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New Developments Summary

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FASB simplifies the accounting for income taxes

ASU designed to reduce cost and complexity of income tax accounting

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On December 18, 2019 the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*, which is expected to reduce the cost and complexity related to accounting for income taxes.

This publication provides a summary of this guidance, which removes certain exceptions to the general principles in ASC 740 and improves how financial statement preparers will apply certain income tax-related guidance. The ASU is part of the FASB's simplification initiative to make narrow-scope improvements to accounting standards through a series of short-term projects.

A. Overview

The ASU removes the following exceptions to the general principles in ASC 740, *Income Taxes,* thereby eliminating the need for an entity to analyze whether they apply in a given accounting period:

- Exception to the incremental approach for intra-period tax allocation
- Exceptions to accounting for basis differences when there are ownership changes in foreign investments
- Exception in interim-period income tax accounting for year-to-date losses that exceed anticipated losses

The ASU also improves how financial statement preparers apply income tax-related guidance and simplifies U.S. GAAP when accounting for

- Franchise taxes that are partially based on income
- Transactions with a government that result in a step-up in the tax basis of goodwill
- Separate financial statements of legal entities that are not subject to tax
- Enacted changes in tax laws in interim periods

The Board decided that different transition approaches (retrospective, modified-retrospective, or prospective) should apply to each income tax simplification provision because each one has a different effect on the financial statements.

The ASU also clarifies the existing guidance with respect to where the tax benefit of tax-deductible dividends on employee stock ownership plan shares should be recorded in the income statement, and corrects a computational error in an example in ASC 323-740, I*nvestments – Equity Method and Joint Ventures: Income Taxes*.

The effective date is different for public business entities and other entities, but all entities may early adopt the new guidance as long as all the amendments are adopted in the same period.

B. Elimination of specific exceptions

Exception to incremental approach for intra-period tax allocation

Under the existing guidance, ASC 740 provides a general framework for allocating tax expense among financial statement components (such as continuing operations, discontinued operations, and other comprehensive income). Under this framework, entities first allocate tax expense or benefit to continuing operations and then allocate the residual of total tax expense or benefit to other components. In general, the tax effect of income from continuing operations is determined without considering the tax effect of other financial statement components. Existing guidance provides an exception to the general framework in situations where there is a loss from continuing operations and a gain within another financial statement component. In the past, this exception often resulted in allocating a tax benefit to continuing operations and a tax expense to another component, even when total tax expense may have been zero.

Example: Allocation of income tax expense before adoption of ASU 2019-12

Company ABC, which has an income tax rate of 25 percent, has a pretax loss from continuing operations of $100,000 and pretax income from discontinued operations of $100,000 for the year. Assuming it has no book-tax differences and has a full valuation allowance, Company ABC would calculate the total income tax expense under the existing guidance in ASC 740 as follows:

Income tax benefit allocated to continuing operations (realizable pretax loss from continuing operations) = $(100,000) x 25%	$(25,000)
Income tax expense allocated to discontinued operations (total income tax expense less amount allocated to continuing operations) = $0 – $(25,000)	$ 25,000
Total income tax expense	$ 0

As shown in the example above, because there is a loss from continuing operations and income from other items, the exception to the general principle of allocating income tax expense/benefit to continuing operations applies. Therefore, the entire tax benefit from the loss from continuing operations is allocated to continuing operations because the income from discontinued operations is considered in determining the tax benefit allocated to continuing operations.

ASU 2019-12 overview

ASU 2019-12 eliminates the exception to the general guidance in ASC 740-20 on how to allocate income tax expense or benefit for the year to continuing operations, discontinued operations, other comprehensive income, and other charges or credits recorded directly to shareholders' equity when there is a loss from continuing operations and a gain or income from other components. Under the new guidance, income from other categories (for example, discontinued operations) is no longer considered in determining the amount of tax benefit that results from a loss from continuing operations when determining the tax benefit that is allocated to continuing operations. The FASB has noted that while the total income tax expense will not change, entities that have been subject to the exception may see a change in the amount of income tax benefit they allocate to continuing operations. In many instances, removing the exception will now result in entities allocating zero tax expense or benefit to continuing operations, where they would allocate a tax benefit to continuing operations under the existing guidance.

Example: Allocation of income tax expense after adoption of ASU 2019-12

Using the same facts in the example above, an entity that adopts the new guidance in ASU 2019-12 would allocate tax expense or benefit as follows:

Income tax benefit allocated to continuing operations (income from discontinued operations is not considered in determining the amount allocated)	$ 0

Income tax expense allocated to discontinued operations (total income tax expense less amount allocated to continuing operations ($0 – $0)	$ 0
Total income tax expense	$ 0

As shown in the example above, the exception to the general principle of allocating income tax expense/benefit to continuing operations no longer applies under ASU 2019-12. Because income from other categories is no longer considered, Company ABC would not be able to realize the benefit of the net operating loss and therefore cannot allocate any tax benefit to continuing operations.

Transition approach

This new intra-period tax allocation guidance is required to be adopted prospectively in the period of adoption for allocations made after the adoption date.

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As noted above, entities are required to adopt this income tax simplification on a prospective basis. As a result, applying this new guidance could impact the comparability of the financial statements in the period of adoption if an entity was subject to this exception in the past, as comparative periods are not required to be restated. Therefore, entities impacted by this change should consider providing additional disclosures to help financial statement users understand why the changes are being made.

Exceptions to accounting for basis differences when there are ownership changes in foreign investments

Existing guidance overview when a subsidiary becomes an equity method investment

Generally, the exception guidance under ASC 740-30-25-15 applies if both (1) an investment in the common stock of a foreign subsidiary changes so that it is no longer a subsidiary but is instead an equity method investment, and (2) a parent entity does not recognize income taxes on the subsidiary's outside basis differences because of the assertion that earnings were indefinitely reinvested or would be remitted in a tax-free liquidation, *but that assertion changes*. In other words, the exception guidance requires a bifurcation of the treatment of the deferred tax liability (DTL) in the pre- and post-change periods. If a permanent reinvestment assertion exists before the change in ownership and if this assertion was removed as a result of the ownership change, the entity would record a post-ownership change DTL. However, the DTL would only reflect post-ownership-change activity occurring after the subsidiary becomes an equity method investment and would not reflect any outside basis differences before the subsidiary becomes an equity method investment.

ASU 2019-12 overview when a subsidiary becomes an equity method investment

Under the new guidance in ASU 2019-12, the ASC 740-30-25-15 exception is removed. If an outside basis difference must be recorded due to a change in the assertion, an entity should recognize a DTL on the *entire* outside basis difference of the foreign equity method investment, and not just on the post-ownership change outside basis difference.

Existing guidance overview when a foreign equity method investment becomes a subsidiary

Generally, when the book basis exceeds the tax basis in a foreign equity method investment, a DTL should be recognized, unless a permanent reinvestment assertion is made or earnings will be remitted in a tax-free liquidation. Under the existing exception guidance in ASC 740-30-25-16, the DTL previously recognized for a foreign equity method investment generally cannot be derecognized when the investment becomes a subsidiary, even if the entity changes its assertion so that earnings are indefinitely reinvested or will be remitted in a tax-free liquidation. In other words, the exception guidance requires a bifurcation of the treatment of the DTL in the pre- and post-change periods so that if a permanent reinvestment assertion were put in place after the change in ownership, the entity would still record a DTL to reflect the pre-ownership change outside basis differences.

ASU 2019-12 overview when a foreign equity method investment becomes a subsidiary

Under the new guidance, the above exception is removed, and no DTL is recorded if an entity subsequently asserts that earnings are indefinitely reinvested or will be remitted in a tax-free liquidation after becoming a subsidiary, regardless of whether the subsidiary was previously held as a foreign equity method investment.

Transition approach

The new guidance on the change in ownership of investments must be adopted using a modified retrospective approach in the period of adoption. That is, an entity will fully recognize or fully remove a DTL at the beginning of the fiscal year of adoption, with a cumulative-effect adjustment to retained earnings based upon (1) an analysis of the new ownership in the equity method investment or subsidiary, and (2) whether or not the entity can apply available recognition exceptions (for example, assert indefinite reinvestment).

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As noted above, this income tax simplification must be adopted using a modified retrospective approach. This new guidance is designed to reduce the complexity of accounting for the tax effects of an entire outside basis difference that relates to a foreign investment based upon a new ownership structure. Entities impacted by this change should consider providing additional disclosures to help financial statements users understand the changes.

Exceptions in interim-period income tax accounting for year-to-date losses that exceed anticipated losses

Under the interim-period guidance in ASC 740-270, an entity is required to make its best estimate of the annual effective tax rate for the full fiscal year at the end of each interim period and to apply that rate to

year-to-date income or loss to calculate income taxes on a year-to-date basis. However, the existing guidance includes an exception for situations where the year-to-date loss in an interim period exceeds the expected loss for the full tax year. That guidance specifies that an entity should apply the annual effective tax rate to the year-to-date loss as long as the tax benefits for any losses are expected to be realized during the year or as a deferred tax asset at the end of the year. In other words, applying this guidance limits the income tax benefit recognized in the interim period to the income tax benefit recognized as though the year-to-date ordinary loss were the anticipated ordinary loss for the year.

ASU 2019-12 overview

ASU 2019-12 eliminates this interim-period exception, which means that an entity should no longer limit the tax benefit recognized in an interim period when the year-to-date loss exceeds the anticipated annual loss if it expects to realize any tax benefit during the year.

Transition approach

This change must be adopted using a prospective approach in the period of adoption.

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The FASB acknowledged that removing this exception could result in an entity recognizing tax benefits in a given period that exceed the tax benefits that would be received on the basis of the year-to-date loss. Given that this change in guidance must be adopted using a prospective approach, entities impacted by this change should consider providing additional disclosures if the comparability of their interim financial statements is significantly affected in the year of adoption.

C. Other simplifications

Franchise taxes that are partially based on income

In certain jurisdictions, franchise taxes are calculated using the greater of two computations—one based on income and one based on items other than income, such as capital. Existing guidance specifies that franchise taxes based on income should be included in income tax expense only to the extent that they exceed the franchise taxes that are not based on income.

ASU 2019-12 overview

ASU 2019-12 essentially flips this requirement so that the franchise taxes calculated based on income should now be included in income tax expense. If a franchise tax is partially based on income (for example, the entity pays the greater of an income-based tax and a non-income-based tax), the amount of current tax expense that is based on income should be included in income tax expense, and deferred tax assets and liabilities should be recognized and accounted for under ASC 740. To the extent that the franchise taxes not based on income exceed the franchise taxes based on income, the excess is recorded as a non-income-based tax expense. Under the new guidance, deferred tax assets and liabilities should be measured using the applicable statutory income tax rate, and an entity should not consider the effect of potentially paying a non-income-based tax in future years when evaluating whether its deferred tax assets will be realized.

Transition approach

Entities must adopt this change using either a retrospective or a modified retrospective approach in the period of adoption.

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Under the new guidance in ASU 2019-12, an entity may be required to remeasure its deferred tax assets and liabilities in the period of adoption. Additionally, because the new guidance changes the order of how an entity determines the amount of franchise tax to account for as an income tax, the reported amounts of pretax income and income tax expense could change. Given that entities have the choice of adopting this change either on a retrospective basis for all periods presented or on a modified retrospective basis with a cumulative-effect adjustment to retained earnings as of the beginning of the adoption period, entities impacted by this change may need to update their accounting processes to comply with this new standard.

Government transaction resulting in a step-up in the tax basis of goodwill

In some jurisdictions, an entity may obtain a step-up in the tax basis of assets by making a cash payment to the government in its capacity as a taxing authority or by surrendering some other tax attribute (such as a net operating loss carryover). In certain situations, the step-up in the tax basis as a result of the transaction with the government results in a step-up in the tax basis of goodwill. Under the existing guidance, if the step-up in the tax basis of goodwill relates to the portion of goodwill from a prior business combination for which a deferred tax liability was not recognized, then the guidance in ASC 740-10-25-54 prohibits an entity from recognizing a deferred tax asset for the increase in tax basis, except to the extent that the tax-deductible goodwill exceeds the remaining book balance of goodwill. Therefore, an entity is precluded from recording a deferred tax asset for the step-up in the goodwill tax basis, unless it recorded a deferred tax asset when the business combination occurred.

ASU 2019-12 overview

ASU 2019-12 requires an entity to determine whether the tax basis step-up transaction relates to (1) a previous business combination for which the book goodwill was originally recognized (in which case, a deferred tax asset would not be recognized unless the newly tax-deductible goodwill exceeds the remaining balance of book goodwill) or (2) a separate transaction (in which case, a deferred tax asset would be recognized, subject to valuation allowance considerations) on the basis of certain indicators included in ASU 2019-12. To the extent that a goodwill step-up transaction is considered a separate transaction unrelated to the original business combination, an entity should record a deferred tax asset for this additional tax basis in goodwill. The new guidance lists factors that may indicate that the step-up in tax basis relates to a separate transaction, which include, but are not limited to, the following:

- A significant lapse in time has occurred between the transactions.
- The tax basis in the newly created goodwill is not the direct result of a settlement of liabilities recorded in connection with the acquisition.
- The step-up in the tax basis is based on a valuation of the goodwill or business that was performed as of a date after the business combination.

- The transaction resulting in the step-up in the tax basis requires more than a simple tax election.
- The entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step-up in the tax basis.
- The transaction resulting in the step-up in the tax basis is not contemplated at the time of the business combination.

Transition approach

This change must be adopted using a prospective approach in the period of adoption for transactions with governments after the adoption date.

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As noted above, this guidance must be adopted using a prospective approach in the period of adoption. Therefore, companies impacted by this change should consider providing additional disclosures if the comparability of their financial statements is affected in the year of adoption.

Separate financial statements of legal entities that are not subject to tax

Under the existing guidance in ASC 740, consolidated current and deferred tax expense should be allocated among the members of a group of entities that files a consolidated tax return if those entities issue separate financial statements. This provision has created substantial diversity in practice as to whether entities allocate or do not allocate the consolidated amount of current and deferred taxes to the separate financial statements of single-member limited liability companies that are disregarded entities in their consolidated financial statements.

ASU 2019-12 overview

The guidance in ASU 2019-12 clarifies that an entity is not required, but may elect, to allocate the consolidated amount of current and deferred tax expense to the separate financial statements issued by legal entities that are both not subject to tax and disregarded by the taxing authority (for example, a single-member limited liability company). This new accounting policy election must be applied on an entity-by-entity basis. What's more, an entity cannot elect to allocate the consolidated amount of current and deferred tax expense for legal entities that are partnerships or other pass-through entities that are not wholly owned.

Transition approach

This change must be adopted using a retrospective approach in the period of adoption. The FASB clarified that retrospective transition applies only to the separate financial statements of those entities that elected to allocate current and deferred taxes.

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A single-member limited liability company or a similar disregarded entity that elects to recognize such an allocation must disclose that election and provide certain additional disclosures required by ASC 740-10-50-17.

Enacted changes in tax laws in interim periods

When there is a change in tax law (such as a change in the statutory tax rate), the existing guidance in ASC 740 requires an entity to recognize the impact of that change on deferred tax assets and liabilities in the reporting period that includes the enactment date. However, the interim-period guidance under ASC 740-270 requires entities to recognize the effect of a change in tax rate in the estimated annual effective tax rate at the enactment date or the effective date, whichever occurs later. As a result, if a rate change was enacted in one interim period but took effect in another interim period, there were inconsistencies with respect to calculating deferred tax balances and taxes payable in the interim period that included the enactment date.

ASU 2019-12 overview

The new guidance modifies the approach to accounting for tax law changes in ASC 740-270 so that entities will now reflect changes in tax law in the estimated annual rate in the period of enactment instead of in the period that includes the effective date. This change better aligns the interim-reporting framework with the overall guidance on accounting for changes in tax law.

Transition approach

This change in tax law must be adopted using a prospective transition approach in the period of adoption.

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Because this income tax simplification must be adopted on a prospective basis, applying this guidance could impact the comparability of the financial statements in the period of adoption, as comparative periods are not required to be restated. Therefore, entities impacted by this change should consider providing additional disclosures to help financial statements users understand the change in guidance.

D. Codification improvements

The existing guidance in ASC 740 simply states that entities should recognize the tax benefit of tax-deductible dividends on employee stock ownership plan shares in the income statement. In contrast, the new guidance ASU 2019-12 is more specific and clarifies that this tax benefit should be included in income or loss from continuing operations.

ASU 2019-12 also corrects a computational error in an example in ASC 323-740 that uses the equity method of accounting for a limited liability investment in a qualified affordable housing project.

E. Effective date

For public business entities, the guidance in ASU 2019-12 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. For all other entities, the standard is effective for fiscal years beginning after December 15, 2021 and for interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted, including adoption in an interim period for public business entities in periods for which financial statements have not yet been issued and for all other entities in periods for which financial statements have not yet been made available for issuance. If an entity adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. An entity that elects early adoption must adopt all the amendments in the same period.

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