22). For a nonqualified stock option, payroll taxes generally will be triggered and recorded on the exercise date. Even though the employer’s payroll taxes are directly related to the appreciation of stock options, those taxes are part of the entity’s operating expenses and should be reflected as such in its income statement (ASC 718-10-25-23). SAB Topic 14 provides guidance on the presentation of compensation cost in a public entity’s financial statements. Under SAB Topic 14, as discussed in Section SC 1.17 of PwC’s Guide to Accounting for Stock-based Compensation, an entity should present the expense related to the stock-based-compensation awards in the same line item(s) as cash compensation paid to the same employees. We believe that employer payroll
taxes payable upon the exercise of awards also should be charged to that same income statement line item.

**18.3.4 Accounting for Options That Are Forfeited or Expire Unexercised**

For a variety of reasons, employees might never exercise their stock options (e.g., the stock option is under water during its contractual term, or the employee might forfeit the option). When a stock-based-compensation award is forfeited or expires unexercised, the accounting for the related deferred tax asset depends on whether the employee had completed the award’s requisite service period at the time of settlement. If an award expires before the requisite service period has been completed and the related book compensation cost is reversed, then the deferred tax asset also is reversed in the current period to income tax expense. If an award expires after the requisite service period has been completed, the related book compensation cost is not reversed. However, the employer will no longer receive a tax deduction for the option and, therefore, there is no longer a temporary difference. Because there is no longer a temporary difference, the related deferred tax asset should be reversed. The entire deferred tax asset is a shortfall and should be recorded as a charge either to income tax expense or to APIC if there is a sufficient pool of windfall tax benefits available. Completion of the requisite service period often, but not always, coincides with the “legal vesting date.” An award is legally vested when an employee’s right to receive or retain the award is no longer contingent on satisfying the vesting condition. For the remainder of this chapter, the legal vesting date is assumed to be the same as the completion of the requisite service period, and therefore the word “vested” will be used to refer to the event that triggers the accounting for the deferred tax asset.

Example 18-3 summarizes the pre- and post-vesting accounting for such an award.

### Example 18-3: Pre- and Post-Vesting Accounting for Awards That Are Forfeited or Expire

<table>
<thead>
<tr>
<th>Item</th>
<th>Award Is Not Vested</th>
<th>Award Is Vested</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>The compensation cost is reversed in the current period.</td>
<td>The compensation cost is not reversed.</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>The deferred tax asset is reversed in the current period</td>
<td>The deferred tax asset is written off. The write-off is</td>
</tr>
<tr>
<td></td>
<td>to income tax expense.</td>
<td>applied first to APIC (up to the amount available for</td>
</tr>
<tr>
<td></td>
<td></td>
<td>offset in the pool of windfall tax benefits), and the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>remainder is charged to income tax expense in the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>current-period income statement.</td>
</tr>
</tbody>
</table>

While the above example summarizes the accounting for individual awards, an entity that has a number of awards and is appropriately applying a forfeiture estimate when recording compensation cost would be recording compensation cost only for the number of awards it expected to vest. Accordingly, a deferred tax asset is only being recorded for the awards the entity expected to vest. As long as actual forfeitures are consistent with the entity’s forfeiture assumptions, there would be no adjustment to the compensation cost and the related deferred tax assets that have been recognized. However, if actual forfeitures caused the entity to change its original forfeiture assumptions, then an adjustment to previously recognized compensation cost and the related amount of deferred tax assets should be recorded.
Example 18-4 is a simplified illustration of the income tax accounting for a grant of an equity-classified, nonqualified stock option.

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**Example 18-4: Income Tax Accounting for Nonqualified Stock Options**

**Background/Facts:**
On January 1, 2006, an entity grants 10 million equity-classified, nonqualified stock options. The $30 exercise price equals the grant-date stock price. The terms of the award specify three-year cliff-vesting. The grant-date fair value is $15 per option and only 8 million options are expected to (and do) vest. This grant is the first option grant in the entity’s history; therefore, it does not have a pool of windfall tax benefits. No additional awards are granted in 2006, 2007, and 2008. The stock price is $50 on January 1, 2009, when all 8 million vested options are exercised.

On January 1, 2009, the entity grants 10 million equity-classified, nonqualified stock options. The $50 exercise price equals the grant-date stock price. The terms of the award specify three-year cliff-vesting. The grant-date fair value is $25 per option and only 8 million options are expected to (and do) vest. On January 1, 2010, the stock price decreases to $45 and the options remain underwater until they expire.

The applicable tax rate for all periods is 40 percent, and the entity has sufficient taxable income for the stock option tax deductions to reduce income taxes payable in all periods.

The entity recognizes compensation cost on a straight-line attribution basis.

**Analysis/Conclusion:**
Computations of Compensation Cost, the Deferred Tax Asset, and the Windfall Tax Benefits for Options Granted on January 1, 2006, and 2009 are as follows:

<table>
<thead>
<tr>
<th></th>
<th>2006 Awards</th>
<th>2009 Awards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>8 million options x $15 = $120 million</td>
<td>8 million options x $25 = $200 million</td>
</tr>
<tr>
<td></td>
<td>= $40 million per year over three years</td>
<td>= $66.6 million per year over three years</td>
</tr>
<tr>
<td>Annual deferred tax</td>
<td>$40 million x 40% = $16 million</td>
<td>$66.6 million x 40% = $26.6 million</td>
</tr>
<tr>
<td>asset recognized</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treatment of taxes</td>
<td>Deferred tax asset on December 31, 2008: $120 million x 40% = $48 million</td>
<td>Deferred tax asset on December 31, 2011 (end of vesting period): $200 million x 40% = $80 million</td>
</tr>
<tr>
<td>upon settlement</td>
<td>Tax deduction: $50 (stock price upon exercise) – $30 (exercise price) x 8 million (vested options) = $160 million</td>
<td>Tax deduction in 2013 (end of contractual term): Zero, because the options expired unexercised</td>
</tr>
<tr>
<td></td>
<td>Current tax benefit: $160 million (tax deduction) x 40% (applicable tax rate) = $64 million</td>
<td>Shortfall: The entity will write off an $80 million ($200 million x 40%) deferred tax asset by charging APIC to the extent of the pool of windfall tax benefits from prior awards ($16 million), and then by recognizing the balance ($64 million) in income tax expense.</td>
</tr>
<tr>
<td></td>
<td>Credit to APIC for windfall: [$160 million (tax deduction) – $120 million (cumulative book compensation cost)] = $40 million x 40% = $16 million</td>
<td>Pool of windfall tax benefits is reduced to zero.</td>
</tr>
<tr>
<td></td>
<td>Pool of windfall tax benefits: $16 million</td>
<td></td>
</tr>
</tbody>
</table>
18.4 Income Tax Accounting for Incentive Stock Options

ISOs provide an employee with significant tax benefits by allowing the employee to exercise the stock options, in limited amounts, without being taxed on the intrinsic value on the exercise date. To qualify as an ISO, an option must comply with certain Internal Revenue Code (IRC) requirements and restrictions.

Although an entity treats nonqualified stock options and ISOs the same way when recognizing book compensation cost under ASC 718, it treats ISOs differently when accounting for the related income taxes. An ISO does not ordinarily result in a tax benefit for the employer, unless there is a disqualifying disposition (as described below). Therefore, a deferred tax asset is not recognized when an entity recognizes compensation cost for book purposes for such options. Moreover, ISOs generally will not result in shortfalls, and windfalls can occur only upon a disqualifying disposition.

18.4.1 Disqualifying Dispositions

A disqualifying disposition for an ISO occurs if the employee does not hold the shares for the minimum holding period that is required by the IRC. When there is a disqualifying disposition, the employee recognizes ordinary income for U.S. tax purposes for the difference between the ISO’s exercise price and the fair value of the shares at the time the option was exercised. The employer will receive a corresponding tax deduction for the amount of income recognized by the employee. The tax benefit for the deduction that corresponds to the cumulative book compensation cost is credited to income tax expense. If the tax deduction is less than the cumulative book compensation cost, the amount credited to income tax expense is limited to the tax benefit associated with the tax deduction. If the tax deduction exceeds the cumulative book compensation cost, the tax benefit associated with the excess deduction (the windfall tax benefit) is credited to APIC.

One of the requirements of an ISO is that the employee must exercise the ISO within three months of terminating employment. If termination results from disability, ISO treatment may continue up to one year following termination. If an employee dies and the ISO is transferred by bequest or inheritance, the option may continue to be treated as an ISO for its full term. Aside from these exceptions, if the employee does not exercise the award within three months and one day, there will be a disqualifying disposition. It is not triggered, however, by the mere passage of time. Rather, the disqualifying disposition event does not occur until the employee exercises the underlying option. The employer should not anticipate this disqualifying disposition until the exercise actually occurs.

**PwC Observation:** The analysis above also would apply to disqualifying dispositions for employee stock purchase plans.

Example 18-5 illustrates the computation of the windfall tax benefit resulting from a disqualifying disposition. See Examples 18-11 and 18-12 for additional guidance on accounting for a disqualifying disposition of an ISO award granted before, but settled after, the adoption of ASC 718, depending on whether the long-form or short-cut method (which are discussed further in Section TX 18.11) was elected for determining the historical pool of windfall tax benefits.
Example 18-5: Income Tax Accounting for Incentive Stock Options

Background/Facts:
On January 1, 2006, an entity grants 10,000 equity-classified ISOs. The exercise price of $30 equals the grant-date stock price. The terms of the award specify one-year cliff-vesting. The grant-date fair value is $15 per option and all 10,000 options are expected to (and do) vest.

The stock-based compensation cost is calculated as follows: 10,000 options x $15 (grant-date fair value) = $150,000

The stock price is $50 on July 1, 2007, when all 10,000 vested options are exercised, and the employees immediately sell the stock in the open market, which causes a disqualifying disposition. Therefore, the option’s intrinsic value on the exercise date and the net amount realized on the sale of the underlying stock are the same.

The applicable tax rate for all periods is 40 percent, and the entity has sufficient taxable income for the stock option tax deductions to reduce income taxes payable in all periods.

Analysis/Conclusion:
$150,000 of compensation cost is recognized in 2006; no deferred tax asset or tax benefit is recorded.

Computations for the Tax Deduction, Tax Benefit, and Windfall Tax Benefit on July 1, 2007:
• Tax deduction: [$50 (stock price on date of disqualifying disposition) – $30 (exercise price)] x 10,000 shares = $200,000
• Tax benefit: tax deduction of $200,000 x 40% tax rate = $80,000
• Tax benefit recorded in income statement: $150,000 of book compensation cost x 40% tax rate = $60,000
• Windfall credited to APIC: $80,000 tax benefit – $60,000 recorded in income statement = $20,000

Pool of windfall tax benefits: $20,000

18.5 Income Tax Accounting for Restricted Stock and Restricted Stock Units

Restricted stock represents shares that an entity grants to an employee and are generally subject to vesting conditions. If the employee fails to vest in the shares, the employee forfeits the right to the shares.

A restricted stock unit (RSU) represents an arrangement whereby an entity promises to issue share(s) either at the time that each underlying unit vests or sometime after vesting. RSUs do not consist of legally issued shares or comprise outstanding shares, and therefore do not give the holder voting rights. Not all RSUs are alike; some can be settled in cash or shares, and some have terms that include anti-dilutive features.

Generally, restricted stock and RSUs (a promise to deliver shares) generate a tax deduction to the employer on the vesting date because the employee has a substantial risk of forfeiture as a result of the award’s vesting condition until the vesting date.
18.5.1 Initial Recognition and Classification of the Deferred Tax Asset

Similar to the accounting for deferred taxes related to a nonqualified stock option discussed in Section TX 18.3.1, an entity recognizes a deferred tax asset based on the book compensation cost for restricted stock and RSUs over the requisite service period. The balance sheet classification of the deferred tax asset as either current or noncurrent should be based on the award’s vesting date (i.e., when the tax deduction generally occurs), absent the employee making an IRC Section 83(b) election, as discussed in Section TX 18.5.2.1.

18.5.2 Measurement of Tax Deduction for Restricted Stock

The tax deduction for restricted stock generally is measured as the restrictions lapse (i.e., as the employee vests in the award). At that time, the entity will determine its windfall or shortfall based on the current stock price. A shortfall occurs when the fair value of the shares decreases between the grant date and the vesting date.

18.5.2.1 IRC Section 83(b) Elections

Under IRC Section 83(b), employees may choose to have their tax liability measured on the grant date instead of the vesting date. An IRC Section 83(b) election enables an employee to pay tax on the fair market value of a restricted stock award on the date it is granted rather than on the vesting date, as required under the normal rule of IRC Section 83(a). An IRC Section 83(b) election, however, does not change the requirement that the employee satisfy the vesting condition. If the employee fails to satisfy the vesting condition, the award will still be forfeited.

If the employee makes an IRC Section 83(b) election, any appreciation in the restricted stock after the grant date will be taxed as either a long- or short-term capital gain instead of as ordinary income. The employer will be required to withhold applicable taxes at the grant date, and the employee will have to make arrangements with the employer to satisfy the withholding requirements. If the stock appreciates in value after the grant, the result of this election can be a significant reduction in the employee’s taxes as a result of favorable capital gains treatment.

If an employee makes an IRC Section 83(b) election, the entity measures the value of the award on the grant date and records a deferred tax liability for the value of the award multiplied by the applicable tax rate, reflecting the fact that the entity has received the tax deduction from the award before any compensation cost has been recognized for financial reporting purposes. In this case, the deferred tax liability offsets the current tax benefit that the entity is entitled to by virtue of the employee’s IRC Section 83(b) election. As the entity recognizes book compensation cost over the requisite service period, the deferred tax liability will be reduced (in lieu of establishing a deferred tax asset since the tax deduction has already occurred). If an IRC Section 83(b) election is made by an employee for an equity-classified award, there will not be a windfall or shortfall upon settlement because the tax deduction equaled the grant-date fair value. If, however, an IRC Section 83(b) election is made for liability-classified restricted stock, a windfall or shortfall likely would occur at settlement because the tax deduction is measured at the grant date, whereas the book compensation cost for a liability award is remeasured through the settlement date.

Example 18-6 illustrates the computation of book compensation cost and the corresponding deferred tax accounting for a grant of an equity-classified restricted stock award under two scenarios (comparing between when an IRC Section 83(b) election has been made and has not been made).
Example 18-6: Income Tax Accounting for Restricted Stock

Background/Facts:
On January 1, 2006, an entity grants 10 million equity-classified restricted shares that have a grant-date fair value of $15 per share and a three-year cliff-vesting requirement.

No forfeitures are assumed or occur during the vesting period.

The stock price is $25 on January 1, 2009, when the requisite service period is complete.

The applicable tax rate is 40 percent during all periods.

The entity recognizes compensation cost on a straight-line basis.

The entity has sufficient taxable income for the restricted stock tax deductions to reduce income taxes payable in all periods.

Analysis/Conclusion:
Computations of Compensation Cost and the Deferred Tax Asset for Restricted Stock Granted on January 1, 2006

<table>
<thead>
<tr>
<th>No IRC Section 83(b) Election</th>
<th>IRC Section 83(b) Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the grant date</td>
<td>No entry</td>
</tr>
<tr>
<td>Tax effect of recording compensation cost over the requisite service period (three years)</td>
<td>Record deferred tax asset of $60 million = 10 million shares x $15 (grant-date fair value) x 40% (tax rate) as book compensation cost is recognized in 2006, 2007 and 2008</td>
</tr>
<tr>
<td>Deferred tax asset (liability) on December 31, 2008</td>
<td>$60 million deferred tax asset</td>
</tr>
<tr>
<td>Awards vest on January 1, 2009</td>
<td>Current tax benefit of $100 million = $25 (fair value on vesting date) x 10 million (number of vested shares) x 40% (tax rate) Reverse $60 million deferred tax asset and credit APIC for windfall of $40 million: ($250 million (tax deduction) – $150 million (cumulative book compensation cost) x 40 percent (tax rate))</td>
</tr>
</tbody>
</table>

Under either alternative, the entity will recognize $150 million of book compensation cost over the three-year vesting period.

The example above assumes that there are no differences between the amount of the book compensation and the tax deduction that result from factors other than increases or decreases in the fair value of the entity’s shares between the grant...
date and exercise date. For example, in the scenario in which an IRC Section 83(b) election is made, the grant-date fair value of the award is equal to the amount of the tax deduction. In the scenario in which an IRC Section 83(b) election is not made, the difference between the amount of the book compensation and the ultimate tax deduction is attributable entirely to increases in the stock price subsequent to the grant date. Example 18-7 illustrates the accounting for the tax effects of differences between the amount of book compensation and tax deduction that result from factors other than increases or decreases in the fair value of an entity's shares between the grant date and exercise date. This might occur, for example, in certain situations when a company concludes that the fair value of an award at the grant date is different under the applicable tax law than the fair value determined for book purposes at the same date.

Example 18-7: Accounting for Tax Benefits when Differences Between the Book Charge and Tax Deduction Result from Factors Other Than Increases or Decreases in the Company's Stock Price

Background/Facts:
Company X (the “Company”) grants fully vested restricted stock to its employees. The award includes restrictions on the transfer of the stock that survive vesting (for example, the employee is prohibited from transferring the stock for a period of five years after the delivery of the vested stock). The Company follows the accounting guidance of ASC 718, Compensation—Stock Compensation, appropriately classifying such awards as equity.

For financial reporting purposes, the grant date fair value reflects the impact of the restrictions that survive vesting. These restrictions are disregarded in determining the tax deduction. Therefore, the fair value of the restricted stock determined for financial reporting purposes was determined to be less than the value used for tax purposes. The difference between the book compensation and the tax deduction was due entirely to reasons other than movement in the stock price between the grant date and the measurement date for tax purposes.

How should Company X account for the difference between the book charge and the tax deduction?

Analysis/Conclusion:
A tax benefit should be recorded for the restricted stock related to the amount of the award that is tax deductible. The difference between the book compensation charge and the tax deduction results in a permanent difference in Company X's income tax provision (i.e., a current tax benefit). The permanent difference would not constitute a “windfall” with a credit potentially reflected in additional paid-in capital because it arises from factors other than the movement of the Company's stock price between the measurement date for accounting and the measurement date for tax purposes. ASC 718-740-45-2, supports this accounting by stating “... an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.”

(continued)

1 ASC 718-10-30-19 states "A restricted share awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties."
In the example above, the Company granted fully vested restricted stock. If the award had not been fully vested at the time of grant, but instead followed a vesting schedule in which the award vests over two years, the tax benefit would not be determined until the award is fully vested in the absence of an IRC Section 83(b) election. In this case, the Company would record the deductible temporary difference over the vesting period, which is measured based on the compensation cost recognized for financial reporting purposes in accordance with ASC 718-740-25-2. Once the award vests for tax purposes, the Company would need to analyze the excess tax benefit to determine the amount that is due to increases and decreases in the stock price (which would result in a windfall or shortfall) and the amount due to other factors (which would be recognized in the income statement).

The accounting treatment would also be consistent with the description above if instead the grant date fair value of the fully vested restricted stock award determined for book purposes exceeded the fair value determined for tax purposes. The resulting permanent difference would not constitute a “shortfall.” Rather, the debit would be recorded to the income tax provision.

### 18.6 Income Tax Accounting for Stock Appreciation Rights

A stock appreciation right (SAR) confers upon an employee the contractual right to receive an amount of cash, stock, or a combination of both that equals the appreciation in an entity’s stock from an award’s grant date to the exercise date. SARs generally resemble stock options in that they may be exercised at the employee’s discretion during the exercise period and do not give the employee an ownership right in the underlying stock. Unlike options, however, SARs generally do not involve payment of an exercise price. How the award is settled (in cash or in stock) also affects the classification of a SAR as either a liability or equity, as discussed in Section SC 1.12.8 of PwC’s Guide to Accounting for Stock-based Compensation.

#### 18.6.1 Cash-Settled SARs

Under ASC 718, cash-settled SARs are classified as liability awards and therefore are remeasured at fair value each reporting period until the award is settled. The related deferred tax asset is adjusted when book compensation cost is recognized each reporting period as the cash-settled SAR is remeasured. When an employee exercises a SAR, the entity’s tax deduction will equal the fair value of the SAR, which is also the amount of the book compensation liability. If the SAR is cancelled prior to expiration, the liability is reversed and the deferred tax asset is reversed through income tax expense. If the SAR expires worthless, there would be no accounting entries at the expiration date because, prior to expiration, the SAR and the corresponding deferred tax asset would have been remeasured each reporting period and at some point in time before expiration, the SAR would have no value and there would be no liability or associated deferred tax asset on the books.

#### 18.6.2 Stock-Settled SARs

Stock-settled SARs generally are equity-classified awards under ASC 718. The income tax accounting is identical to that for an equity-classified, nonqualified stock option. Accordingly, a deferred tax asset is recorded as book compensation cost is recognized. When an employee exercises a stock-settled SAR, the entity measures the amount of the tax deduction based on the award’s intrinsic value at that time, determining the amount of any windfall or shortfall.
Example 18-8 compares the income tax accounting for cash-settled SARs and stock-settled SARs.

### Example 18-8: Income Tax Accounting Comparison of Cash-Settled SARs and Stock-Settled SARs

<table>
<thead>
<tr>
<th>On the grant date</th>
<th>Cash-Settled SAR</th>
<th>Stock-Settled SAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>As the award vests</td>
<td>Remeasure the book compensation liability at fair value and adjust it each reporting period accordingly, and recognize the corresponding deferred tax asset</td>
<td>Record the book compensation cost (based on the grant-date fair value) and recognize the corresponding deferred tax asset</td>
</tr>
<tr>
<td>After the award has vested but before it is settled</td>
<td>Remeasure the book compensation liability at fair value and adjust it each reporting period accordingly, and adjust the corresponding deferred tax asset</td>
<td>No accounting required</td>
</tr>
<tr>
<td>At the time of settlement</td>
<td>The deferred tax asset at the time of settlement should equal the current tax benefit, resulting in no windfall or shortfall</td>
<td>Determine the amount of windfall or shortfall and record accordingly</td>
</tr>
</tbody>
</table>

### 18.7 Accounting for the Tax Benefit of Dividends on Restricted Stock and Options

Employees, as part of stock-based compensation awards, may receive dividends on their awards during their vesting periods or, in the case of options, during the period until the exercise of their options (so-called “dividend protection”). ASC 718 provides guidance on the accounting for these dividends and states that dividends paid on restricted stock and dividend-protected options that are expected to vest are factored into the fair value of the award. The fair value of dividend-paying stock already incorporates the expected payment of dividends and therefore the entity would make no adjustment to the fair value of restricted shares for the expected payment of dividends during the vesting period. However, the fair value of an option for stock that pays dividends should be adjusted to appropriately reflect the dividend protection. ASC 718 states that the payment of dividends on restricted stock or options should be accounted for in retained earnings if the shares are expected to vest. When the related award is not expected to vest, the payment of the dividends or dividend equivalents are recognized as additional compensation cost.

From a tax perspective, dividends paid to employees on restricted stock for which an employee has not made an IRC Section 83(b) election are not treated as dividends paid to a shareholder because the IRS does not recognize the employee as having received the restricted stock until the restriction lapses (that is, until the shares vest). Therefore, the IRC treats the payment of these dividends as compensation, and the entity is entitled to receive a deduction on the dividends paid. Likewise, dividends paid as part of a dividend-protection plan for option grants are treated as compensation for U.S. tax purposes.

Consequently, entities that pay dividends on options and restricted stock (when a Section 83(b) election is not made) during the vesting period will receive a tax benefit...
from the deduction on those dividends. ASC 718-740-45-8 states that a realized tax benefit from dividends, or dividend equivalents, that is charged to retained earnings and paid to employees for equity-classified restricted stock, restricted stock units, and outstanding options should be recognized as an increase to APIC. Those tax benefits are considered windfall tax benefits under ASC 718 and would be included in the pool of windfall benefits. Pursuant to the guidance in ASC 718-740-25-10, the tax benefit would not be recognized in APIC (or included in the pool of windfall tax benefits) until the tax benefit actually reduces income taxes payable. As an entity’s forfeiture estimate changes, the amount of tax benefits from dividends on awards no longer expected to vest should be reclassified from APIC to income tax benefit, with a related adjustment to the pool of windfall tax benefits. The amount reclassified should be limited to the amount of the entity’s pool of windfall tax benefits (i.e., the pool of windfall tax benefits should not be less than zero).

**PwC Observation:** The tax deduction that an employer is eligible for under IRC Section 83(h) may be subject to certain limitations. Please see Section TX 3.2.8 for a discussion of the 162(m) limitation.

### 18.8 Modification of Awards

ASC 718 defines a modification as a change in any of the terms or conditions of a stock-based compensation award, for example, a repricing, an extension of the vesting period, or a change in the terms of a performance condition. A modification of an award under ASC 718 generally will be treated as an exchange of the original award for a new award. An entity should measure book compensation cost as the excess (if any) of the fair value of the new award over the fair value that the original award had immediately before its terms were modified. In addition, an entity also will assess the potential effect of the modification on the number of awards expected to vest, including a reassessment of the probability of vesting.

If the entity records additional book compensation cost as a result of the modification, there will be a corresponding increase in the deferred tax asset. To the extent an equity-classified award is modified to a liability-classified award, any deferred tax asset would need to be adjusted at the date of modification to an amount which corresponds with the recognized liability. Even if the book compensation continues to be based on the grant date fair value of the original award (for example, if the fair value at the modification date is lower than the fair value at the original grant date), the deferred tax asset should be calculated based on the value of the liability. Refer to ASC 718-20-35-3 and Section SC 1.13 of PwC’s *Guide to Accounting for Stock-Based Compensation* for further guidance related to modifications.

There also may be additional tax and legal ramifications of a modification. Certain modifications to an outstanding stock award at any time after the grant date may be considered a “material modification” as defined by the IRC and may impact the qualified status of ISOs. Additionally, a modification of an award may have potentially adverse tax implications to the employee under Section 409A.

**PwC Observation:** Entities that plan to modify the terms of an outstanding stock award should consult with their tax advisors and/or legal counsel before completing the modification.
Certain modifications could result in an ISO losing its qualified status and in the modified award being considered a nonqualified stock option. Whereas previously no deferred taxes were recorded on compensation expense recognized related to the ISO because it does not ordinarily result in a tax deduction, if, as a result of the modification, the award would no longer be an ISO, the entity would have to begin recording the related deferred taxes on the nonqualified award.

18.9 Repurchase of an Award

As further described in Section SC 1.13.4 of PwC’s Guide to Accounting for Stock-Based Compensation, the accounting for the repurchase of an award is affected by several factors, including whether the award is vested or unvested and probable of vesting. If the repurchased award is unvested and probable of vesting, the company should recognize the cash settlement as a repurchase of an equity instrument that vests the award. Accordingly, any unrecognized compensation cost measured at the grant date and related deferred tax asset should be accelerated and recognized on the settlement date.

If the award (either vested or unvested and probable of vesting) is cash-settled at its current fair value as of the settlement date, no incremental compensation cost should be recognized. If the award is cash-settled for an amount greater than its fair value, compensation cost for the difference should be recognized. If the award is cash-settled for an amount less than its fair value, the entire amount of cash transferred to repurchase the award should be charged to APIC.

From a tax perspective, the amount of the cash settlement is generally deductible by the employer to the extent the entity has not previously taken a tax deduction for the award. For example, a deduction would not have previously been taken by the employer for a nonqualified stock option that has not been exercised by the employee. The amount that is deductible may also be subject to the IRC Section 162(m) limitation for covered employees (see further discussion of the IRC Section 162(m) limitation in Section TX 3.2.8). Generally, the entity is not entitled to an additional deduction for the cash settlement if it has previously taken a deduction on the award (for example, a restricted stock award in which the employee made an IRC Section 83(b) election—see Section TX 18.5.2.1 for further discussion of IRC Section 83(b) elections).

When there is a repurchase of an award for cash, any remaining deferred tax asset (in excess of the tax benefit resulting from the repurchase, if any) related to the awards generally would be reversed as a shortfall. A cash settlement of ISOs will create a tax benefit reported in earnings (to the extent of book compensation) similar to a disqualifying disposition.

18.10 Clawback of an Award

Entities may include a “clawback” provision in stock-based compensation awards. Per ASC 718-10-55-8: “A clawback feature can take various forms but often functions as a noncompete mechanism. For example, an employee that terminates the employment relationship and begins to work for a competitor is required to transfer to the issuing entity (former employer) equity shares granted and earned in a share-based transaction.” Other clawback features may require forfeiture of an award, or a portion of an award, if there is a termination for cause or as required by the Sarbanes-Oxley Act. In addition, the Dodd-Frank Act signed into law in 2010 requires stock exchanges to put rules in place requiring entities listed on the exchange to adopt certain clawback provisions in their incentive compensation.
plans, including stock compensation, for certain current and former executive officers. The Dodd-Frank Act and financial statement accounting considerations relating to clawback provisions are discussed in more detail in Chapter SC 8 of PwC’s *Guide to Accounting for Stock-based Compensation*.

The income tax accounting for a clawback that has been triggered depends on the status of the award at the time of the clawback and whether the entity has previously taken the tax benefit from the stock-based compensation award. If the clawback occurs prior to the exercise of a stock option (or the vesting of restricted stock for tax purposes) and no tax deduction has been taken for the clawed-back awards, the related deferred tax asset would be reversed through income tax expense and not considered a shortfall. If an entity has taken deduction(s) for a stock-based compensation award that is being clawed-back, taxable income resulting from the clawback would be allocated to the various components of the financial statements (e.g., continuing operations, APIC) in accordance with ASC 740-20. See Section TX 12.2 for further discussion of the basic intraperiod allocation model and Section TX 12.2.3.2.1 for discussion of the treatment of tax effects related to equity items other than items of comprehensive income (e.g., APIC).

### 18.11 Pool of Windfall Tax Benefits

#### 18.11.1 General Guidance

When the stock-based compensation standard was most recently revised, the transition guidance provided public companies and nonpublic companies that used the fair-value-based method for either recognition or disclosure under the prior standard with three transition alternatives: (1) modified prospective application (MPA); (2) modified retrospective application (MRA) to interim periods in the year of adoption; and (3) modified retrospective application to all prior periods. Regardless of the transition alternative chosen, entities should have determined the amount of eligible windfall tax benefits (the pool of windfall tax benefits) that were available on the adoption date to offset future shortfalls. Subsequent to the adoption of the revised standard (now codified in ASC 718), an entity should continue to track the balance of the pool of windfall tax benefits based on windfalls or shortfalls incurred after the adoption date. Refer to Section TX 18.11.6 for a discussion of the method for determining the historical pool of windfall tax benefits for nonpublic companies that adopted the stock-based compensation standard under the prospective method.

Entities could have elected to calculate their historical pool of windfall tax benefits (i.e., the amount that would have accumulated as of the adoption date) using either of two methods. The “long-form method” is discussed in Section TX 18.11.2. Determining the pool of windfall tax benefits using the long-form method was complex and required an entity to conduct an extensive data-gathering exercise to compile information from various sources over an extended time period. Alternatively, a “short-cut method” was provided for determining the historical pool of windfall tax benefits. The short-cut method is discussed in Section TX 18.11.4. Once an entity has determined its historical pool of windfall tax benefits, the long-form method is utilized for all activity subsequent to the adoption of ASC 718.

Example 18-9 summarizes the key differences between the long-form and short-cut methods of calculating the historical pool of windfall tax benefits at the adoption date.
Example 18-9: Key Differences When Calculating the Pool of Windfall Tax Benefits Using the Long-Form or Short-Cut Methods

<table>
<thead>
<tr>
<th></th>
<th>Long-Form Method</th>
<th>Short-Cut Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation of the historical</td>
<td>Detailed annual calculation performed on an award-by-award basis and rolled</td>
<td>Two-step, short-cut calculation: (1) Net increases to APIC related to tax</td>
</tr>
<tr>
<td>pool of windfall tax benefits</td>
<td>forward</td>
<td>benefits from stock-based compensation after the effective date of the prior</td>
</tr>
<tr>
<td>at the adoption date</td>
<td></td>
<td>standard less (2) the product of cumulative incremental compensation cost under</td>
</tr>
<tr>
<td></td>
<td></td>
<td>the prior standard multiplied by the current blended statutory tax rate</td>
</tr>
<tr>
<td>Transition provisions to</td>
<td>“As if” accounting required to determine windfalls and shortfalls for inclusion in</td>
<td>Fully vested awards: The tax benefit recognized in APIC upon settlement is</td>
</tr>
<tr>
<td>account for the ongoing</td>
<td>the pool of windfall tax benefits</td>
<td>included in the pool of windfall tax benefits (i.e., no “as if” accounting)</td>
</tr>
<tr>
<td>income tax effects for partially</td>
<td></td>
<td></td>
</tr>
<tr>
<td>or fully vested awards as of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>the date of adoption(^1)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) Applicable only to entities that adopted the stock-based compensation standard using the modified prospective application method (or the modified retrospective application method for interim periods in the year of adoption only).

ASC 718 does not require entities to disclose the amount of their pool of windfall tax benefits available to offset future shortfalls. However, the amount of the pool of windfall tax benefits is needed to determine whether shortfalls after adoption are recorded against APIC or charged to income tax expense. The pool of windfall tax benefits is not directly related to the balance in an entity’s APIC account. Therefore, an entity cannot assume that it has a sufficient pool of windfall tax benefits to offset shortfalls based on having a large credit balance in APIC. Likewise, an entity could have a zero balance in APIC and have a pool of windfall tax benefits.

Although ASC 718 implicitly requires that recordkeeping be on an award-by-award basis, it allows the windfall tax benefits of all awards accounted for under the prior standard and ASC 718 to be aggregated for purposes of determining the pool of windfall tax benefits. Thus, any windfalls resulting from employee stock options, restricted stock, and most ESPPs that are granted on or after the effective date of the prior standard are eligible for aggregation, whereas any windfalls generated by Employee Stock Ownership Plans (ESOPs) or other stock-based arrangements that are outside the scope of ASC 718 are excluded.

The pool of windfall tax benefits should be calculated for windfalls and shortfalls generated by all entities that are included in the consolidated financial statements, without regard to tax jurisdiction (i.e., windfalls in one jurisdiction may offset shortfalls from another jurisdiction). Deferred tax accounting for stock-based compensation, however, generally should be determined on a jurisdiction-by-jurisdiction basis (and potentially on a tax-return-by-tax-return basis) consistent with how taxes are computed and paid.

When calculating the pool of windfall tax benefits, the balance of the pool can never be less than zero. For example, assume that an entity has no pool of windfall tax
benefits as of the adoption date of ASC 718. In the first year after adoption, the entity incurs a shortfall of $1,500. In this case, at the end of the first year, the pool of windfall tax benefits would still be zero and income tax expense of $1,500 would be recognized in the income statement. The entity would begin the next year with a balance of zero in the pool of windfall tax benefits.

In addition, entities may have windfall tax benefits and shortfalls from both employee and nonemployee awards and should have elected as an accounting policy one of two approaches to determining the pool of windfall tax benefits.

The Resource Group reached a consensus that either a one-pool approach (grouping employee and nonemployee awards together) or a two-pool approach (segregating employee and nonemployee awards into two separate pools) would be acceptable when accounting for the pool of windfall tax benefits. The accounting policy selected should be disclosed in the financial statements and followed consistently.

**PwC Observation:** As discussed in Section TX 18.11.4, entities were only permitted to use the short-cut method for calculating their historical pool of windfall tax benefits related to employee stock-based compensation. This implies that an entity did not have the ability to use the short-cut method to calculate its historical pool of windfall tax benefits related to nonemployee awards. We believe, however, that entities still had the ability to account for the pool of windfall tax benefits related to employees and nonemployees on a combined basis subsequent to the adoption of ASC 718, using the combined pool (whether or not the individual pools were calculated using the same method) as of the adoption date.

### 18.11.2 Determining the Pool of Windfall Tax Benefits Using the Long-Form Method

Under the long-form method, entities that did not adopt the recognition provisions of the prior stock-based compensation standard in the year that standard originally went into effect (January 1, 1995, for a calendar-year-end entity) needed to determine what their pool of windfall tax benefits and the related deferred tax assets would have been on ASC 718’s adoption date “as if” they had been following the recognition provisions of the prior standard since its effective date. Calculation of the pool of windfall tax benefits under the long-form method was subject to potential adjustment for net operating loss (NOL) carryforwards if such NOL carryforwards included windfall tax benefits that had not been realized (see Section TX 18.14). Thus, the pool of windfall tax benefits at the adoption date of ASC 718 consisted of the net credits to APIC (both windfalls and shortfalls) that an entity would have recorded under the prior standard (subject to potential adjustment for NOL carryforwards).

Using the long-form method required an entity to compile various data from the effective date of the prior standard through the date it adopted ASC 718 because calculating the pool of windfall tax benefits under this method implicitly required tracking each award separately and maintaining detailed information on an award-by-award basis. To obtain much of the information necessary to calculate the pool of windfall tax benefits on the adoption date, an entity needed to draw on historical records from human resources’ information systems, previously filed tax returns, records for stock-based compensation plans, and data from financial reporting systems dating back to the effective date of the prior standard. When using the long-form method, awards that were granted before the effective date of the prior standard should have been excluded from the analysis unless the awards were subsequently modified.
18.11.3 Considerations for Equity-Classified Awards Granted Before but Settled After Adoption of ASC 718 under the Long-Form Method

Numerous transition issues arise for equity-classified awards granted before but settled after an entity’s adoption of ASC 718 if the entity used the modified prospective application method (or the modified retrospective application method for interim periods in the year of adoption only). The transition considerations discussed in the following sections are not applicable to entities that adopted ASC 718 using the modified retrospective application method for all prior periods because these entities would have adjusted their financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994.

Under the long-form method, there are two calculations that an entity needs to complete for awards exercised after the adoption of ASC 718 that were granted prior to the adoption of ASC 718. The following sections discuss when and how each of these calculations is performed for nonqualified stock options, ISOs, and restricted stock awards.

18.11.3.1 Nonqualified Stock Options—Long-Form Method

If an entity used the modified prospective application method (or the modified retrospective application method for interim periods in the year of adoption only), the deferred tax assets related to equity-classified, stock-based compensation awards should not have been adjusted at the date of adoption. If an equity-classified, nonqualified stock option was granted before but settled after the adoption of ASC 718, the first calculation is to determine the amount of the windfall the entity should recognize. The tax deduction an entity realizes should be compared with the amount of cumulative book compensation cost recognized in the entity’s financial statements (compensation cost both recognized after the adoption of ASC 718 and recognized under prior standards, if any). The windfall tax benefit of any excess deduction should be recorded in APIC. For stock options that were fully vested at the adoption of ASC 718 and did not result in any compensation expense being recorded under prior standards, the exercise of the option after adoption could not result in a recognized shortfall. However, the entity could have incurred an “as if” shortfall for purposes of calculating the impact on the pool of windfall tax benefits, as discussed below.

The second calculation that an entity should perform is to determine the impact of the tax deduction on the pool of windfall tax benefits. The entity should calculate the windfall or shortfall by comparing the tax deduction with the total cumulative book compensation cost recognized in the financial statements under ASC 718 and disclosed in the pro forma footnote under the prior standard (the “as if” windfall or shortfall). This “as if” windfall (or shortfall) is the windfall (or shortfall) that the entity would have incurred if the entity had been following the recognition provisions of the prior standard since its effective date. Any resulting “as if” windfall would increase the pool of windfall tax benefits and any “as if” shortfall would reduce the pool of windfall tax benefits. If an entity does not have a pool of windfall tax benefits, there would be no further accounting for an “as if” shortfall because the pool of windfall tax benefits cannot be reduced below zero.

In some reporting periods, an entity may incur both recognized shortfalls and incremental “as if” shortfalls. In some cases, the total recognized shortfalls and “as if” shortfalls may exceed the entity’s pool of windfall tax benefits. It is important to understand the order in which shortfalls reduce the pool of windfall tax benefits.
For example, consider an entity with a pool of windfall tax benefits of $1,400 that recognizes a shortfall of $1,000 in its financial statements and also incurs an “as if” shortfall of $2,500 as a result of several option exercises within one period. In this situation, the order in which the recognized and “as if” shortfalls reduce the pool may impact the amount of recognized shortfalls that are recorded as income tax expense. We believe that an entity should first reduce the pool of windfall tax benefits for any recognized shortfalls and then reduce the pool for “as if” shortfalls. In this example, the recognized shortfall of $1,000 would reduce the pool of windfall tax benefits to $400. The incremental “as if” shortfall of $1,500 would reduce the pool of $400 to zero and there would be no accounting consequence of the remaining $1,100 “as if” shortfall. Because the pool of windfall tax benefits is determined on an annual basis, recognized shortfalls should be prioritized within the annual period (i.e., within an annual period, an entity should reduce the pool of windfall tax benefits for recognized shortfalls before considering the impact of any “as if” shortfalls).

Example 18-10 illustrates the above guidance, using three different scenarios.

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**Example 18-10: “As If” Deferred Tax Assets and the Pool of Windfall Tax Benefits**

**Background/Facts:**
A calendar-year public entity adopted ASC 718 on January 1, 2006, using the modified prospective application method. At the adoption date, it had only one stock-based compensation award grant outstanding. On January 1, 2004, the entity granted 100,000 equity-classified, nonqualified stock options with an exercise price of $25 (equal to the grant-date stock price) with a four-year cliff-vesting period. Because the options were at-the-money on the grant date, no compensation cost was recognized under prior standards. The grant-date fair value of each option as determined under the prior standard was $5. Upon adopting ASC 718, the entity determined it had a pool of windfall tax benefits of $60,000. The entity’s applicable tax rate for all periods is 40 percent. The entity has sufficient taxable income for the stock option tax deductions to reduce income taxes payable in all periods.

Assuming straight-line attribution of compensation cost, the entity would have recognized the following:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Prior Standard Pro Forma</th>
<th>ASC 718</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Compensation Cost</td>
<td>Deferred Tax Assets</td>
</tr>
<tr>
<td>2004</td>
<td>$125,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>2005</td>
<td>$125,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>2006</td>
<td>$125,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>2007</td>
<td>$125,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

At the end of 2007, the entity has the following balances:

<table>
<thead>
<tr>
<th>“As if” Deferred Tax Assets</th>
<th>Pool of Windfall Tax Benefits</th>
<th>Recognized Deferred Tax Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

The sum of “as if” and recognized deferred tax assets at the end of 2007 is $200,000.

(continued)
On January 1, 2008, all of the options are exercised. Below are three scenarios that illustrate the income tax accounting for the stock options described above.

<table>
<thead>
<tr>
<th>Stock price</th>
<th>Scenario A</th>
<th>Scenario B</th>
<th>Scenario C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$31.25</td>
<td>$28.75</td>
<td>$27.00</td>
<td></td>
</tr>
</tbody>
</table>

| Less: Exercise price | 25.00 | 25.00 | 25.00 |

| Intrinsic value | 6.25 | 3.75 | 2.00 |

| Tax deduction | 625,000 | 375,000 | 200,000 |

| Applicable tax rate | 40% | 40% | 40% |

| Tax benefit | $250,000 | $150,000 | $80,000 |

Calculation #1: Recognized windfall/(shortfall) = [(Tax deduction – recognized cumulative compensation cost of $250,000) x 40%]

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Scenario A</th>
<th>Scenario B</th>
<th>Scenario C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$150,000</td>
<td>$50,000</td>
<td>$(20,000)</td>
<td></td>
</tr>
</tbody>
</table>

Calculation #2: “As if” windfall/(shortfall) = [(Tax deduction – cumulative recognized and unrecognized compensation cost of $500,000) x 40%]

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Scenario A</th>
<th>Scenario B</th>
<th>Scenario C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000</td>
<td>$(50,000)</td>
<td>$(120,000)</td>
<td></td>
</tr>
</tbody>
</table>

The previous chart illustrates that the pool of windfall tax benefits and the recognized windfall tax benefits will not equal each other for awards granted before ASC 718’s adoption date.

In Scenario A, the tax deduction of $625,000 would be compared with the cumulative compensation cost (recognized and disclosed) of $500,000, resulting in a $125,000 excess deduction and a $50,000 ($125,000 x 40%) “as if” windfall tax benefit, which increases the pool of windfall tax benefits. As a result, the pool of windfall tax benefits would be $110,000 and the recognized windfall tax benefit would be $150,000 (see below).

In Scenario A, the entity’s pool of windfall tax benefits would be as follows:

| Opening balance, 12/31/07 | $60,000 |
| Add: “As if” windfall | 50,000 |
| Ending balance, 1/1/08 | $110,000 |

In Scenario A, the entity would record the following journal entries:

| Dr Income taxes payable | $250,000 |
| Cr Deferred tax assets | $100,000 |
| Cr APIC | $150,000 |

In Scenario B, the tax deduction of $375,000 would be compared with the cumulative compensation cost (recognized and disclosed) of $500,000, resulting in a $125,000 deficiency and a $50,000 ($125,000 x 40%) “as if” shortfall, which decreases the pool of windfall tax benefits. As a result, the pool of windfall tax benefits would now be $10,000, and the recognized windfall tax benefit would be $50,000 (see below).

(continued)
In Scenario B, the entity’s pool of windfall tax benefits would be as follows:

<table>
<thead>
<tr>
<th>Pool of Windfall Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance, 12/31/07</td>
</tr>
<tr>
<td>Less: “As if” shortfall</td>
</tr>
<tr>
<td>Ending balance, 1/1/08</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$60,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>$10,000</td>
<td></td>
</tr>
</tbody>
</table>

In Scenario B, the entity would record the following journal entries:

Dr Income taxes payable $150,000
Cr Deferred tax assets $100,000
Cr APIC $50,000

In Scenario C, the tax deduction of $200,000 would be compared with the cumulative compensation cost (recognized and disclosed) of $500,000, resulting in a $300,000 deficiency and a $120,000 ($300,000 x 40%) “as if” shortfall, which decreases the pool of windfall tax benefits. With the balance at $60,000, the entity exhausts its pool of windfall tax benefits. Additionally, the entity will have a recognized shortfall of $20,000 because the realized tax benefit of $80,000 is less than the recognized deferred tax assets of $100,000 (see below).

In Scenario C, the entity’s pool of windfall tax benefits would be as follows:

<table>
<thead>
<tr>
<th>Pool of Windfall Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance, 12/31/07</td>
</tr>
<tr>
<td>Less: “As if” shortfall</td>
</tr>
<tr>
<td>Ending balance, 1/1/08</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$60,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>$(60,000)</td>
<td></td>
</tr>
</tbody>
</table>

In Scenario C, the entity would record the following journal entries:

Dr Income taxes payable $80,000
Dr APIC $20,000
Cr Deferred tax assets $100,000

Note: As previously discussed, when determining how recognized and “as if” shortfalls will impact the pool of windfall tax benefits and the income statement, the pool of windfall tax benefits should be reduced by recognized shortfalls before “as if” shortfalls. Therefore, the recognized shortfall is recorded as a reduction of APIC, even though the “as if” shortfall exceeds the balance in the pool of windfall tax benefits.

PwC Observation: To appropriately apply the approach described above, an entity should have ensured that it had the necessary records for all outstanding equity-classified awards when it determined its pool of windfall tax benefits and its “as if” deferred taxes. An entity should have determined and maintained pro forma balance sheet deferred tax accounts for stock-based compensation awards that were outstanding on the date that it adopted ASC 718. Additionally, entities with a large number of vested, deep-out-of-the-money stock options should pay particular attention to the pool of windfall tax benefits because it is likely that those stock options will expire unexercised and the “as if” deferred tax assets will reduce the pool of windfall tax benefits.
18.11.3.2 Incentive Stock Options—Long-Form Method

As previously discussed, an ISO does not ordinarily result in a tax benefit for the employer unless there is a disqualifying disposition. Therefore, a deferred tax asset is not recognized when an entity recognizes book compensation cost for ISOs. If and when a disqualifying disposition occurs, the employer will receive a tax deduction generally equal to the intrinsic value of the ISO on the date of the disqualifying disposition.

If an ISO was vested at the date of adoption of ASC 718 and a disqualifying disposition occurs subsequent to adoption, an entity using the modified prospective application method should record the entire tax benefit in APIC. If an ISO was partially vested at the date of adoption (i.e., a portion but not all of the requisite service period has been completed) and a disqualifying disposition occurs in a period subsequent to adoption, there is a two-step process to the first calculation to determine where the tax benefit should be recognized, as follows:

- **Vested portion**: The tax benefit allocated to the portion of the ISO that was vested at the date of adoption should be recorded in APIC.

- **Unvested portion**: The tax benefit allocated to the portion of the ISO that was unvested at the date of adoption, up to the amount of compensation cost recognized after the adoption of ASC 718, is credited to income tax expense. If the pro rata portion of the tax deduction exceeds the recognized cumulative compensation cost, the excess is credited to APIC.

For example, if a calendar-year-end entity granted ISOs with a grant-date fair value of $2 for the purchase of 120,000 shares on June 1, 2005, that cliff-vest in 12 months, the “vested” portion of the award as of the ASC 718 adoption date of January 1, 2006, would be $140,000 (120,000 shares x 7/12 x $2) and the “unvested” portion would be $100,000.

The “as if” windfall that increases the pool of windfall tax benefits is calculated by comparing the tax deduction with the total cumulative book compensation cost, both recognized in the financial statements and disclosed in the pro forma footnote under the prior standard. The tax benefit associated with the excess deduction is the “as if” windfall and increases the pool of windfall tax benefits. As previously discussed, compensation cost recorded for an ISO does not result in the recognition of a deferred tax asset and therefore the settlement of an ISO will not result in either a recognized or an “as if” shortfall.

Example 18-11 illustrates the tax implications of an ISO granted before the adoption of ASC 718, when a disqualifying disposition occurs after the adoption of ASC 718, for an entity using the modified prospective application method.
Example 18-11: Disqualifying Dispositions and the Pool of Windfall Tax Benefits

This illustration uses the same assumptions as in Example 18-10, except the entity granted 100,000 equity-classified incentive stock options on January 1, 2005.

Assuming straight-line attribution of compensation cost, the entity would have recognized the following:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Prior Standard Pro Forma</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Compensation Cost</td>
<td>Deferred Tax Assets</td>
</tr>
<tr>
<td>2005</td>
<td>$125,000</td>
<td>$—</td>
</tr>
<tr>
<td>2006</td>
<td>$125,000</td>
<td>$—</td>
</tr>
<tr>
<td>2007</td>
<td>$125,000</td>
<td>$—</td>
</tr>
<tr>
<td>2008</td>
<td>$125,000</td>
<td>$—</td>
</tr>
</tbody>
</table>

At the end of 2008, the entity has the following balances:

<table>
<thead>
<tr>
<th>“As if” Deferred Tax Assets</th>
<th>Pool of Windfall Tax Benefits (Long-form)</th>
<th>Recognized Deferred Tax Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>$—</td>
<td>$60,000</td>
<td>$—</td>
</tr>
</tbody>
</table>

On January 1, 2009, all of the options are exercised when the market price of the entity’s common stock is $32. The employees immediately sell the stock in the open market, which causes a disqualifying disposition. The calculations of the tax implications resulting from the disqualifying disposition are summarized in the schedule below.

Calculation of tax benefit:

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Formula</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price of shares ($32 x 100,000 options)</td>
<td>$3,200,000</td>
<td></td>
</tr>
<tr>
<td>Less: Exercise price ($25 x 100,000 options)</td>
<td>2,500,000</td>
<td></td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>700,000</td>
<td></td>
</tr>
<tr>
<td>Applicable tax rate</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>Tax benefit</td>
<td>$280,000</td>
<td></td>
</tr>
</tbody>
</table>

Calculation #1, Step 1: Tax benefit that will be recorded in income statement upon disqualifying disposition

= Recognized cumulative compensation cost of $375,000 x 40%

= $150,000

Calculation #1, Step 2a: Recognized windfall for unvested portion of ISO as of ASC 718 adoption date

= [(Tax deduction of $700,000 x 75%) – recognized compensation cost of $375,000] x 40%

= $60,000

Calculation #1, Step 2b: Recognized windfall for vested portion of ISO as of ASC 718 adoption date

= [(Tax deduction of $700,000 x 25%) – recognized compensation cost of $0] x 40%

= $70,000

Calculation #2: “As if” windfall

= [(Tax deduction of $700,000 – cumulative recognized and unrecognized compensation cost of $500,000) x 40%]

= $80,000

(continued)
In this example, the entity’s pool of windfall tax benefits would be as follows:

<table>
<thead>
<tr>
<th>Pool of Windfall Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance, 12/31/08</td>
</tr>
<tr>
<td>Add: “As if” windfall</td>
</tr>
<tr>
<td>Ending balance, 1/1/09</td>
</tr>
</tbody>
</table>

In this example, the entity would record the following journal entries:

Dr Income taxes payable $280,000  
Cr Income tax provision $150,000  
Cr APIC $130,000

If the stock price was $28 on the date of the disqualifying disposition and the tax deduction was $300,000 (i.e., an amount less than the cumulative recognized and unrecognized compensation cost of $500,000), this tax deduction would be allocated between the compensation cost reflected in the pro forma footnote under the prior standard and the compensation cost recognized in the financial statements post adoption of ASC 718. As discussed earlier in this section, the settlement of an ISO will not result in an “as if” shortfall and thus the disqualifying disposition would have no impact on the pool of windfall tax benefits because the tax deduction was less than the cumulative recognized and unrecognized compensation cost. The vested and unvested portion of the award will be used to allocate the tax benefit received upon disqualifying disposition between the periods before and after the pre- and post-adoption of ASC 718. The calculations of the tax implications resulting from the disqualifying disposition are summarized in the schedule below and followed by the corresponding journal entries.

**Calculation of tax benefit:**

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Description</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation #1, Step 1: Tax benefit to be recorded in income statement upon disqualifying disposition = Recognized cumulative compensation cost of $375,000 x 40% = $150,000, limited to the amount allocated</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Calculation #1, Step 2a: Recognized windfall for unvested portion of ISO at ASC 718 adoption = [(Tax deduction of $300,000 x 75%) – recognized compensation cost of $375,000] x 40%. Since this would be negative, amount is zero</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Calculation #1, Step 2b: Recognized windfall for vested portion of ISO at adoption = [(Tax deduction of $300,000 x 25%) x 40%]</td>
<td>$30,000</td>
<td></td>
</tr>
</tbody>
</table>

**Calculation #2: “As if” windfall = [(Tax deduction of $300,000 – cumulative recognized and unrecognized compensation cost of $500,000) x 40%]. Since negative, “as if” windfall is zero; no shortfalls can result from settlement of an ISO. | $0 |

(continued)
In this example, there would be no change to the entity’s pool of windfall tax benefits and the entity would record the following journal entries:

<table>
<thead>
<tr>
<th>Dr Income taxes payable</th>
<th>$120,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Income tax provision</td>
<td>$90,000</td>
</tr>
<tr>
<td>Cr APIC</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

### 18.11.3.3 Restricted Stock—Long-Form Method

The transition considerations for an equity-classified restricted stock award are similar to those for a nonqualified stock option. As previously discussed, an entity generally receives a tax deduction for restricted stock as the restrictions lapse (i.e., as the employee vests in the award). If an equity-classified restricted stock award is granted before but vests after the adoption of ASC 718, the tax deduction an entity realizes should be compared with the cumulative compensation cost recognized in the entity’s financial statements (compensation cost recognized both before and after adoption). The windfall tax benefit of any excess tax deduction should be recorded in APIC. Because equity-classified restricted stock generally is granted with a zero exercise price, it was accounted for at fair value under prior standards. It generally will not be necessary to calculate an “as if” windfall or shortfall as a restricted stock award vests, because the recognized windfall or shortfall will be equal to the “as if” windfall or shortfall.

### 18.11.4 Determining the Pool of Windfall Tax Benefits Using the Short-Cut Method

As noted above, entities have the option to use a short-cut method to calculate the historical pool of windfall tax benefits upon adoption of ASC 718. This method was available to entities that used the modified retrospective or modified prospective application method. Additionally, an entity could have elected to use the short-cut method regardless of whether it had the information available to calculate its pool of windfall tax benefits under the long-form method.

**Short-Cut Calculation**

Under the short-cut method, the pool of windfall tax benefits as of the date of adoption of ASC 718 was calculated using the following two steps:

**Step 1:** Determine the sum of all net increases of APIC recognized in an entity’s annual financial statements related to tax benefits from stock-based employee compensation during fiscal periods subsequent to the adoption of the prior standard but before the adoption of ASC 718, regardless of whether the entity had previously adopted the recognition provisions or disclosed the pro forma effects of applying the prior standard. If the entity continued to use the intrinsic-value method, the amounts recorded to APIC under that method should be used in this step because those amounts would be the amounts recognized in the annual financial statements.

**Step 2:** Subtract from the amount determined in step one the cumulative incremental pretax employee compensation cost that would have been recognized if the prior standard had been used to account for stock-based employee compensation, multiplied by the entity’s blended statutory tax rate upon adoption of ASC 718, inclusive of federal, state, local, and foreign taxes.
The cumulative incremental compensation cost used in step two of the short-cut calculation was the total stock-based employee compensation cost included in an entity's pro forma footnotes less the stock-based compensation cost included in its financial statements. If an entity recorded stock-based compensation cost in its financial statements, those amounts were excluded from cumulative incremental compensation cost. In addition, cumulative incremental compensation cost should also have excluded:

- Compensation cost associated with awards that were partially vested upon the adoption of ASC 718, and
- Compensation cost associated with an award that ordinarily does not result in a tax deduction under existing tax law. An entity did not need to exclude this compensation cost if (1) a tax deduction has been obtained prior to the adoption of ASC 718 or (2) an entity was unable to obtain the information necessary to determine the amount of such cost. For example, compensation cost for ISOs and ESPPs would have been excluded unless there was a disqualifying disposition prior to the adoption of ASC 718. Other awards that may have qualified for exclusion in step two include awards issued in jurisdictions in which the entity is not entitled to a local tax deduction.

**PwC Observation:** Using the short-cut method would not necessarily have approximated the amount of the pool of windfall tax benefits that would have been derived if the long-form method was used because it (1) does not adjust for the impact of equity restructurings; (2) is based on net activity over several years (as opposed to the long-form method, under which the net windfall or shortfall is calculated on an annual basis); (3) does not require an entity to exclude from its pool any windfalls that did not reduce taxes payable (see Section TX 18.14), but instead is based on the windfalls recorded in an entity’s annual financial statements prior to the adoption of ASC 718; and (4) includes windfalls related to awards issued prior to and settled after the effective date of the prior standard (such windfalls are excluded from the pool under the long-form method). Therefore, the pool of windfall tax benefits, as calculated under the short-cut method, may have been higher or lower than the amount determined by the long-form method.

**18.11.4.1 Transition Considerations under the Short-Cut Method**

The transition considerations for the income tax effects of awards granted before the adoption of ASC 718 were not applicable to entities that used the modified retrospective application method for all prior periods because these entities would have adjusted their financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994.

In the related guidance, the term “partially vested” was used to describe awards for which compensation cost is not fully recognized because only a portion of the requisite service period has been completed. “Fully vested” awards are awards for which the compensation cost is fully recognized (generally, because the award is legally vested).
PwC Observation: For awards with graded vesting, we believe that an entity should have considered whether any individual tranche is legally vested when identifying awards that were partially and fully vested at the adoption date of ASC 718. If one or more tranches were legally vested, each tranche should have been assessed separately. For example, an award that vests 25 percent each year over four years, with two of the four tranches vested as of the adoption date of ASC 718, should have been treated as four separate awards, two of which were fully vested and two of which were partially vested.

Entities that grant nonqualified options or restricted stock awards using the modified prospective application method (or the modified retrospective application method for interim periods in the year of adoption only) should calculate windfall tax benefits or shortfalls for purposes of determining the impact on the pool of windfall tax benefits for awards that are settled following the adoption of ASC 718 as follows:

- **Partially vested awards:** The windfall tax benefit (or shortfall) that increases (or decreases) the pool of windfall tax benefits should be determined by comparing the tax deduction for a partially vested award with the sum of the compensation cost recognized and disclosed for that award under the prior standard and ASC 718 (i.e., the “as if” windfall or shortfall).

- **Fully vested awards:** The windfall tax benefit (or shortfall) that increases (or decreases) the pool of windfall tax benefits is equal to the tax effects recognized in APIC as a result of the settlement of the award subsequent to the adoption of ASC 718 (i.e., the windfall recognized under the prior guidance).

The ongoing income tax accounting for partially vested awards as of the adoption date of ASC 718, as described above, is the same under the short-cut and long-form methods. However, an election to use the short-cut method affects the ongoing income tax accounting for awards that were fully vested as of the adoption date of ASC 718. The windfall tax benefits related to fully vested awards calculated for purposes of the roll-forward of the pool of windfall tax benefits will be calculated on an “as if” basis under the long-form method, while under the short-cut method these windfalls will be equal to the amounts recognized in APIC under the prior guidance.

Example 18-12 illustrates the tax implications of an ISO award granted and vested before the adoption of ASC 718, when a disqualifying disposition occurs after the adoption of ASC 718 under the modified prospective application method. This entity elected the short-cut method for calculating the historical pool of windfall tax benefits.

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**Example 18-12: Disqualifying Dispositions and the Pool of Windfall Tax Benefits**

A calendar-year public entity adopts ASC 718 on January 1, 2006, using the modified prospective application method. On January 1, 2001, the entity granted 100,000 equity-classified, incentive stock options with an exercise price of $25 (equal to the grant-date stock price) with a four-year cliff-vesting period; therefore, these options were fully vested upon the adoption of ASC 718. Because the options were at-the-money on the grant date, no compensation cost was recognized. Upon adopting ASC 718, the entity determines it has a pool of windfall tax benefits of $60,000.

(continued)
The entity’s applicable tax rate for all periods is 40 percent. The entity has sufficient taxable income for the stock option tax deductions to reduce income taxes payable in all periods.

At the end of 2007, the entity has the following balances:

<table>
<thead>
<tr>
<th>“As if” Deferred Tax Assets</th>
<th>Pool of Windfall Tax Benefits as Determined under the Short-Cut Method</th>
<th>Recognized Deferred Tax Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>$—</td>
<td>$60,000</td>
<td>$—</td>
</tr>
</tbody>
</table>

On January 1, 2008, all of the options are exercised when the market price of the entity’s common stock is $32. The employees immediately sell the stock in the open market, which causes a disqualifying disposition. The calculations of the tax implications resulting from the disqualifying disposition are similar to those in Example 18-11 and are summarized in the schedule below.

**Calculation of tax benefit:**

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price of shares ($32 x 100,000 options)</td>
<td>$3,200,000</td>
</tr>
<tr>
<td>Less: Exercise price ($25 x 100,000 options)</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>$700,000</td>
</tr>
<tr>
<td>Applicable tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Tax benefit</td>
<td>$280,000</td>
</tr>
</tbody>
</table>

Calculation #1: Recognized windfall for vested portion of ISO at ASC 718 adoption = [(Tax deduction of $700,000 x 100%) – recognized compensation cost of $0] x 40% = $280,000

Calculation #2: “As if” windfall = [(Tax deduction of $700,000 – cumulative recognized of $0) x 40%] = $280,000

Note that, for entities that elected the short-cut method, the recognized windfall in APIC for fully vested awards at the date of adoption of ASC 718 upon exercise of the award equals the “as if” windfall being added to the pool of windfall tax benefits.

In this example, the entity’s pool of windfall tax benefits would be as follows:

<table>
<thead>
<tr>
<th>Pool of Windfall Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance, 12/31/07</td>
</tr>
<tr>
<td>Add: “As if” windfall</td>
</tr>
<tr>
<td>Ending balance, 1/1/08</td>
</tr>
</tbody>
</table>

In this example, the entity would record the following journal entries:

Dr Income taxes payable $280,000
Cr APIC $280,000
18.11.5 **Determining the Pool of Windfall Tax Benefits for Entities That Became Public Entities After the Effective Date of the Prior Standard but Before Adopting ASC 718**

Entities that were not public entities as of the adoption date of the prior standard but that became public entities before adopting ASC 718 had two alternatives in calculating the historical pool of windfall tax benefits. An entity’s decision to apply one of these two methods would have been an accounting policy decision. The key difference between these two alternatives was how an entity treated awards that were granted prior to its becoming a public entity that were valued using the minimum-value method.

**Alternative 1:** Under the first approach, an entity would only have included in the historical pool of windfall tax benefits those awards measured using the fair value method (i.e., awards granted as a public entity). Entities could have elected either the short-cut or long-form method to calculate their ASC 718 pool of windfall tax benefits, but would have applied this method only to awards granted as a public entity. These entities would maintain a separate pool of windfall tax benefits for awards granted prior to becoming a public entity, for which they would continue to apply prior standards to calculate the windfall. Any windfalls generated from such awards would be tracked separately and would not impact the ASC 718 pool of windfall tax benefits. Similarly, if a shortfall was incurred upon exercise of an award accounted for under prior standards (after ASC 718’s adoption), entities should determine the accounting for the shortfall (i.e., whether to record it in equity or the income statement) based on this separate pool of windfall tax benefits. The shortfall from this award would not impact the ASC 718 pool of windfall tax benefits.

**Alternative 2:** Under this approach, an entity would have combined the windfall tax benefits from awards measured using the minimum-value method and fair value method when determining its historical pool of windfall tax benefits. Additionally, entities could have elected either the short-cut or long-form method and applied this method to their awards regardless of whether the awards were measured using the minimum value method or the fair value method. This alternative permits entities that were public entities on the date they adopted ASC 718, using either the modified prospective or modified retrospective transition method, to include all settlements of awards, measured previously using the minimum value or fair value method, in the pool of windfall tax benefits. Entities that elected this alternative would have maintained a separate pool of windfall tax benefits for awards granted prior to becoming a public entity, for which they will continue to apply for the prior recognition provisions.

If a shortfall is incurred upon exercise of an award accounted for under prior standards (after ASC 718’s adoption), an entity would account for the shortfall based on a two-step process: (1) the recognition of the shortfall (i.e., the determination of the amount and whether the shortfall is recorded in equity or the income statement) should be determined based on the prior pool of windfall tax benefits and (2) the shortfall calculated based on the award’s minimum value also should be included in the ASC 718 pool of windfall tax benefits. If a windfall is incurred upon exercise of an award, the amount of the windfall to be recorded in APIC would be based on a comparison of the tax benefit with the amount of compensation cost recognized in the financial statements. The windfall would be calculated based on the award’s minimum value and would be included in the ASC 718 pool of windfall tax benefits. Entities that elected this alternative are effectively required to calculate and track two pools for the exercises of minimum value awards—the prior pool and the ASC 718 pool.
18.11.6 Determining the Pool of Windfall Tax Benefits for Prospective Adopters

The short-cut method was available only to entities adopting under the modified prospective or modified retrospective methods and, therefore, should not have been used by a nonpublic entity adopting ASC 718 under the prospective transition method. We believe that the historical pool of ASC 718 windfall tax benefits would have been zero as of the adoption date of ASC 718 for nonpublic entities adopting under the prospective transition method, because ASC 718 is applied only to awards granted or modified after the adoption date. Nonpublic entities that adopted ASC 718 under the prospective transition method should track two separate pools of windfall tax benefits: (1) windfall tax benefits generated from awards accounted for under prior standards and (2) windfall tax benefits generated from awards accounted for under ASC 718. Shortfalls incurred under ASC 718 should not be offset against windfall tax benefits generated by awards accounted for under prior standards.

18.11.7 Determining the Tax Benefit from Awards with Graded Vesting and Separate Fair Values

In some cases, an entity may grant awards with graded vesting (e.g., 25 percent of the award vests each year for four years) and separately estimate the fair value for each vesting tranche, which could make it difficult to determine how to calculate the windfall or shortfall. If an entity is unable to determine which tranche of options was exercised, the entity should assume that the first exercises were from the first tranche to vest and that subsequently exercised options were from any remaining options in the first tranche, followed by options in later tranches, in order of vesting.

18.12 Business Combinations, Equity Restructurings, and Separately Reporting Subsidiaries

18.12.1 Impact of Business Combinations, Equity Restructurings, Spin-offs, Equity-Method Investments, Majority-Owned Subsidiaries, and Bankruptcy on the Pool of Windfall Tax Benefits

When applying the long-form method of calculating the pool of windfall tax benefits, entities that completed business combinations or equity restructurings after the effective date of the prior standard and before adopting ASC 718 need to determine the impact of these transactions when calculating their pool of windfall tax benefits. Additionally, after the adoption of ASC 718, all entities need to consider the impact of business combinations or equity restructurings on the pool of windfall tax benefits.

ASC 718 does not provide specific guidance on the impact of these transactions on the pool of windfall tax benefits. We believe the following approaches are acceptable:

- **Business combination:** The windfall pool of an acquired entity is set to zero at the acquisition date (i.e., the acquired entity's historic windfall pool does not carry over).

- **Pooling of interests (for business combinations accounted for under this method prior to June 30, 2001):** Because a pooling of interests represents a transaction that combines the ownership interests, on a predecessor basis, via the exchange of equity securities, the pool of windfall tax benefits will include both entities’ windfall tax benefits, determined on an annual basis.

- **Sale of a subsidiary:** If the windfall tax benefit resulted from the parent entity’s equity, the pool of windfall tax benefits will remain with the parent entity. Alternatively, if the pool relates to the subsidiary’s equity (e.g., the subsidiary
had its own option program), the pool of windfall tax benefits should follow the subsidiary.

- **Spin-off of a subsidiary:** One view is that the pool of windfall tax benefits should follow the employees. For example, if the pool of windfall tax benefits generated by awards settled prior to the spin-off resulted from awards that were issued to the spinnee’s employees, such amounts should be carved out of the parent entity’s (the spinnor’s) pool of windfall tax benefits and be allocated to the spinnee. An alternative view is that if the pool of windfall tax benefits was generated as a result of parent entity equity, it should remain with the parent entity. If, on the other hand, the pool of windfall tax benefit relates to the spun-off subsidiary’s equity, then it should remain with the subsidiary after the spin-off. We believe either alternative, applied consistently, is acceptable.

- **Equity-method investee:** Windfall tax benefits that the investee generates should not be included in the investor's pool of windfall tax benefits.

- **Majority-owned subsidiary:** An entity’s majority-owned subsidiary may issue awards in the subsidiary’s separate equity. The consolidated pool of windfall tax benefits should include the pools for both the parent and the majority-owned subsidiary. However, the portion of windfall tax benefits that relates to the noncontrolling interest should not be presented in the consolidated entity’s APIC. Instead, it should be included in the noncontrolling interest line item within the equity section of the consolidated enterprise’s balance sheet. In addition, if the majority-owned subsidiary issues separate financial statements, the pool of windfall tax benefits for purposes of the subsidiary’s separate financial statements likely will differ from the pool included in the parent entity’s consolidated pool of windfall tax benefits.

- **Bankruptcy:** For entities that adopt fresh-start reporting upon emergence from a formal reorganization under ASC 852 Reorganizations, the pool of windfall tax benefit would be zero as of the date of emergence from bankruptcy.

### 18.12.2 Pool of Windfall Tax Benefits for Separately Reporting Subsidiaries

For separately reporting subsidiaries, the determination of the pool of windfall tax benefits will depend on the method used to allocate income taxes to the entities within the consolidated tax group. Under a separate-return method, the subsidiary determines its income tax provision as if it were a separate taxpayer. Although the separate-return method is preferable, other methods or a modification of the separate-return method may be used by some entities.

**PwC Observation:** We believe that subsidiaries using the separate-return method generally should calculate a “stand-alone” pool of windfall tax benefits based on windfalls generated by awards issued to the subsidiaries’ employees. However, some flexibility may exist for entities that use other methods to determine a subsidiary’s income tax provision. For example, such entities might adopt an accounting policy of using the consolidated pool of windfall tax benefits to determine the accounting for shortfalls in the subsidiary’s financial statements. Although the amount of the pool of windfall tax benefits is not a required disclosure, a separately reporting subsidiary may want to consider disclosure of the method used to determine the pool of windfall tax benefits in its separate financial statements.
18.12.3 Tax Effects of Awards Exchanged in a Business Combination

18.12.3.1 Awards That Ordinarily Result in a Tax Deduction

For awards that ordinarily result in a tax deduction, a deferred tax asset should be recorded at the acquisition date related to the fair value of a replacement award. If the acquirer is obligated to grant the replacement award, the fair value of the award and the deferred tax asset related to pre-combination services should be included in the consideration transferred for the acquiree. This deferred tax asset represents a future tax benefit that the acquirer has obtained the right to receive as a result of the acquisition. If the acquirer is not obligated to grant the replacement award, the entire fair value of the award and the related deferred tax asset should be recognized as expense in the post-combination financial statements. For the fair value of a replacement award that is attributed to post-combination services, a deferred tax asset is recorded in the post-combination financial statements as the service period is completed.

18.12.3.1.1 Equity-Classified Awards That Ordinarily Result in a Tax Deduction

As noted above, a deferred tax asset should be recorded at the acquisition date for replacement awards that ordinarily result in a tax deduction and are included in the consideration transferred for the acquiree. The resulting income tax effects of equity-classified awards (e.g., stock options or restricted shares) exchanged in a business combination should be accounted for in accordance with ASC 718. If the tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is greater than the sum of the fair value of the award added to the purchase price plus the cumulative U.S. GAAP compensation cost recorded by the acquirer, the tax benefit related to the excess tax deduction (i.e., windfall) should be recorded as an adjustment to additional paid-in capital. If the tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is less than the sum of the fair value of the award included in the purchase price plus the cumulative U.S. GAAP compensation cost recorded by the acquirer, the resulting difference (i.e., shortfall) should be charged first to additional paid-in capital, to the extent of the acquirer’s pool of windfall tax benefits. Any remaining shortfall would be recognized in income tax expense. Windfalls and shortfalls generated from replacement awards are included in the acquirer’s pool of windfall tax benefits, similar to other awards granted by the acquirer. Example 18-13 illustrates this guidance. Please note that the following example does not consider the par value of the common stock issued or cash received for the option’s exercise price.

Example 18-13: Income Tax Accounting for a Vested Equity-Classified Nonqualified Option

Background/Facts:

Company K (the acquirer) exchanges replacement awards with a fair value of $50 at the acquisition date for Company L’s (the acquiree) awards with a fair value of $50. Company K was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company L’s awards had a service period of four years. As of the acquisition date, all four years of service have been rendered. The awards are nonqualified options and, therefore, result in a tax deduction upon exercise of the awards. The exercise price of the awards is $30. Company K’s

(continued)
applicable tax rate is 40 percent. All of the awards are exercised six months after the acquisition date when the market price of Company K’s shares is $90.

**Analysis/Conclusion:**

As the replacement awards do not have any excess fair value at the acquisition date and 100 percent (4 years pre-combination service / 4 years total service) of the fair value of the awards is attributable to pre-combination services, the entire $50 should be included in the consideration transferred for the acquiree:

1. 

Dr Net assets acquired (e.g., goodwill) $50
Cr APIC $50

Company K should also record a deferred tax asset equal to $20 ($50 x 40%) because, at the time of the acquisition, the awards are expected to result in a tax deduction (assuming that it is more-likely-than-not that the deferred tax asset will be realized):

Dr Deferred tax asset $20
Cr Net assets acquired (e.g., goodwill) $20

Upon exercise of the awards, Company K will be entitled to a tax deduction of $60 ($90 market price of Company K’s shares – $30 exercise price). The tax benefit of the tax deduction (i.e., the reduction in taxes payable) is $24 ($60 x 40%). The excess tax benefit of $4 (tax benefit of $24 – deferred tax asset of $20) is recorded to additional paid-in capital (i.e., windfall tax benefit). Assuming that Company K has sufficient taxable income such that the tax deduction results in a reduction in taxes payable (in accordance with ASC 718-740-25-10), the journal entries to record the income tax effects of the option exercise would be to (i) reverse the deferred tax asset against deferred tax expense and (ii) reduce taxes payable:

Dr Deferred tax expense $20
Cr Deferred tax asset $20
Dr Taxes payable $24
Cr Current tax expense $20
Cr APIC $4

1 All computations have been provided on an individual award basis.

The income tax effects of equity-classified awards that were transferred as part of a business combination and are attributable to post-combination services should be recorded in the post-combination financial statements in the period those effects arise, as if the awards were issued absent a business combination. No adjustment should be made to the accounting for the business combination for the related tax effects.

For example, if a partially vested replacement award is granted on the acquisition date, a deferred tax asset would only be recorded for the portion of the award’s fair value that was attributed to pre-combination services. A deferred tax asset related to the portion of the awards’ fair value attributed to post-combination services would be recorded in the post-combination financial statements as the service period is completed. For the portion of the awards’ fair value attributed to post-combination services, no deferred tax asset would be recorded as part of the consideration transferred for the acquiree (i.e., there are no adjustments to goodwill for the deferred tax asset related to awards attributed to post-combination services).
Example 18-14 illustrates this guidance. Please note that the following example does not consider the par value of the common stock issued or cash received for the option’s exercise price.

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Example 18-14: Income Tax Accounting for a Partially Vested Equity-Classified Nonqualified Option

Background/Facts:
Company K (the acquirer) exchanges replacement awards with a fair value of $50 at the acquisition date for Company L’s (the acquiree) awards with a fair value of $50. Company K was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company L’s awards had a service period of four years. As of the acquisition date, three years of service required by the original terms of Company L’s awards have been rendered. The replacement awards have the same terms as the original awards. The awards are nonqualified options and, therefore, are expected to result in a tax deduction upon exercise of the awards. The exercise price of the awards is $30. Company K’s applicable tax rate is 40 percent. All of the awards are exercised two years after the acquisition date when the market price of Company K’s shares is $90.

Analysis/Conclusion:
As of the acquisition date, 75 percent (3 years pre-combination service / 4 years total service) of the fair value of the awards is attributable to pre-combination services. The replacement awards had no excess fair value over the acquiree awards; therefore, $37.5 ($50 x 75%) should be included in the consideration transferred for the acquiree:

\[
\begin{align*}
\text{Dr Net assets acquired (e.g., goodwill)} & \quad \text{Cr APIC} \\
$37.5 & \quad $37.5
\end{align*}
\]

Company K should also record a deferred tax asset for the portion of the awards attributed to pre-combination services equal to $15 ($37.5 x 40% tax rate) because, at the time of the acquisition, 75 percent of the awards are expected to result in a tax deduction (assuming that it is more-likely-than-not that the deferred tax asset will be realized):

\[
\begin{align*}
\text{Dr Deferred tax asset} & \quad \text{Cr Net assets acquired (e.g., goodwill)} \\
$15 & \quad $15
\end{align*}
\]

One year after the acquisition date, the remaining year of service is completed, resulting in the vesting of the replacement awards. Company K should record compensation cost of $12.5 ($50 x 25%) in the post-combination financial statements for the remaining 25 percent of the fair value of the awards. A deferred tax asset should also be recorded for the portion of the awards attributed to post-combination services equal to $5 ($12.5 x 40% tax rate), since the awards are

(continued)

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1 All computations have been provided on an individual award basis.
expected to result in a tax deduction (assuming that it is more-likely-than-not that the deferred tax asset will be realized):

\[
\begin{align*}
\text{Dr Compensation cost} & \quad \text{Cr APIC} & \quad \$12.5 \quad \$12.5 \\
\text{Dr Deferred tax asset} & \quad \text{Cr Deferred tax expense} & \quad \$5 \quad \$5
\end{align*}
\]

Upon exercise of the awards, Company K will be entitled to a tax deduction of $60 ($90 market price of Company K’s shares – $30 exercise price). The tax benefit of the tax deduction (the reduction in taxes payable) is $24 ($60 x 40%). The excess tax benefit of $4 (tax benefit of $24 – deferred tax asset of $20) is recorded to additional paid-in capital (i.e., windfall tax benefit). Assuming that Company K has sufficient taxable income such that the tax deduction results in a reduction in taxes payable (in accordance with ASC 718-740-25-10), the journal entries to record the income tax effects of the option exercise would be to (i) reverse the deferred tax asset against deferred tax expense and (ii) reduce taxes payable:

\[
\begin{align*}
\text{Dr Deferred tax expense} & \quad \text{Cr Deferred tax asset} & \quad \$20 \quad \$20 \\
\text{Dr Taxes payable} & \quad \text{Cr Current tax expense} & \quad \text{Cr APIC} & \quad \$24 \quad \$20 \quad \$4
\end{align*}
\]

The income tax effects of replacement awards (i.e., windfalls and shortfalls) are accounted for through adjustments to the total pool of windfall tax benefits of the consolidated company, reflecting the windfall tax benefits of all awards granted by the company (not only the replacement awards). In other words, the income tax effects of awards for pre-combination services or post-combination services are considered against a single pool of windfall tax benefits which includes the tax effects of all awards, including those unrelated to the business combination, granted by the acquirer to its employees or any of its consolidated subsidiaries as of the exercise or settlement date.

18.12.3.1.2 Liability-Classified Awards That Ordinarily Result in a Tax Deduction

For liability-classified awards, the income tax accounting for awards exchanged in a business combination is similar to that for equity-classified awards. If the acquirer is obligated to grant the replacement award, the fair value of the award and the deferred tax asset related to pre-combination services should be included in the consideration transferred for the acquiree. However, for liability-classified awards, book compensation cost and the related deferred tax asset should be remeasured every reporting period. Therefore, liability-classified awards will generally not generate a windfall or a shortfall, because the tax deduction will equal book compensation cost upon settlement. For purposes of ASC 805, all changes in the fair value of liability-classified awards after the acquisition date and the related income tax effects are recognized in the post-combination financial statements of the acquirer in the period(s) in which the change occurs (ASC 805-30-55-13).
18.12.3.2 Awards That Do Not Ordinarily Result in a Tax Deduction

For awards that do not ordinarily result in a tax deduction (e.g., an incentive stock option) where the award's fair value was attributed to pre-combination services, the acquirer should not recognize a deferred tax asset at the acquisition date, because the awards are not expected to result in a tax benefit. In some situations, the acquirer may receive a tax deduction due to events that occur after the acquisition date (e.g., the disqualifying disposition of an incentive stock option because the employee did not hold the underlying shares for the minimum holding period required by the Internal Revenue Code). The tax effect of a disqualifying disposition should be recognized when it occurs (ASC 805-740-25-11). However, ASC 805 does not address where in the financial statements the tax benefit of such an event should be recorded. We believe there are two acceptable approaches: (i) the entire tax benefit of the disqualifying disposition is recorded to equity (i.e., additional paid-in capital), or (ii) the tax benefit is recorded in the income tax provision up to the amount of the tax benefit related to the fair value of the award that was included in the consideration transferred, with the remaining portion of the tax benefit recorded as an adjustment to additional paid-in capital.

Incentive stock options that do not ordinarily result in a tax deduction and for which the award's fair value was attributed to post-combination services should be accounted for in the same manner as awards that were granted absent a business combination. That is, the tax effects, if any, should be reported in the post-combination financial statements in the period they arise, and no adjustment should be made to the accounting for the business combination (ASC 805-740-25-11).

When determining the deferred tax asset that should be recognized, companies should also consider whether the IRC Section 162(m) limitation applies. Refer to Section TX 3.2.8 for further discussion.

18.13 Ongoing Accounting for Share-Based Awards Granted Prior to the Effective Date of ASC 805

Prior to the adoption of ASC 805, entities were not permitted to recognize deferred tax assets at the acquisition date for replacement share-based payment awards. Instead, any tax deduction resulting from the exercise of the award was recognized as an adjustment to the cost of the acquisition (usually as a reduction of goodwill) to the extent of the fair value of the award recognized at the acquisition date.

However, if any incremental compensation cost was recorded in the acquirer’s financial statements as a result of applying modification accounting (see Chapter SC 1 of PwC’s Guide to Accounting for Stock-Based Compensation, for further guidance on accounting for modifications of awards), a corresponding deferred tax asset was recorded. Additionally, unvested awards that generate post-acquisition compensation cost result in the recognition of a deferred tax asset as compensation cost is recorded.

For those replacement awards granted as part of a business combination that was consummated prior to the effective date of ASC 805 (i.e., where no deferred tax asset was recorded at the acquisition date), the acquirer should continue to adjust goodwill for the tax benefits realized upon the settlement of the awards.
Upon settlement of equity-classified, nonqualified awards exchanged in a business combination prior to the effective date of ASC 805, entities would do the following:

- **For nonqualified awards that were vested as of the acquisition closing date and for the vested portion of a partially vested award:** An adjustment to the purchase price would be recorded equal to the tax benefit for the deduction that corresponds to the fair value of the awards recognized as part of the purchase price. Any excess tax deduction over the fair value of the awards recognized as part of the purchase price is a windfall tax benefit and would be recorded to APIC.

- **For nonqualified awards that were unvested as of the acquisition closing date and for the unvested portion of a partially vested award:** Because compensation cost and a related deferred tax asset are recorded post-combination, the accounting treatment upon settlement is the same as the accounting for an award granted after the acquisition. Any excess tax deduction over the recognized compensation cost is a windfall tax benefit and would be recorded to APIC.

We believe that the tax effects of (1) liability-classified awards and (2) ISOs should be accounted for as follows:

- **For Liability-classified awards exchanged in a business combination:** We believe that the guidance in ASC 805-740-25-3 would require the recognition of a deferred tax asset for the difference between the fair value and the tax basis of a liability-classified award. As the liability-classified award continues to be remeasured at fair value each reporting period, the deferred tax asset also would be adjusted each reporting period until settlement. Therefore, there would be no windfall tax benefit or shortfall upon settlement of the award.

- **For ISOs exchanged in a business combination:** For ISOs that were vested as of the acquisition date and for the vested portion of partially vested ISOs, the entity should not record deferred tax assets as of the acquisition date. Rather, the entity should recognize any tax benefit as a result of a disqualifying disposition in APIC on the date of the disqualifying disposition and should not adjust the purchase price, because the ISO was not expected to result in a tax deduction at the date of acquisition. For awards that were unvested as of the acquisition date and for the unvested portion of partially vested awards, compensation cost should be recognized after the acquisition without recording deferred tax assets. The tax benefit of a disqualifying disposition will be recognized on the date of the disqualifying disposition following the same accounting treatment as for any other disqualifying disposition.

### Example: Options Exchanged in a Business Combination Prior to the Effective Date of ASC 805

This example illustrates the accounting treatment of options exchanged in a business combination prior to the effective date of ASC 805.

On September 1, 2007, Entity A announces its intention to acquire Entity B and the signing of a definitive purchase agreement. As part of the purchase agreement, Entity A will issue nonqualified stock options to purchase 100,000 shares of Entity A’s common stock to Entity B’s employees in exchange for their existing nonqualified stock options to purchase 100,000 shares of Entity B’s common stock, which is the same exchange ratio (1 to 1) offered to all other shareholders. No other terms of the options granted to Entity B’s employees will be modified in connection with the acquisition. The options originally issued by Entity B contain only a service condition.
and were equity-classified. No modifications are made to the purchase agreement or Entity B’s employee stock options between September 1, 2007, and the acquisition closing date of December 31, 2007. Additionally, there are no forfeitures of Entity B’s stock options in the period from the announcement date to the closing date.

**Example 18-15: Options Exchanged in a Business Combination Prior to the Effective Date of ASC 805**

**Background/Facts:**
Entity A is a calendar-year-end entity that adopted the guidance in ASC 805 using the modified prospective application method.

Entity A’s common stock has a par value of $0.01 per share.

Entity A has an applicable tax rate of 40 percent. In each period, there is sufficient taxable income so that Entity A realizes any windfall tax benefits generated from the exercise of the options. Entity A also has determined that it is more-likely-than-not that all deferred tax assets will be realized (i.e., there is no valuation allowance). Entity A has elected to consider only the direct effects of stock-based compensation tax deductions when calculating windfall tax benefits and shortfalls.

<table>
<thead>
<tr>
<th>Number of options exchanged</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Options’ exercise price (before and after exchange)</td>
<td>$40</td>
</tr>
<tr>
<td>Acquisition closing date</td>
<td>December 31, 2007</td>
</tr>
</tbody>
</table>

At the closing date of the acquisition, 50,000 of Entity B’s options are vested. The remaining 50,000 options were granted originally by Entity B on December 31, 2006, and cliff-vest on December 31, 2008 (i.e., one year of the vesting period remains as of the closing date of the acquisition). The vesting terms are not modified as a result of the exchange.

The comparison of the fair value of the exchanged options immediately before and immediately after the closing date does not result in incremental compensation cost.

**18.13.1.1 Fair Value of Options Exchanged**

Entity A estimates that the fair value of the stock options exchanged in the acquisition is $25 per option, using the Black-Scholes model. The fair value of $25 is based on Entity A’s assumptions as of the announcement date (September 1, 2007) and the market price of Entity A’s stock a few days before and a few days after the announcement date. As of December 31, 2007, Entity A estimates a 5 percent forfeiture rate for the 50,000 unvested options. Therefore, total options expected to vest are 97,500 (50,000 vested options + 47,500 partially vested options). The total fair value of the exchanged options is estimated to be $2,437,500 (97,500 x $25).

Entity A includes the fair value of the options exchanged in the acquisition as part of the purchase price paid for Entity B.

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>To record the fair value of the options exchanged in the business combination—pre-ASC 805</td>
<td>$2,437,500</td>
</tr>
<tr>
<td>Dr Purchase price (e.g., goodwill)</td>
<td>$2,437,500</td>
</tr>
<tr>
<td>Cr APIC</td>
<td>$2,437,500</td>
</tr>
</tbody>
</table>
Entity A does not record a deferred tax asset for the exchanged options on the closing date because no compensation expense has been recorded. Additionally, Entity A does not record a liability for the employer's portion of the payroll taxes associated with the exchanged options until the event occurs that triggers the measurement and payment of the tax (generally, the exercise date for nonqualified stock options). If the triggering event occurs after the closing date of the acquisition, no adjustment should be made to the purchase price of the business combination for the payroll taxes.

18.13.1.2 Entry to Record Fair Value Allocated to Future Service

When employee service is required subsequent to the closing of the acquisition in order for the employees to vest in the options, a portion of the option’s fair value should be allocated to the future service and recognized over the future service period. The value attributed to the unvested options is based on the fair value of the options as of the closing date of the acquisition. Entity A estimates a fair value of $23 per option on December 31, 2007, which differs from the fair value estimated as of September 1, 2007 (i.e., $25), because of the different measurement date. The fair value of the unvested options that relates to the future service period is $546,250 (47,500 options expected to vest x $23 x 50% of requisite service period remaining). This amount is deducted from the purchase price paid for Entity B. However, deferred compensation should not be recorded because this deferred compensation is now considered unrecognized compensation cost under ASC 718. Therefore, the value of the unvested options reduces additional paid-in capital.

2) To account for the fair value of the unvested options allocated to future service as of the closing date—pre-ASC 805
   Dr APIC $546,250
   Cr Purchase price (e.g., goodwill) $546,250

18.13.1.3 Requisite-Service-Period Entries

During the period from December 31, 2007, through December 31, 2008, Entity A records compensation cost for the exchanged options and the related deferred tax assets.

3) To record compensation cost of $546,250 over the requisite service period
   Dr Compensation cost $546,250
   Cr APIC $546,250

4) To record the related deferred tax asset of $218,500 ($546,250 x 40%) over the requisite service period
   Dr Deferred tax assets $218,500
   Cr Deferred tax provision $218,500

If Entity A revises its forfeiture-rate assumption during the requisite service period, it would adjust compensation cost in the period of the change in estimate and no adjustment would be recorded to the previously measured purchase price for the business combination.

None of the employees forfeit their options during the one-year requisite service period as compared with Entity A's estimated pre-vesting forfeiture rate of 5 percent. Therefore, Entity A records the remaining $57,500 (2,500 options x $23) of compensation cost, along with the related deferred tax assets.
5) To record compensation cost of $57,500 for the adjustment of the forfeiture-rate assumption

<table>
<thead>
<tr>
<th>Dr Compensation cost</th>
<th>$ 57,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr APIC</td>
<td>$ 57,500</td>
</tr>
</tbody>
</table>

6) To record the related deferred tax asset of $23,000 ($57,500 x 40%)

<table>
<thead>
<tr>
<th>Dr Deferred tax assets</th>
<th>$ 23,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Deferred tax provision</td>
<td>$ 23,000</td>
</tr>
</tbody>
</table>

18.13.1.4 Exercised Options—Options Vested at Closing Date

On April 30, 2008, when the market price of Entity A’s common stock is $70 per share, all 50,000 of the options that were vested as of the closing date of the acquisition are exercised. Because a deferred tax asset was not recorded at the closing date of the acquisition, the tax deduction resulting from the exercise of the stock options is recognized as an adjustment to the purchase price of Entity B to the extent that the tax deduction does not exceed the fair value of the exchanged options recognized as part of the purchase price. To the extent that the tax deduction exceeds the fair value of the exchanged options recognized as purchase price, that windfall would be recognized in APIC and would be included in the pool of windfall tax benefits. The calculations of the tax implications resulting from the exercise are summarized in the schedule below and followed by the corresponding journal entries.

**Calculation of tax benefit:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price of shares ($70 x 50,000 options)</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>Less: Exercise price ($40 x 50,000 options)</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Multiplied by applicable tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>$ 600,000</td>
</tr>
</tbody>
</table>

**Calculation of windfall tax benefit:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intrinsic value</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Less: Fair value recorded in purchase accounting ($25 x 50,000 options)</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Excess tax deduction</td>
<td>250,000</td>
</tr>
<tr>
<td>Multiplied by applicable tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Windfall tax benefit</td>
<td>$ 100,000</td>
</tr>
</tbody>
</table>

7) To recognize the exercise of 50,000 options at an exercise price of $40

<table>
<thead>
<tr>
<th>Dr Cash</th>
<th>$2,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Common stock (par value $0.01)</td>
<td>$ 500</td>
</tr>
<tr>
<td>Cr APIC</td>
<td>$1,999,500</td>
</tr>
</tbody>
</table>

8) To recognize the windfall tax benefit and the adjustment to the purchase price of $500,000 ($1,250,000 x 40%)

<table>
<thead>
<tr>
<th>Dr Income taxes payable</th>
<th>$ 600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr APIC</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Cr Purchase price (e.g., goodwill)</td>
<td>$ 500,000</td>
</tr>
</tbody>
</table>

As a result of the exercise of these options, Entity A’s pool of windfall tax benefits increased by $100,000.
On February 15, 2009, when the market price of Entity A’s common stock is $75 per share, the remaining 50,000 options, which vested on December 31, 2008, are exercised. Because 50 percent of the requisite service period for these options was completed prior to the closing date of the business combination (i.e., the options were 50 percent vested), the tax benefit should be prorated between the vested and unvested portion of the award. The accounting for the income tax effects of the vested portion is recorded as an adjustment to the purchase price. The accounting for the unvested portion is the same as the accounting for options granted absent a business combination. The calculations of the tax implications resulting from the exercise are summarized in the schedule below and followed by the corresponding journal entries.

<table>
<thead>
<tr>
<th>Calculation of tax benefit:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price of shares ($75 x 50,000 options)</td>
<td>$3,750,000</td>
</tr>
<tr>
<td>Less: Exercise price ($40 x 50,000 options)</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>1,750,000</td>
</tr>
<tr>
<td>Multiplied by applicable tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>$ 700,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Calculation of windfall tax benefit related to the vested portion of the award:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of intrinsic value ($1,750,000 x 50%)</td>
<td>$ 875,000</td>
</tr>
<tr>
<td>Less: 50% of fair value recorded in purchase accounting ($25 x 47,500 options x 50%)</td>
<td>593,750</td>
</tr>
<tr>
<td>Excess tax deduction</td>
<td>281,250</td>
</tr>
<tr>
<td>Multiplied by applicable tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Windfall tax benefit</td>
<td>$ 112,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Calculation of windfall tax benefit related to the unvested portion of the award:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of intrinsic value ($1,750,000 x 50%)</td>
<td>$ 875,000</td>
</tr>
<tr>
<td>Less: Recognized book compensation cost ($546,250 + $57,500)</td>
<td>603,750</td>
</tr>
<tr>
<td>Excess tax deduction</td>
<td>271,250</td>
</tr>
<tr>
<td>Multiplied by applicable tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Windfall tax benefit</td>
<td>$ 108,500</td>
</tr>
</tbody>
</table>

9) To recognize the exercise of 50,000 options at an exercise price of $40
   Dr Cash $2,000,000
   Cr Common stock (0.01 x 50,000) $ 500
   Cr APIC $1,999,500

10) To recognize the windfall tax benefit related to the vested portion of the awards and the adjustment to purchase price of $237,500 ($593,750 x 40%)
    Dr Income taxes payable ($700,000 x 50%) $ 350,000
    Cr APIC $ 112,500
    Cr Purchase price (e.g., goodwill) $ 237,500

11) To recognize the windfall tax benefit related to the unvested portion of the awards and to reverse deferred taxes of $241,500 ($603,750 x 40%)
    Dr Income taxes payable ($700,000 x 50%) $ 350,000
    Cr APIC $ 108,500
    Cr Deferred tax assets $ 241,500
As a result of the exercise of these options, Entity A's pool of windfall tax benefits increased by $221,000 ($112,500 + $108,500).

18.14 Net Operating Losses

Under ASC 740, a deferred tax asset is recorded for an NOL carryforward and is offset by a valuation allowance if it is more-likely-than-not that the entity will not have sufficient future taxable income to realize the economic benefit from the NOL carryforward.

When the settlement of an award results in an NOL carryforward, or increases an NOL carryforward, that settlement will generate a tax deduction before the realization of the tax benefit from that tax deduction. In that case, ASC 718-740-25-10 provides that the excess tax benefit and the credit to APIC for the windfall should not be recorded until the deduction reduces income taxes payable, on the basis that cash tax savings have not occurred. When an entity cannot recognize the tax benefit of an excess deduction because it did not reduce income taxes payable, the NOL carryforwards for which a deferred tax asset is recorded will differ from the amount of NOL carryforwards available to the entity (as disclosed in the entity's tax return). The NOL carryforwards related to windfall tax benefits will need to be tracked separately but will be included with the other available NOL carryforwards that are disclosed in the footnotes. An entity also should disclose in its footnotes the amount of NOL carryforwards for which a benefit would be recorded in APIC when realized. This accounting should be applied only to the windfall portion of the deduction. The portion of the NOL that corresponds to the book compensation cost will be recorded as a deferred tax asset under ASC 740 and will be subject to normal valuation allowance considerations.

PwC Observation: This significant change in practice is applied prospectively; thus an entity should apply the new guidance to awards that are settled after ASC 718 was adopted, except when determining the historical pool of windfall tax benefits using the long-form method. When determining its historical pool of windfall tax benefits using the long-form method, an entity with NOL carryforwards should evaluate whether it would have recognized windfalls if it had been following the guidance in ASC 718-740-25-10. If some portion of the windfall that accumulated in APIC related to windfalls that (1) were embedded in an NOL and (2) did not reduce income taxes payable in a subsequent period, that portion should have been excluded from the historical pool of windfall tax benefits. As discussed in Section TX 18.11.4, under the short-cut calculation, windfall tax benefits that are embedded in NOL carryforwards for which a deferred tax asset initially was recognized in accordance with ASC 740 are included in the historical pool of windfall tax benefits.

In instances where a company will claim a refund for prior taxes paid (i.e., a company will record a debit to taxes receivable) as a result of an NOL carryback that includes a windfall deduction, the company may have realized a tax benefit for the excess deduction in accordance with ASC 718-20-55-20. Although the company will not reduce income taxes payable in the current period, the windfall deduction may reduce the amount of taxes paid related to prior years. If the company were able to carry back only a portion of the losses generated in the current year (e.g., because the income in the carryback period was less than the losses generated in the current period), ASC 718-20-55-20 would prohibit the recognition of a tax benefit for the portion of the windfall deduction that has not yet reduced cash taxes paid.
or payable. While authoritative literature does not directly address this situation, we believe it would be appropriate to follow an approach similar to an allocation of the IRC 162(m) limitation as discussed in TX 3.2.8.

The implications of ASC 718-740-25-10 also may impact the accounting for NOL carryforwards acquired in a business combination. For example, if a business combination results in a new book basis, and if the acquiree had NOL carryforwards that resulted partly from windfall tax benefits that were not recognized on its books because of ASC 718-740-25-10, the NOL carryforwards would lose their “taint” after the acquisition and therefore would be considered in determining the amount of the deferred tax asset that the acquirer would recognize in acquisition accounting, subject to any valuation allowance that might be necessary. This would not be the case, however, in a carryover-basis transaction such as a spin-off. In these cases, the NOL carryforwards resulting from windfall tax benefits of the spinnee that were not recognized because of ASC 718-740-25-10 would have to be realized before being recognized in the spinnee's financial statements.

18.15 Valuation Allowances

For most stock-based compensation awards, an entity will recognize a related deferred tax asset. An entity should provide a valuation allowance for a deferred tax asset if, based on the weight of the available positive and negative evidence, it is more-likely-than-not that the deferred tax asset will not be realized. See Chapter TX 5 for guidance on assessing the need for a valuation allowance.

When an entity measures its deferred tax asset related to stock-based compensation awards or determines whether a valuation allowance is necessary, the current fair value of its stock should not be considered. An entity should establish a valuation allowance only if it expects that it will not have sufficient future taxable income to realize economic benefit from the deferred tax asset.

**PwC Observation:** An entity should not anticipate shortfalls and record a valuation allowance for an outstanding award, even if it believes that there is only a remote probability that the award will result in a tax deduction. For example, on December 31, 2006, an entity cannot record a valuation allowance related to an out-of-the-money award that expires on January 1, 2007. The entity should wait until the award’s expiration date to adjust the related deferred tax asset. If an entity expects that pending deferred tax write-offs will be material, it should disclose this expectation.

In practice, prior to the adoption of ASC 718, deferred tax assets generally were recorded for windfall tax benefits even if such amounts increased or created an NOL carryforward for which a valuation allowance was required. As discussed previously, ASC 718-740-25-10 provides that the tax benefit and the credit to APIC for the windfall tax benefit should not be recorded until the tax deduction reduces current taxes payable. Entities need to consider how ASC 718-740-25-10 impacts the reversal of any valuation allowance established for deferred tax assets related to windfall tax benefits prior to the adoption of ASC 718.

The Resource Group reached a consensus on the treatment of a valuation allowance that existed as of the adoption date of ASC 718 and was reversed after adoption. If the windfall tax benefit gave rise to an increase in the net deferred tax asset and a concurrent increase in the valuation allowance, no net tax benefit was recorded in APIC because no initial recognition had occurred. If, after the adoption of ASC 718,
an entity concludes that it should release some or all of its valuation allowance, it should not recognize the net deferred tax asset and corresponding credit to APIC for windfall tax benefits until such amounts are realized in accordance with ASC 718-740-25-10 (i.e., until these amounts reduce taxes payable). The Resource Group agreed that, for purposes of disclosure upon adoption of ASC 718, the entity could either (1) net its NOL deferred tax asset and the related valuation allowance for the windfall tax benefit determined previously or (2) continue to reflect a deferred tax asset and valuation allowance for such NOL carryforwards.

Alternatively, if the windfall tax benefit initially was recognized in APIC and then a valuation allowance was established in a subsequent period, the valuation allowance would have been recorded as a charge to continuing operations. In this case, it would be appropriate to reverse the entire valuation allowance through continuing operations in a period after the adoption of ASC 718, including the portion that originally resulted from the windfall tax benefits. See Chapters TX 5 and TX 6 for further guidance on accounting for releases of valuation allowances.

### 18.15.1 Accounting for Settlements When There Is a Valuation Allowance

For an entity with a valuation allowance recorded against its deferred tax assets, the entity will not recognize any shortfalls upon settlement of an award. ASC 718-740-35-5 provides that the write-off of a deferred tax asset is net of any related valuation allowance. Thus, when an award is settled and the award’s related deferred tax asset has a valuation allowance recorded against it, the shortfall, if any, results in no net effect on the income statement or the balance sheet because any effect from reversing the deferred tax asset is offset by reversing the corresponding valuation allowance.

### 18.16 Uncertain Tax Positions

Because tax laws, related regulations, and corresponding legal interpretations are voluminous and complex, it is sometimes unclear whether a particular position taken in a tax return will ultimately be sustained if the tax authorities challenge it. Such filing positions commonly are referred to as uncertain tax positions. Uncertainty as to whether deductions related to stock-based compensation will be sustained should be assessed in accordance with ASC 740’s recognition and measurement criteria described in Chapter TX 16. Favorable or unfavorable adjustments that either increase or decrease the pool of windfall tax benefits should be recorded based on the source of the item that resulted in the uncertain tax position. Thus, the favorable or unfavorable adjustments related to windfalls for stock-based compensation should be traced backwards to APIC in accordance with ASC 740-20-45-11.

See Chapter TX 16 for further guidance on the accounting and disclosure requirements related to uncertain tax positions. Entities should consider whether tax benefits not yet recorded should be presented as an unrecognized tax benefit in the tabular reconciliation that will be disclosed in the footnotes to the financial statements. We believe that this footnote reconciliation should include all unrecognized tax benefits, whether or not they are reflected in a tax reserve liability account or are not recognized in the financial statements pursuant to other GAAP, such as the ASC 718-740-25-10 criteria for recording a tax benefit only when it reduces taxes payable.
Intraperiod tax allocation is the allocation of income tax expense or benefit among continuing operations, discontinued operations, extraordinary items, other comprehensive income, and items charged or credited directly to equity. Intraperiod tax allocation is discussed in Chapter TX 12. For issues regarding the ordering of when tax benefits reduce taxes payable, see Section TX 12.2.2.3.3. For other intraperiod allocation issues relating to stock-based compensation, including accounting for the indirect effects of stock-based compensation deductions and the effects of windfall tax benefits under the alternative minimum tax, see Section TX 12.2.3.2.5.

Entities should bear in mind certain interim-period considerations when estimating their annual effective tax rate and recognizing windfalls and shortfalls. For instance, an entity might issue incentive stock options, thereby causing a permanent difference in the tax rate. For a discussion on accounting for the effects of windfalls and shortfalls in the annual effective tax rate, see Section TX 17.4.6.

U.S. generally accepted accounting principles require that, in certain cases, compensation cost be capitalized in the balance sheet, such as when employees devote significant time to a particular project (e.g., manufacturing inventory or constructing fixed assets). If the related stock-based compensation award will give rise to a tax deduction (e.g., when exercised, or over time as the asset is depreciated), ASC 718-740-25-2 specifies that compensation cost that is capitalized as part of the cost of an asset will be considered part of the tax basis of that asset for financial reporting purposes. With respect to the determination of windfalls and shortfalls and the corresponding income statement and APIC presentation, and with respect to the impact on the pool of windfall tax benefits, upon realizing a tax deduction for awards for which the underlying compensation cost was capitalized, an entity would apply the same income tax accounting methodology as for awards whose compensation costs were expensed.

Example 18-16 illustrates the journal entries that will be recorded to account for compensation expense related to a nonqualified option that is capitalized as part of an asset:

Example 18-16: Capitalization of Compensation Cost Related to an Equity-Classified Nonqualified Option

Background/Facts:
An entity grants nonqualified stock options to employees involved in the self-construction of a fixed asset, and $1,000 of compensation cost is capitalized as part of the fixed asset. The asset has a 10-year life and the awards are fully vested on the grant date. The entity will receive a tax deduction for the amount of the intrinsic value when the option is exercised.

The entity has a 40 percent tax rate and has sufficient taxable income to realize the deduction.

(continued)
At the end of the first year, the entity records $100 of incremental depreciation expense and has a $900 book basis in the portion of the carrying amount of the equipment that relates to the stock options. Pursuant to ASC 718-740-25-2, the entity’s corresponding tax basis is presumed to be $1,000, which is not depreciated for tax-return purposes; therefore, a $40 deferred tax asset is recorded \([($1,000 \text{ tax basis} – $900 \text{ book basis}) \times \text{the 40 percent tax rate}]\).

At the end of the second year, the employees exercise the options when the intrinsic value is $5,000, and an additional $100 of incremental book depreciation expense has been recorded. The entity receives a tax deduction for the intrinsic value of the options when they are exercised. Thus at the end of the second year, the entity’s tax basis is zero and book basis is $800, resulting in a $320 deferred tax liability. This deferred tax liability would be reversed as book depreciation is recognized.

The following journal entries illustrate how an entity would account for this transaction and record the tax benefit.

**Grant Date**

1) To record capitalized compensation cost on the grant date

| Dr Fixed asset | $1,000 |
| Cr APIC | $1,000 |

**Depreciation—Years 1 and 2**

2) To record incremental depreciation in year 1

| Dr Depreciation expense | $100 |
| Cr Accumulated depreciation | $100 |
| Dr Deferred tax asset | $40 |
| Cr Deferred tax expense | $40 |

To record depreciation in year 2

| Dr Depreciation expense | $100 |
| Cr Accumulated depreciation | $100 |
| Dr Deferred tax asset | $40 |
| Cr Deferred tax expense | $40 |

**Exercise at the End of Year 2**

3) To record the income tax effects of the exercise\(^1\)

| Dr Income taxes payable | $2,000 |
| Cr APIC | $1,600 |
| Cr Current tax expense | $400 |
| Dr Deferred tax expense | $400 |
| Cr Deferred tax asset | $80 |
| Cr Deferred tax liability | $320 |

\(^1\) If the tax law required the intrinsic value of the award to be added to the tax basis of the asset instead of being deducted when exercised, then the windfall tax benefit would be recorded over time as the tax basis of the asset is deducted and the windfall tax benefit is realized (ASC 718-740-25-10). The deferred tax asset or liability related to the temporary difference in the PP&E would be based on the book compensation amount of $1,000 (i.e., it would not include the windfall). To illustrate, assume the same facts as in this example, except that instead of being immediately deductible when the award is exercised, the intrinsic value is added to the tax basis in the fixed asset. At the end of Year 2, the book basis would be $800 ($1,000 original basis – $200 depreciation), and the tax basis for purposes of measuring temporary differences for financial reporting would be $1,000, which is equal to the book compensation amount, (this assumes no catch-up depreciation on the tax return). This would yield a deferred tax asset of $80 \([($1,000 \text{ tax basis} – $800 \text{ book basis}) \times 40\%]\), which has already been recorded (in Years 1 and 2). The windfall tax benefit of $1,600 \([($5,000 \text{ deduction} – $1,000 \text{ of compensation cost} ) \times 40\%]\) will be credited to APIC in subsequent periods as the tax basis is depreciated and the windfall benefit is realized.

(continued)
• The deferred tax asset that has already been established is removed from the books.

• A deferred tax liability is recorded for the taxable temporary difference of $800, which will be expensed for book purposes over the remaining eight years.

• APIC, and the pool of windfall tax benefits, increased by $1,600 (related to the excess deduction of $4,000 [$5,000 deduction for the intrinsic value at exercise less $1,000 of compensation cost]).

Depreciation—Years 3–10 (Cumulative Entry)

4) To record depreciation and reverse the deferred tax liability over years 3–10

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Depreciation expense $800</td>
<td>Cr Accumulated depreciation $800</td>
</tr>
<tr>
<td>Dr Deferred tax liability $320</td>
<td>Cr Deferred tax expense $320</td>
</tr>
</tbody>
</table>

The tax accounting related to the capitalization of compensation cost for an ISO is different because an ISO is not ordinarily expected to result in a tax deduction and therefore the tax effects are recorded only upon a disqualifying disposition. As an ISO is not expected to result in a tax benefit to the entity, no deferred tax benefit is established either at the outset or as the compensation cost is either capitalized or recognized in the income statement (through amortization or depreciation). Upon a disqualifying disposition, an entity will receive a tax deduction. Assuming the related capitalized asset is not fully amortized or depreciated and the book compensation expense will be recognized over a future period, upon the disqualifying disposition an entity will have to establish a deferred tax liability that will be recognized as deferred tax expense as the amortization or depreciation expense is recognized.

Example 18-17 illustrates the journal entries that will be recorded to account for the compensation cost from an ISO that is capitalized as part of an asset that results in a disqualifying disposition when the asset has not been fully amortized or depreciated when the disqualifying disposition occurs.

Example 18-17: Capitalization of Compensation Cost Related to an Equity-Classified ISO That Later Has a Disqualifying Disposition

Background/Facts:
An entity issues an ISO award to an employee where the compensation cost is capitalized because the employee provides services on the self-construction of one of the entity’s fixed assets. Compensation cost of $1,000 will be capitalized as part of the fixed asset. The asset has a 10-year life, the entity uses straight-line depreciation, and the awards are vested on the grant date.

The entity has a 40 percent tax rate and has sufficient taxable income to absorb a tax deduction in the event that there is a disqualifying disposition.

At the end of the first year, the employee exercises the options when the intrinsic value is $5,000 and enters into a same-day sale, resulting in a disqualifying disposition.

(continued)
The following journal entries illustrate how an entity would account for this transaction and record the tax benefit from the disqualifying disposition.

### Grant Date
1) To record capitalized compensation cost on the grant date. There are no tax entries recorded because an ISO does not ordinarily result in a tax deduction.
   - Dr Fixed asset $1,000
   - Cr APIC $1,000

### Depreciation—Year 1
2) To record incremental depreciation in year 1. There are no tax entries recorded because an ISO does not ordinarily result in a tax deduction.
   - Dr Depreciation expense $ 100
   - Cr Accumulated depreciation $ 100

### Disqualifying Disposition at the End of Year 1
3) To record the income tax effects of the disqualifying disposition
   - Dr Taxes payable $2,000
   - Cr Current tax expense $ 400
   - Cr APIC $1,600
   - Dr Deferred tax expense $ 360
   - Cr Deferred tax liability $ 360

- The recognized income tax benefit is limited to the amount of compensation cost that has been expensed for book purposes ($100) (i.e., depreciation expense). Accordingly, a $40 tax benefit has been recognized (i.e., $400 current tax benefit partially offset by $360 deferred tax expense). The remaining tax benefit will be recognized as depreciation expense is recorded for book purposes.

- A deferred tax liability is recorded for the difference between the tax deduction of $900 and the book basis, which will be reversed for book purposes over the remaining nine years.

- The pool of windfall tax benefits increased by $1,600.

### Depreciation—Years 2–10 (Cumulative Entry)
4) To record depreciation expense and reverse the deferred tax liability in years 2–10.
   - Dr Depreciation expense $ 900
   - Dr Deferred tax liability $ 360
   - Cr Accumulated depreciation $ 900
   - Cr Deferred tax expense $ 360

---

### 18.20 Multinational Entities

U.S. multinational entities face several income tax issues involving stock-based compensation for non-U.S.-based employees. Income tax laws in each country are unique and may provide for tax deductions that differ from those permitted under U.S. tax law. This may result in a different income tax accounting treatment than for a stock-based compensation award issued to U.S. employees.
A non-U.S. subsidiary generally must bear the cost of a stock-based compensation award in order to be eligible for a local corporate income tax deduction. If the costs of a stock-based compensation award are recharged to the non-U.S. subsidiary in return for cash, the recharge should be treated as the parent entity’s issuance of capital stock in exchange for cash or property, and generally should not result in a taxable transaction in the U.S.

When a U.S. multinational entity issues stock-based compensation to its employees in non-U.S. subsidiaries and it expects to receive a tax deduction in the local jurisdiction, the non-U.S. subsidiary should record a deferred tax asset, based on the local tax rate, as it recognizes book compensation cost over the requisite service period. At the time of settlement, the non-U.S. subsidiary would determine its windfall or shortfall based on the local jurisdiction tax deduction and account for such amount in accordance with ASC 718.

Stock-based compensation deductions incurred by non-U.S. subsidiaries also may have an indirect effect on the ultimate U.S. taxes paid by the U.S. parent entity. For example, such deductions may reduce the non-U.S. subsidiary’s earnings and profits for U.S. tax purposes and thereby reduce the amount of U.S. taxes paid when cash is distributed from non-U.S. subsidiaries (i.e., the deduction will affect the portion of a cash distribution from the non-U.S. subsidiary that would be considered a dividend versus a return of capital for tax purposes). In other cases, amounts that are charged back to the U.S. parent under transfer pricing arrangements that are determined on a “cost plus” basis might include a deduction for stock-based compensation, thereby providing the U.S. parent with a greater tax deduction than would have been the case absent the award. The Resource Group agreed that such indirect tax effects of awards should not be considered for purposes of either (1) establishing the deferred tax asset over the requisite service period or (2) measuring the windfall or shortfall at settlement of the award (i.e., the tax benefit is limited to the tax benefit of the deduction taken on the local tax return).

### 18.21 Cost-Sharing Pool

Affiliated entities that plan to share the cost of developing intangible property may choose to enter into a cost-sharing agreement whereby one entity bears certain expenses on behalf of another entity and is reimbursed for those expenses. U.S. tax regulations specify the expenses that should 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.

U.S. tax regulations provide two methods for determining the amount and timing of stock-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 are based on the intrinsic value that the award has on the exercise date. Under this method, the tax deduction and initial deferred tax asset recorded are directly affected by the cost-sharing arrangement and, accordingly, the amounts are recorded net of any impact of the arrangement.
Entities that elect to follow the grant method use grant-date fair values that are determined based on the amount of book compensation cost to be included in a pool of shared costs. Effectively, all shared costs related to stock options will be included in U.S. taxable income, in the same amount (and at the same time) as the expenses that an entity concurrently records for book purposes. Entities should include such costs in U.S. taxable income regardless of whether the options ultimately are exercised by the holder and result in a U.S. tax deduction.

**PwC Observation:** Several taxpayers have challenged the IRS’s position that stock-based compensation should be included in the pool of shared costs. On August 30, 2005, a U.S. tax court issued an opinion in favor of one taxpayer, finding that the allocation of stock option costs to cost-sharing agreements is contrary to the arm’s-length standard. However, the decision is limited to years prior to the issuance of Regulation Section 1.482-7 of the U.S. tax code, which requires the inclusion of stock-based compensation cost in the pool of shared costs. Furthermore, in August 2006, the IRS filed to appeal this case to a higher court. In March 2010, the U.S. Court of Appeals for the Ninth Circuit affirmed the U.S. tax court’s opinion in favor of the taxpayer that stock-based compensation need not be included in the pool of costs shared under a cost-sharing agreement prior to August 26, 2003.

The following example illustrates the income tax accounting for cost-sharing payments for Entity A (the parent entity) and Entity B (an affiliate of the parent entity).

Entity A, which is located in the U.S., enters into a cost-sharing arrangement with Entity B, which is located in Switzerland. Under the arrangement, the two entities share costs associated with the research and development of certain technology. Entity B reimburses Entity A for 30 percent of the research and development costs incurred by Entity A. The U.S. tax rate is 40 percent. Cumulative book compensation for a vested option is $100 for the year-ended December 31, 2006. The award is exercised during 2007, when the intrinsic value of the option is $150.

The tax accounting impact is as follows:

- **Exercise method:** On December 31, 2006, Entity A has recorded a $28 deferred tax asset related to the option [$100 book compensation cost x 70 percent (percentage not reimbursed) x 40 percent]. In 2007, when the option is exercised, any tax benefit associated with the excess tax deduction is a windfall. The entity is entitled to a U.S. tax benefit (net of the inclusion) of $42 [$150 intrinsic value when the option is exercised x 70 percent (percentage not reimbursed) x 40 percent]. Accordingly, the windfall tax benefit is $14 [$42 U.S. tax benefit (net of the inclusion) – $28 deferred tax asset].

- **Grant method:** On December 31, 2006, Entity A has recorded a $40 deferred tax asset related to the option ($100 book compensation cost x 40 percent). 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 should have no direct impact on the carrying amount of the U.S. deferred tax asset related to stock-based compensation. If there was $100 of stock-based compensation during 2006, the impact on the December 31, 2006, current tax provision would be $12 [$100 book compensation cost x 30 percent (percentage reimbursed) x 40 percent]. The net impact on the 2006 income statement is a tax benefit of $28 ($40 – $12). At settlement, the windfall tax benefit is $20 [$60 ($150 intrinsic value when the option is exercised x 40 percent) – $40 deferred tax asset]. In this
example, the cost-sharing reimbursement under the grant method is smaller and provides a $6 greater tax benefit.

This example considers only the U.S. tax implications. Entity B’s accounting is not considered. In measuring deferred tax assets and potential windfalls, entities also need to consider any possible tax benefit in the foreign jurisdiction where the compensation charge has been allocated.

18.22 Income Tax Disclosures, Assumed Proceeds under the Treasury Stock Method, and Cash Flow Statement Presentation

The following should be disclosed related to the tax effects of stock-based compensation awards:

- The amount of cash resulting from the settlement of the awards, and the corresponding tax benefit that the entity realized for the current year.

- The total compensation cost that the entity recognized in income, as well as the total recognized tax benefit for all income statements that the entity presented.

18.22.1 Assumed Proceeds in the Computation of Dilutive EPS under the Treasury Stock Method

In applying the treasury stock method of ASC 260-10-45, the assumed proceeds of stock-based compensation arrangements are the sum of (1) the amount, if any, the employee must pay on exercise, (2) the amount of compensation cost that will be recognized in the future, and (3) the amount of tax benefits (either windfalls or shortfalls), if any, that would be debited or credited to additional paid-in capital for awards that ordinarily result in a tax deduction. The tax benefit is calculated using the average share price for the period and the tax rate in effect at the beginning of the period. Tax benefits that would be available only upon further action by the employee (such as a disqualifying disposition of stock received upon exercise of an incentive stock option) should not be assumed. The entity also should consider whether windfall tax benefits would be “realized” pursuant to ASC 718-740-25-10. Windfall tax benefits that would not be realized should be excluded from the assumed proceeds.

In calculating diluted EPS in an interim period early in the year, an entity should consider the annual estimate of taxable income when determining whether the windfall tax benefits would be “realized,” consistent with the methodology described in ASC 740-270-30 for determining the effective tax rate. An entity could have a loss in the first quarter but expect that for the year it will have taxable income. The entity would be able to consider the windfall tax benefits as realized in this situation. In addition, we believe that entities should determine whether a windfall has been “realized” using the same method (i.e., “with-and-without” or tax law ordering) used to determine whether windfall tax benefits are “realized” for financial statement purposes.

If an award would result in a shortfall, the amount of the shortfall is a reduction of the assumed proceeds from recording the shortfall as a charge to APIC (because there is a sufficient pool of windfall tax benefits). If the shortfall would be charged to income tax expense (because there is not a sufficient pool of windfall tax benefits), the shortfall should be excluded from the assumed proceeds. Thus, the amount of the shortfall that reduces assumed proceeds is limited to the amount of the entity’s pool of windfall tax benefits.
18.22.2 **Cash Flow Statement Presentation**

Windfall tax benefits from stock-based compensation cost should be classified, under both the direct and indirect methods of reporting cash flows, as cash inflows from financing activities. The amount shown in the financing section of the statement of cash flows should equal the sum of the gross windfall tax benefits that the entity realized from awards, even though the shortfalls are netted against the pool of windfall tax benefits in the statement of stockholders’ equity.

A non-public entity that previously used the minimum value method to measure its share-based awards and adopted ASC 718 using the prospective method should report windfall tax benefits from those exercised awards as operating cash flows. Prior to the effective date of ASC 718, prior guidance stipulated that the reduction of income taxes paid as a result of the deduction triggered by employee exercise of stock options (i.e., windfall tax benefit) should be classified as an operating cash flow. While ASC 718 changed this guidance, the prior accounting treatment should continue to be applied to awards accounted for under the prospective method.

In certain cases where the tax benefit from a stock option relates to awards that were exchanged in a business combination consummated prior to the effective date of ASC 805, the tax benefit may be recorded as a reduction of goodwill. The tax benefit in this situation would be shown as an operating activity, because ASC 230 requires that all income tax-related matters be shown as operating activities, with the only exception being for the excess tax benefit received from stock-based compensation, which is required to be shown as a financing activity.

If an entity elects to use the long-form method to calculate its historical pool of windfall tax benefits, the windfall amounts disclosed as cash inflows from financing activities should be based on the “as if” windfall tax benefits calculated by comparing the tax deduction with the sum of the compensation recognized and disclosed under the prior standard and ASC 718. The “as if” windfall is the windfall that increases the pool of windfall tax benefits, as discussed in Section TX 18.11.

Entities that elected to use the short-cut method to calculate their historical pool of windfall tax benefits should have calculated the windfall amounts disclosed as cash inflows from financing activities, as follows:

- Partially vested awards as of ASC 718 adoption: The windfall tax benefit or shortfall should be determined by comparing the tax deduction for a partially vested award with the sum of the compensation cost recognized and disclosed for that award under the prior standard and ASC 718 (i.e., the “as if” windfall or shortfall).

- Fully vested awards as of ASC 718 adoption: The windfall tax benefit is equal to the tax effects recognized in APIC as a result of the settlement of the award subsequent to the adoption of ASC 718 (i.e., the recognized windfall).

Example 18-18 illustrates how a windfall and a shortfall should be shown in the statement of cash flows.

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1 EITF Issue No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option.*
Example 18-18: Windfall and Shortfall Presentation in the Statement of Cash Flows

Background/Facts:
The pool of windfall tax benefits is zero at December 31, 2006. Individual employees at a calendar-year entity exercised the following four nonqualified stock options during 2007 (i.e., one employee award was exercised during each quarter). All awards were granted post-adoption and no other awards were exercised during the period. The following table depicts the results of the awards exercised:

### Analysis of Shortfalls and Windfalls

<table>
<thead>
<tr>
<th>Exercise Date</th>
<th>Total Deferred Tax Assets</th>
<th>Tax Benefit</th>
<th>Shortfall</th>
<th>Windfall</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/2007</td>
<td>$400</td>
<td>$500</td>
<td></td>
<td>$100</td>
</tr>
<tr>
<td>2/2/2007</td>
<td>900</td>
<td>450</td>
<td>$(450)</td>
<td></td>
</tr>
<tr>
<td>4/2/2007</td>
<td>560</td>
<td>1,000</td>
<td></td>
<td>440</td>
</tr>
<tr>
<td>5/2/2007</td>
<td>990</td>
<td>500</td>
<td>$(490)</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$2,850</strong></td>
<td><strong>$2,450</strong></td>
<td><strong>$(940)</strong></td>
<td><strong>$540</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount Reported in Financing Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>First quarter ended March 31, 2007</td>
<td>$100</td>
</tr>
<tr>
<td>Six months ended June 30, 2007</td>
<td>$540</td>
</tr>
</tbody>
</table>

Note: The entity recognized in its income tax provision a net tax shortfall of $400 ($940 less $540) for the six months ended June 30, 2007.
Chapter 19:
Income Tax Accounting: U.S. GAAP Comparison to IFRS
Chapter Summary

The current income tax accounting frameworks under U.S. GAAP and IFRS are both balance sheet liability models and share many fundamental principles. For example, International Accounting Standard No. 12, *Income Taxes* (IAS 12) and ASC 740 require an entity to recognize the current and deferred tax consequences of transactions. However, there are significant differences in the details. This chapter provides a summary of the primary conceptual differences between accounting for income tax under U.S. GAAP and IFRS.

A comprehensive discussion of the accounting for income taxes under IAS 12 can be found in PwC's *Manual of Accounting—IFRS*. 
19.1 Short-Term Convergence

Since 2002, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have been committed to the convergence of IFRS and U.S. GAAP. Preparers and others, including regulators, have called for convergence to simplify financial reporting and to reduce the burden of compliance for listed companies, especially those with a stock-market listing in more than one jurisdiction. The SEC, in removing the U.S. GAAP reconciliation requirement for foreign private issuers using IFRS, has cited the continuing convergence of IFRS and U.S. GAAP as a fundamental building block. As part of its strategy to better protect European investors investing in non-European companies, the European Commission has also thrown its weight behind convergence.

In March 2009, the IASB issued an exposure draft proposing changes to IAS 12 with the objective of clarifying various aspects of the standard and to reduce differences between IFRS and U.S. GAAP. The comment period ended on July 31, 2009. As a result of the feedback received, the IASB abandoned the 2009 exposure draft and instead took on a limited scope project to amend IAS 12 to address certain specific practice issues. The limited scope project resulted in the 2010 amendment to IAS 12 addressing the accounting for deferred taxes associated with investment properties measured at fair value in accordance with IAS 40, Investment Property. The IASB, however, has since suspended consideration of the other specific practice issues it intended to address as part of the limited scope project, such as the accounting for uncertain tax positions, until work is completed on other higher priority projects. While both boards have indicated that they would consider undertaking a fundamental review of accounting for income taxes at some time in the future, the time table and path forward is not clear.

The table below compares U.S. GAAP and IFRS accounting for income tax. While the table compares many aspects of accounting for income tax, the table may not address all of the differences that should be considered to interpret and apply in practice the individual accounting standards. For example, there is income tax related guidance in U.S. GAAP literature that does not exist in IFRS, such as the guidance related to leveraged leases. All such instances may not be captured in the table.

19.2 Comparison between U.S. GAAP and IFRS

19.2.1 Comparison between the U.S. GAAP and IFRS Income Tax Accounting Models

Although both frameworks require a provision for deferred taxes, they differ in some areas with regard to methodology (as outlined in the table below). In the area of income tax accounting for business combinations, the U.S. GAAP and IFRS models are essentially converged following the issuance of the revised business combination standards.

Note: The following table should neither be used as a substitute for reading the entire standard(s) nor be viewed as a complete list of the principle differences and similarities between income tax accounting under U.S. GAAP and IFRS.
<table>
<thead>
<tr>
<th>Issue</th>
<th>IFRS</th>
<th>U.S. GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General considerations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General approach</td>
<td>Full provision</td>
<td>Similar to IFRS</td>
</tr>
<tr>
<td>Basis for deferred tax assets</td>
<td>Temporary differences (i.e., the difference between the carrying</td>
<td>Similar to IFRS, except the carrying amount is not bifurcated and tax basis is determined based on the amount that is deductible via amortization or depreciation, as well as the amount that would be deductible upon sale or abandonment.</td>
</tr>
<tr>
<td></td>
<td>and liabilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax basis is determined based on the expected manner of recovery.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assets and liabilities may have a dual manner of recovery (e.g.,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>through use and through sale). In that case, the carrying amount</td>
<td></td>
</tr>
<tr>
<td></td>
<td>of the asset or liability is bifurcated, resulting in more than a</td>
<td></td>
</tr>
<tr>
<td></td>
<td>single temporary difference related to that item.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A rebuttable presumption exists that investment property measured</td>
<td></td>
</tr>
<tr>
<td></td>
<td>at fair value will be recovered through sale.¹</td>
<td></td>
</tr>
<tr>
<td>Initial recognition exception</td>
<td>A temporary difference may arise on initial recognition of an asset</td>
<td>A temporary difference may arise on initial recognition of an asset or liability. In asset purchases that are not business combinations, a deferred tax asset or liability is recorded with the offset generally recorded against the assigned value of the asset. The amount of the deferred tax asset or liability is determined by using a “simultaneous equations” method.</td>
</tr>
<tr>
<td></td>
<td>or liability. A deferred tax liability or asset is not recognized</td>
<td></td>
</tr>
<tr>
<td></td>
<td>for such a temporary difference if the initial recognition of an</td>
<td></td>
</tr>
<tr>
<td></td>
<td>asset or liability is in a transaction that (1) is not a business</td>
<td></td>
</tr>
<tr>
<td></td>
<td>combination, and (2) affects neither accounting profit nor taxable</td>
<td></td>
</tr>
<tr>
<td></td>
<td>profit at the time of the transaction.</td>
<td></td>
</tr>
<tr>
<td>Measurement of deferred tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td>Tax rates and tax laws that have been enacted or substantively</td>
<td>Use of substantively enacted rates is not permitted. The effect of changes in tax rates and tax laws are reflected only on the enactment date.</td>
</tr>
<tr>
<td></td>
<td>enacted may be used.</td>
<td></td>
</tr>
<tr>
<td>Recognition of deferred tax</td>
<td>A deferred tax asset is recognized if it is probable that sufficient</td>
<td>A deferred tax asset is recognized in full, but is then reduced by a valuation allowance if it is more-likely-than-not that some or all of the deferred tax asset will not be realized.</td>
</tr>
<tr>
<td>assets</td>
<td>taxable profit will be available to utilize against the temporary</td>
<td></td>
</tr>
<tr>
<td></td>
<td>difference.</td>
<td></td>
</tr>
<tr>
<td>Discounting</td>
<td>Prohibited for deferred taxes. Discounting current tax assets and</td>
<td>Prohibited.</td>
</tr>
<tr>
<td></td>
<td>liabilities is allowed but not required.</td>
<td></td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Issue</th>
<th>IFRS</th>
<th>U.S. GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized intragroup profits (e.g., on inventory or fixed assets)</td>
<td>Any associated current and deferred taxes are recognized at the time of the transaction. A temporary difference usually arises on consolidation as a result of retaining the pre-transaction carrying amount of the transferred asset while having its tax base according to the intragroup transaction price.</td>
<td>Any income tax effects to the seller, including taxes paid and tax effects of any reversal of temporary differences, that occur as a result of the intercompany sale are deferred and recognized upon sale to a third party or as the transferred property is amortized or depreciated. In addition, the buyer is prohibited from recognizing a deferred tax asset for any excess of tax basis over the carrying amount of the transferred assets in the consolidated financial statements.</td>
</tr>
<tr>
<td>Revaluation of PP&amp;E and intangible assets</td>
<td>Deferred tax asset or liability is recognized with offsetting entry in equity.</td>
<td>Prohibited.</td>
</tr>
<tr>
<td>Intraperiod tax allocation (&quot;backwards tracing&quot;)</td>
<td>Income tax expense is recognized in the income statement unless the tax arises from a transaction or event which is recognized (in the same or different period) outside of the income statement (e.g., in equity), or unless the tax arises from a business combination.</td>
<td>Similar to IFRS for items occurring during the year. However, subsequent changes (e.g., tax rate changes, valuation allowance changes, etc.) are recognized in continuing operations except in limited circumstances (i.e., “backwards tracing” is generally prohibited).</td>
</tr>
<tr>
<td>Foreign nonmonetary assets/liabilities when the tax-reporting currency is not the functional currency</td>
<td>Deferred tax is recognized on the difference between the carrying amount, which is determined using the historical rate of exchange, and the tax basis, which is determined using the exchange rate on the balance sheet date.</td>
<td>No deferred tax is recognized for differences related to assets and liabilities that are remeasured from local currency to the functional currency using historical exchange rates if those differences result from changes in exchange rates or indexing for tax purposes.</td>
</tr>
<tr>
<td>Investments in subsidiaries</td>
<td>Deferred tax liabilities are recognized on investments in foreign and domestic subsidiaries unless (1) the parent is able to control the distribution of profits and (2) it is probable that the temporary differences will not reverse in the foreseeable future. Deferred tax assets are recognized on investments in foreign and domestic subsidiaries only to the extent that it is probable that the temporary difference will reverse in the foreseeable future.</td>
<td>Deferred tax liabilities are required on temporary differences arising after 1992 that relate to investments in domestic subsidiaries, unless such amounts can be recovered tax-free and the parent expects to use that method. No deferred tax liabilities are recognized on undistributed profits (and other outside basis differences) of foreign subsidiaries that meet the indefinite reversal criterion. Deferred tax assets are recognized only if it is apparent that the temporary difference will reverse in the foreseeable future.</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Issue</th>
<th>IFRS</th>
<th>U.S. GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments in corporate joint ventures</td>
<td>Deferred tax liabilities are recognized on investments in foreign and domestic corporate joint ventures unless (1) the venturer can control the sharing of profits and (2) it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax assets are recognized on investments in foreign and domestic corporate joint ventures only to the extent that it is probable that the temporary difference will reverse in the foreseeable future.</td>
<td>Deferred tax liabilities are required on temporary differences arising after 1992 that relate to investments in domestic corporate joint ventures. No deferred taxes are recognized on the undistributed profits (and other outside basis differences) of foreign corporate joint ventures (that are permanent in duration) that meet the indefinite reversal criterion. Deferred tax assets are recognized only when it is apparent that the temporary difference will reverse in the foreseeable future.</td>
</tr>
<tr>
<td>Investments in associates (equity-method investments)</td>
<td>Deferred tax liabilities are recognized unless (1) the investor can control the sharing of profits and (2) it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax assets are recognized only to the extent that it is probable that the temporary difference will reverse in the foreseeable future.</td>
<td>Deferred tax liabilities and assets are generally recognized on temporary differences relating to equity-method investments.</td>
</tr>
<tr>
<td>Change from investee status to subsidiary status</td>
<td>No specific rules apply. General guidance regarding deferred taxes on undistributed profits (and other outside basis differences) should be followed.</td>
<td>A deferred tax liability related to undistributed profits of the prior foreign investee that would not otherwise be required after the foreign investee becomes a subsidiary is ‘frozen.’ The deferred tax liability continues to be recognized to the extent that dividends from the subsidiary do not exceed the parent company’s share of the subsidiary’s earnings subsequent to the date it became a subsidiary, until the disposition of the subsidiary.</td>
</tr>
<tr>
<td>Issue</td>
<td>IFRS</td>
<td>U.S. GAAP</td>
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<tr>
<td>-------</td>
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</tr>
<tr>
<td>Share-based compensation (equity-classified awards)</td>
<td>For awards that ordinarily result in a tax deduction (e.g., nonqualified stock options in the federal U.S. jurisdiction), deferred taxes are recorded as the compensation is earned. The deductible temporary difference is based on the expected future tax deduction corresponding to the percentage earned to date (e.g., intrinsic value of the award at the reporting date times the percentage vested). If the actual or estimated tax deduction exceeds the cumulative share-based compensation expense, the tax effect of the excess is recorded directly in equity. If the actual or estimated tax deduction is less than or equal to cumulative share-based compensation expense, the tax effect is recorded in the income statement. The unit of accounting is an individual award (i.e., no windfall pool).</td>
<td>For awards that ordinarily result in a tax deduction (e.g., nonqualified stock options in the federal U.S. jurisdiction), deferred taxes are recorded as the compensation is earned. The deductible temporary difference is based on the compensation cost recognized for financial reporting purposes, and is not adjusted for changes in stock price. Changes in the stock price do not affect the deferred tax asset or result in any adjustments prior to settlement or expiration. If the actual tax benefit exceeds the deferred tax asset, the excess benefit, which is known as a “windfall” tax benefit, is credited directly to shareholders’ equity. If the tax benefit is less than the deferred tax asset, the shortfall is recorded as a direct charge to shareholders’ equity to the extent of the available windfall pool, and as a charge to income tax expense thereafter.</td>
</tr>
<tr>
<td>Uncertain tax positions—unit of account</td>
<td>The unit of account is not specified. An entity may consider uncertain tax positions at the level of the individual uncertainty or group of related uncertainties. Alternatively, it may choose to consider tax uncertainties at the level of its total tax liability to each taxing authority. The approach taken for determining the unit of account is a policy election.</td>
<td>The unit of account is an individual tax position, determined based on 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 exam.</td>
</tr>
<tr>
<td>Issue</td>
<td>IFRS</td>
<td>U.S. GAAP</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>-----------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Uncertain tax positions—measurement</td>
<td>When it is probable(^2) that an entity has incurred a liability (without considering detection risk), the liability is measured using either a weighted average probability approach or at the single best estimate of the most likely outcome.</td>
<td>For uncertain tax positions whose technical merits meet the more-likely-than-not recognition threshold, the benefit is measured at the largest amount of tax benefit that is greater than 50 percent likely of being realized.</td>
</tr>
<tr>
<td>Uncertain tax positions—subsequent events</td>
<td>Relevant developments to uncertain tax positions occurring after the balance sheet date but before issuance of the financial statements (which would include discovery of information that was not available as of the balance sheet date) should be considered either an adjusting or nonadjusting event depending on whether the new information provides evidence of conditions that existed at the end of the reporting period.</td>
<td>Relevant developments to uncertain tax positions occurring after the balance sheet date but before the issuance of the financial statements (which would include the discovery of information that was not available as of the balance sheet date) should be considered a nonrecognized subsequent event for which no effect would be recorded in the current period financial statements.</td>
</tr>
<tr>
<td>Uncertain tax positions—balance sheet classification</td>
<td>A liability for uncertain tax positions is generally classified as a current liability because entities typically do not have the unconditional right to defer settlement of uncertain tax positions for at least 12 months after the reporting period.</td>
<td>A liability for unrecognized tax benefits is classified as a current liability only to the extent that cash payments are anticipated within 12 months of the reporting date. Otherwise, such amounts are reflected as noncurrent liabilities.</td>
</tr>
<tr>
<td>Uncertain tax positions—interest and penalties</td>
<td>IAS 12 does not specifically address the treatment of interest and penalties. As such, an entity can elect an accounting policy to recognize and measure interest and penalties in accordance with (a) IAS 12, or (b) IAS 37, Provisions, Contingent Liabilities and Contingent Assets. The accounting policy applies to amounts payable and amounts recoverable. IAS 37 prohibits recognition of a contingent asset until it is &quot;virtually certain,&quot; whereas IAS 12 requires uncertain tax assets to be recorded on the basis of the amount expected to be recovered. The accounting policy selected is applied to classification (i.e., income tax vs. finance or another expense).</td>
<td>Interest expense is recognized in the first period the interest would begin accruing according to the provisions of the relevant tax law. While not specifically addressed in ASC 740, we believe interest income should be accounted for in the same manner as interest expense. An expense for the amount of the statutory penalty is recognized in the period in which the entity claims or expects to claim the position in the tax return. An accounting policy is selected and applied consistently to the classification of interest and penalties (i.e., income tax vs. interest or another expense).</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Issue</th>
<th>IFRS</th>
<th>U.S. GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Presentation of deferred taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Offset of deferred tax assets and liabilities</td>
<td>This is permitted only when the entity has a legally enforceable right to offset and the balance relates to the tax levied by the same authority.</td>
<td>Similar to IFRS</td>
</tr>
<tr>
<td>Current/noncurrent</td>
<td>Deferred tax assets and liabilities are classified net as noncurrent on the balance sheet, with a supplemental note disclosure for (1) the components of the temporary differences, and (2) the amounts expected to be recovered or settled within 12 months of the balance sheet date and after 12 months from the balance sheet date.</td>
<td>Deferred tax assets and liabilities are either classified as current or noncurrent based on the classification of the related non-tax asset or liability for financial reporting. Tax assets that are not associated with an underlying asset or liability (e.g., net operating loss carryforwards) are classified in accordance with the expected reversal period.</td>
</tr>
<tr>
<td>Reconciliation of actual and expected tax expense</td>
<td>An explanation between tax expense and accounting profit in either or both of the following forms: (1) a reconciliation computed first by applying the applicable tax rate(s) to accounting profit and then by disclosing the basis on which the applicable tax rate(s) are calculated, or (2) a reconciliation between the average effective tax rate and the applicable tax rate, disclosing the basis on which the applicable tax rate is computed.</td>
<td>Reconciliation is required for public companies of the reported amount of income tax from continuing operations to the amount of tax expense that would result from applying the domestic, federal statutory tax rates to pretax income from continuing operations.</td>
</tr>
</tbody>
</table>

1 The exception to the measurement principle for investment properties measured at fair value was issued in an amendment to IAS 12 in December 2010. The amendment is effective for annual periods beginning on or after January 1, 2012, with early adoption permitted.

2 The term “probable” is generally interpreted to mean more-likely-than-not when applying IFRS.
19.2.2 Differences in Interpretation

Although the income tax accounting guidance under U.S. GAAP and IFRS share many fundamental principles, in some places, the standards use different terms to describe the same or similar concepts and, as a result, can be interpreted and applied in a number of different ways. In other places, one standard provides additional interpretive guidance (such as accounting for uncertain tax positions under ASC 740) that does not exist under the other framework. In still other places, the standards provide different exceptions or “carve-outs” to the basic principle.

One of the more apparent differences between the standards involves the language used to define the threshold for recognition of a deferred tax asset. IAS 12 requires the recognition of a deferred tax asset if future realization of a tax benefit is “probable.” ASC 740-10-30-5 requires a valuation allowance to be applied to a deferred tax asset if realization of the underlying future tax benefits is not more-likely-than-not. Although the two frameworks use different terminology, we understand that the two Boards intended for the meaning of those terms to be consistent under both IFRS and U.S. GAAP. In its 2009 exposure draft on accounting for income taxes, the IASB considered what the term “probable” should mean in the context of the recognition of a deferred tax asset and proposed clarifying that the recognition threshold be consistent with the meaning of the term “probable” as defined in IAS 37, Provisions, Contingent Liabilities and Contingent Assets, IFRS 3, Business Combinations (revised 2008), and with the recognition threshold in ASC 740.

Another difference in application stems from the assessment of deferred tax assets when losses have occurred in recent years. ASC 740-10-30-21 states, “Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years.” Further, ASC 740-10-30-23, provides that the weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. A history of losses in recent years can be objectively verified and thus can be particularly difficult to overcome. IAS 12, par. 35, states:

. . . the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilized by the entity.

IAS 12 does not prescribe a method for weighting the available evidence. As a result, there could be differences in the way that evidence is weighted under U.S. GAAP, which uses the term “objectively verifiable,” and IAS 12, which uses the term “convincing.” It is important to note, however, that in most cases we would expect that “convincing” evidence would be “objectively verifiable.” Still, in any area of accounting where judgment is required, differences can potentially arise.
Appendix A
Summary of Noteworthy Revisions
Appendix A: Summary of Noteworthy Revisions

The 2013 edition of PwC’s Guide to Accounting for Income Taxes (the Guide) has been updated to reflect new and updated authoritative and interpretive guidance since the June 30, 2012 edition. This appendix includes a summary of noteworthy revisions to the Guide.

Noteworthy Revisions

Chapter 2: Objectives and Basic Principles

- Section 2.3.4.2.2 was updated to address the accounting for intra-entity transfers reported at predecessor basis in the context of a spin-off.

Chapter 3: Temporary Differences

- Section 3.2.5 was updated to address the FASB’s EITF project on low-income housing credits, as well as the recent exposure draft to revise the criteria to qualify for the “effective yield” method to account for low-income housing credit investments.

Chapter 5: Valuation Allowance

- Section 5.1.1 was updated to add Example 5-1, which considers the impact of an anticipated merger as part of a Company’s valuation allowance assessment.
- Section 5.3.3 was updated to reflect the 2013 revision to the required consultation policy when there are going concern considerations. The revised policy addresses the consultation requirement when the engagement team performs extended going concern procedures.
- Section 5.4.2 was updated to add Example 5-7, which illustrates consideration of limitations on the use of net operating loss carryforwards in assessing the need for a valuation allowance.
- In Section 5.4.3.2.1.1, a PwC Observation Box was added which indicates that the sale of appreciated securities classified as available-for-sale or trading should only be considered an available tax-planning strategy to the extent that a company is prepared to sell those securities and trigger the realized gains.
- Section 5.4.3.2.1.2 was updated to address the FASB’s recent exposure draft which proposes that deferred tax assets on debt instruments measured at fair value with changes in fair value recognized in other comprehensive income be evaluated separately from other deferred tax assets of an entity.

Chapter 8: Change in the Tax Status of an Entity

- Section 8.1 was updated to add Example 8-1, which illustrates the accounting for deferred taxes on an available for sale security when a change in tax status occurs.

Chapter 10: Business Combinations

- Section 10.11.8 was updated to add Question 8, which addresses changes to amounts recorded in acquisition accounting subsequent to the completion of the measurement period.
Chapter 11: Outside Basis Differences and Other Special Areas

- **Section 11.1.4.5.1** was updated to add Example 11-3, which illustrates the recording of an outside basis deferred tax liability when an investment in a domestic subsidiary is impaired for tax purposes.

- **Section 11.1.5.9** was updated to reflect the 2013 revision to the required consultation policy when there are going concern considerations. The revised policy addresses the consultation requirement when the engagement team performed extended going concern procedures.

- **Section 11.1.7** was updated to add Example 11-6, which illustrates the measurement of a deferred tax liability related to excess book-over-tax outside basis in an equity method investment.

- **Section 11.1.8.1** was updated to add Example 11-7, which illustrates when to recognize a tax benefit for a worthless stock deduction.

- **Section 11.1.10.1** was revised to indicate that the income tax accounting guidance for subsidiaries, as defined by the ASC Master Glossary, applies to consolidated variable interest entities.

- **Section 11.6.1** was updated to add Example 11-14, which illustrates the recording of foreign currency fluctuation impact on deferred income taxes related to foreign branches.

Chapter 12: Intraperiod Tax Allocation

- **Section 12.2.3.3.3.1** was updated to add Example 12-23, which illustrates the consideration as to whether to include deferred taxes in the carrying amount of a disposal group classified as held-for-sale.

Chapter 14: Separate Financial Statements of a Subsidiary

- In **Section 14.3**, a PwC Observation Box was added which indicates that an SEC registrant currently following the separate return method would be unable to justify the preferability of another method (e.g., the benefits-for-loss method) and therefore would not be able to make a change in accounting principle.

- **Section 14.8** was updated to add Example 14-7, which illustrates the consideration of foreign taxes paid in the separate company financial statements of subsidiary.

Chapter 15: Financial Statement Presentation & Disclosure

- **Section 15.5.1.5.1** was updated to add Example 3 and 4, which illustrate that uncertain tax positions included in the tabular reconciliation that do not initially result in a liability for unrecognized tax benefits.

Chapter 16: Accounting for Uncertainty in Income Taxes

- **Section 16.2.1.4** was updated to add Example 16-1, which illustrates the consideration of detection risk when evaluating uncertainty in non-income based taxes.

- In **Section 16.7.2.2**, a PwC Observation Box was added to address the FASB’s recent exposure draft which would potentially require an unrecognized tax benefit.
be presented in the statement of financial position as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward.

Chapter 17: Accounting for Income Taxes in Interim Periods

- **Section 17.1.1.2.1** was updated to clarify that items reported separately in the financial statement must meet the infrequent and unusual criteria in order to be excluded from the estimated annual effective tax rate calculation.

- **Section 17.2.2.1** was updated to add Example 17-4, which illustrates the treatment of withholding taxes in an interim period tax calculation for an entity with operations in multiple jurisdictions.

- **Section 17.2.2.1** was updated to add Example 17-9, which clarifies the guidance on the recognition of prior year windfall benefits during interim periods.

- **Section 17.5.1** was updated to add Example 17-11, which illustrates interim tax accounting for acquisition related transaction costs.
**How PwC Can Help**

PwC has deep expertise and experience in navigating the complexities that exist in accounting for income taxes. This expertise makes us uniquely qualified to assist our clients in addressing the broad spectrum of business, accounting, and tax issues associated with accounting for income taxes.

In addition, PwC is at the forefront of interpreting and understanding the technical impacts and implementation issues associated with new and constantly evolving accounting standards. Changes to both tax law and GAAP accounting standards are commonplace, making this type of assistance and guidance more and more important.

If you have questions relating to the accounting for income taxes, contact your PwC engagement partner or nearest PwC office.

**About PwC**

PwC United States helps organizations and individuals create the value they’re looking for. We’re a member of the PwC network of firms in 158 countries with more than 180,000 people. We’re committed to delivering quality in assurance, tax and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com/US.
Acknowledgements

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