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Technical Line

FASB — final guidance

FASB issues guidance that simplifies the accounting for income taxes

In this issue:

What you need to know

- The FASB issued final guidance that simplifies the accounting for income taxes by eliminating certain exceptions to the guidance in ASC 740 related to the approach for intraperiod tax allocation, the methodology for calculating income taxes in an interim period and the recognition of deferred tax liabilities for outside basis differences.
- The new guidance also simplifies aspects of the accounting for franchise taxes and enacted changes in tax laws or rates and clarifies the accounting for transactions that result in a step-up in the tax basis of goodwill.
- It clarifies that single-member limited liability companies and similar disregarded entities that are not subject to income tax are not required to recognize an allocation of consolidated income tax expense in their separate financial statements, but they could elect to do so.
- The guidance is effective for calendar-year public business entities in 2021 and interim periods within that year. For all other calendar-year entities, it is effective for annual periods beginning in 2022 and interim periods in 2023. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued **final guidance**[1] that simplifies the accounting for income taxes by eliminating some exceptions to the general approach in Accounting Standards Codification (ASC) 740, *Income Taxes*. It also clarifies certain aspects of the existing guidance to promote more consistent application, among other things.

Building a better working world

The new guidance is part of the FASB's broader simplification initiative that is aimed at reducing the cost and complexity of applying accounting standards. Stakeholders had recommended that the FASB make these changes to the guidance.

Key considerations

Exceptions the new guidance eliminates

The new guidance eliminates the following exceptions to the general approach in ASC 740:

Exception to the general intraperiod tax allocation principle

The amendments eliminate the legacy 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. As a result, entities that have been subject to the exception may see a change in the amount of income tax benefit they allocate to continuing operations.

The general guidance requires entities to first determine the tax effect of their pretax income from continuing operations without regard to the tax effect of the other items. However, the legacy exception in ASC 740-20-45-7 requires that, when an entity has a loss from continuing operations, all items (i.e., discontinued operations, other comprehensive income and so forth) be considered in determining the amount of the tax benefit from the loss from continuing operations that is allocated to continuing operations.

Stakeholders said this exception is difficult to apply and doesn't benefit users of the financial statements because the outcome is often counterintuitive. That is, a tax benefit may be allocated to continuing operations and an offsetting tax expense may be allocated to another item, even though total tax expense in the period is zero. Stakeholders also noted that there is diversity in practice in how the exception is applied.

The following illustration provides an example of the allocation of income tax expense after an entity adopts the guidance that eliminates the exception.

Illustration — Allocation of income tax expense after adoption of ASU 2019-12

Facts

Company A has a pretax loss from continuing operations of $10,000 and pretax income from discontinued operations of $12,000 for the year. Company A's income tax rate is 25%.

This example assumes that there are no temporary differences (i.e., the company's pretax financial income equals its taxable income) for simplicity. This example also assumes that the company would not be able to realize the benefit of the net operating loss (NOL) carryforward from the loss in continuing operations (i.e., would need a full valuation allowance) if it can't consider the income from discontinued operations.

The calculation of the total income tax expense would be the same under the legacy and new guidance and is shown below.

Calculation of the total income tax expense

Pretax loss from continuing operations	$ (10,000)
Pretax income from discontinued operations	12,000
Pretax income	$ 2,000
Income tax rate	25%
Total income tax expense	$ 500

Analysis under the new guidance

Company A will no longer be able to consider the pretax income recorded in other categories when it determines the tax benefit to allocate to continuing operations. Company A's total income tax expense is allocated between the loss from continuing operations and income from discontinued operations as follows:

Allocate income tax expense to continuing operations and other items

Income tax benefit allocated to continuing operations (income from discontinued operations is not considered in determining the amount allocated)	$ –
Income tax expense allocated to discontinued operations (total income tax expense less amount allocated to continuing operations or $500 - $0 = $500)	500
Total income tax expense	$ 500

Because Company A cannot consider income from other categories and would be unable to realize the benefit of the NOL carryforward without considering the income from discontinued operations, it cannot allocate any tax benefit to continuing operations. Instead, the entire amount of the total income tax expense is allocated to discontinued operations.

Analysis under the legacy guidance

Because there is a loss from continuing operations and income from other items, the exception to the general principle of allocating income tax expense to continuing operations applies, and the $12,000 income from discontinued operations is considered in determining the tax benefit that is allocated to continuing operations. Under this guidance, the total income tax expense of $500 is allocated to continuing operations and discontinued operations as follows:

Allocate income tax expense to continuing operations and other items

Income tax benefit allocated to continuing operations (realizable pretax loss from continuing operations of $10,000 * 25% tax rate)	$ (2,500)
Income tax expense allocated to discontinued operations (total income tax expense less amount allocated to continuing operations or $500 - $(2,500) = $3,000)	3,000
Total income tax expense	$ 500

In this example, the entire tax benefit from the loss from continuing operations is allocated to continuing operations.

The standard requires that the new intraperiod tax allocation guidance be applied prospectively in the period of adoption. The Board noted that the new guidance will not change the total reported amount of deferred taxes or total income tax expense. However, applying the new standard could affect the comparability of the financial statements in the period of adoption because the amount of income tax benefit allocated to continuing operations will be determined differently when there is a loss in continuing operations and a gain or income from other components.

How we see it

Companies that have losses from continuing operations and income from other categories in periods before and after adoption may need to consider whether to make additional disclosures in the notes to the financial statements or management discussion and analysis to help users understand the changes in the income tax expense allocated to continuing operations and effective tax rates.

Entities that prepare interim financial statements and are subject to the legacy exception will also need to consider the effect of the new guidance when determining their effective annual estimated tax rate in interim periods after adoption.

Exception to the general methodology for calculating income tax for an interim period

The amendments eliminate a legacy exception to the guidance on accounting for income taxes for interim periods. The interim reporting guidance in 740-270 addresses how and when income tax expense or benefit is recognized for an interim period and generally requires companies to make their best estimate of the annual effective tax rate for the full fiscal year in each interim period and apply that estimate to the year-to-date pretax income or loss to calculate income taxes on a year-to-date basis.

The new guidance reduces complexity and will make the application of ASC 740 more consistent.

If an entity has year-to-date ordinary losses that exceed the anticipated ordinary loss for the year and the entity expects to realize a tax benefit for all anticipated ordinary losses, a legacy exception in ASC 740-270-30-28 limits the income tax benefit recognized in the year-to-date interim period to the amount of the tax benefit determined based on the year-to-date ordinary loss. That is, an entity is not permitted to recognize tax benefits in excess of the amount that would be recognized if its year-to-date ordinary loss were the anticipated ordinary loss for the year. Under the new guidance, an entity would no longer limit the tax benefit recognized in an interim period if it expects to realize a tax benefit.

The elimination of the exception will not change the total income tax expense or benefit an entity will recognize on an annual basis, but it may change the amount of income tax expense or benefit recognized in interim periods.

How we see it

The Board noted it required a prospective transition approach for this amendment because interim reporting does not affect the amount of deferred taxes or income tax expense reported at the end of the year and, therefore, will not affect the comparability of annual financial statements. However, applying the amendment prospectively might affect the comparability of interim periods in the year of adoption. Companies may need to consider additional disclosure if the application of this amendment significantly affects the comparability of their interim results.

Exceptions to the recognition of deferred taxes when investment ownership changes

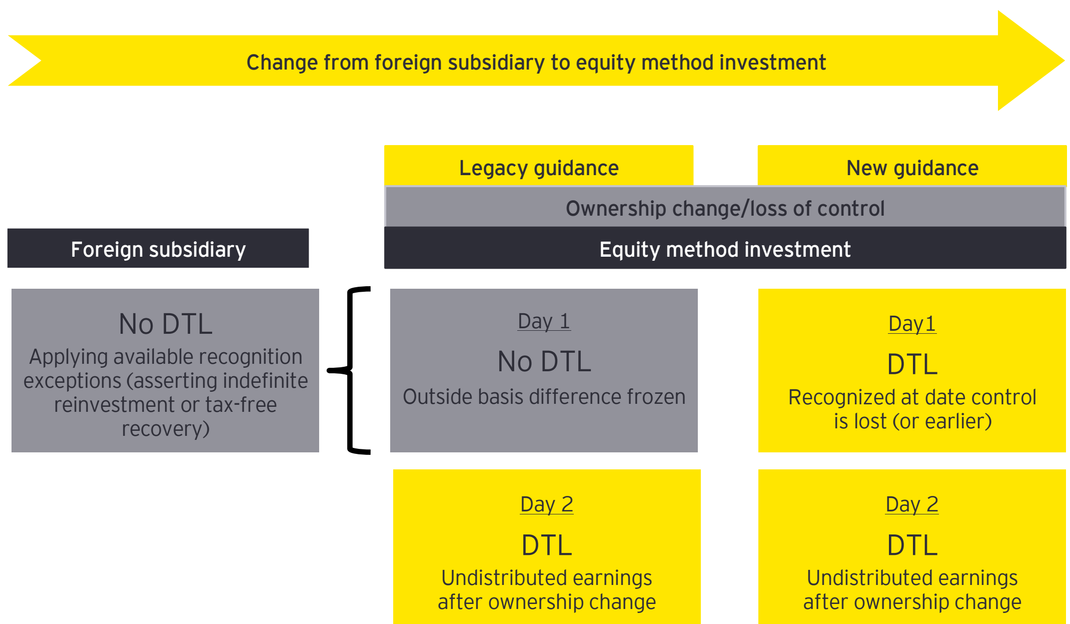
The amendments eliminate the exceptions to the general requirements for recognizing and not recognizing a deferred tax liability (DTL) related to the outside basis differences (e.g., undistributed earnings) that predate changes in ownership of equity method investments and foreign subsidiaries. Instead, the guidance will require entities to account for the tax effects of the entire outside basis difference that relate to an investment in which there is an ownership change as if the entity had always accounted for the investment based on the new ownership structure.

The FASB said the exceptions add to the cost and complexity of accounting for outside basis differences and reduce comparability because they apply to only the portion of the outside basis difference of an investment that existed before the change in ownership.

Entity loses control of a foreign subsidiary

Under the legacy exception in ASC 740-30-25-15, an entity, under certain circumstances, is required to continue to not recognize a deferred tax liability on the outside basis differences of a foreign subsidiary (or a corporate joint venture that was essentially permanent in duration) that existed before it lost control and became an equity method investment. That is, if the parent entity did not recognize income taxes on its outside basis difference because of the assertion that undistributed earnings were indefinitely reinvested or remitted in a tax-free manner, the legacy guidance requires that the outside basis difference be "frozen" (and no deferred tax liability would be recognized). Eliminating this exception will require an entity with a foreign subsidiary that becomes an equity method investment to record a deferred tax liability for the total outside basis difference related to the equity method investment on the date of the ownership change (or earlier).

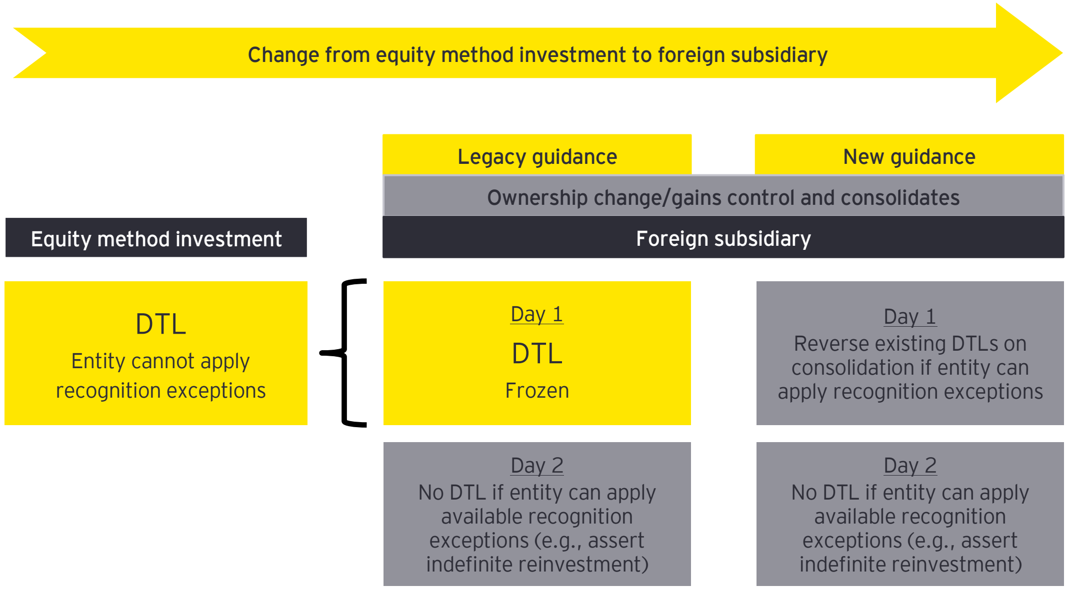
The following graphic compares the legacy guidance with the new guidance when an entity loses control of a foreign subsidiary.



Entity gains control of a foreign equity method investment

Under the legacy exception in ASC 740-30-25-16, an entity is required to "freeze" a deferred tax liability previously recognized for a foreign equity method investment if the investee becomes a subsidiary, even if the entity is able to apply the recognition exceptions in ASC 740 (for example, after obtaining control, the foreign earnings for periods prior to gaining control are indefinitely reinvested or can be remitted in a tax-free manner). The new guidance allows an entity to apply the exceptions to recognizing deferred tax liabilities on its outside basis differences that predate the change in ownership if it asserts its intent and it has the ability to indefinitely reinvest those earnings or remit them in a tax-free manner.

The following graphic compares the legacy guidance with the new guidance when an entity gains control of a foreign equity method investment.



An entity may elect to allocate income tax expense to the separate financial statements of an SMLLC.

How we see it

Requiring an entity to account for the tax effects of an entire outside basis difference that relates to a foreign investment based on the new ownership level will improve the comparability of financial statements and reduce the complexity of accounting for outside basis differences.

Other simplifications

Allocation of consolidated income tax expense to separate financial statements of entities not subject to income tax

The legacy guidance in ASC 740-10-30-27 requires the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return to be allocated among the members of the group when those members issue separate financial statements. The new guidance clarifies that an entity is not required to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are not subject to tax.

However, the new guidance allows an entity to make an election to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of legal entities that are both not subject to tax and disregarded by the taxing authority (e.g., a single-member limited liability company or SMLLC). The election is not required for all such members of a group that file a consolidated tax return. Therefore, an entity may elect to do so in the separate legal entity financial statements on an entity-by-entity basis. An entity cannot make the election 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.

Stakeholders had said that, under the legacy guidance, some groups that file consolidated tax returns allocate a portion of the current and deferred tax expense to SMLLCs not subject to income tax for presentation in the SMLLCs' separate financial statements, while others do not. The FASB added the clarification to address this diversity in practice.

The FASB said it is allowing SMLLCs and other similar disregarded entities (that are wholly owned by the entity) that are not subject to income tax to recognize an allocation of income taxes in their separate financial statements because certain entities (e.g., rate-regulated entities) may need to do so for business reasons. However, an SMLLC or a similar disregarded entity that elects to recognize such an allocation must disclose that fact and provide certain other disclosures required by ASC 740.

Accounting for the interim period effects of changes in tax laws or rates

The new guidance requires an entity to reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the first interim period that includes the enactment date of the new legislation. This amendment aligns the timing of recognition of the effects from enacted tax law changes on the effective tax rate with the effects on deferred tax assets and liabilities by requiring both effects to be recognized in the interim period including the enactment date.

The legacy guidance in ASC 740 requires an entity to recognize the effect of the enacted tax law on deferred tax assets and liabilities in the period of enactment and the effect of the enacted tax law on the annual effective tax rate (i.e., on the interim period income tax calculation) in the period that includes the effective date of the tax law.

Accounting for franchise taxes

Certain jurisdictions impose franchise taxes (or other similar taxes) that are calculated using the greater of two tax computations: one based on income and the other based on items other than income.

To reduce complexity in the calculation and recognition of deferred taxes, the new guidance amends ASC 740-10-15-4 to require entities to recognize the franchise tax by (1) accounting for the amount based on income under ASC 740 and (2) accounting for any residual amount as a non-income-based tax.

The legacy guidance in ASC 740 requires companies subject to this type of franchise tax (or other similar tax) to first account for the amount calculated based on items other than income as a non-income-based tax and then account for any residual amount under ASC 740.

The amendments provide guidance on the measurement of deferred tax assets and liabilities, stating they should be measured using the applicable statutory income tax rate. The amendments also clarify that an entity should not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets.

Because the new guidance changes the order of how an entity determines the amount of franchise tax to account for as income tax, the reported amounts of pretax income and income tax expense could change. In addition, in the period of adoption, an entity may also be required to remeasure its deferred tax assets and liabilities. The Board decided that entities may adopt this provision on a retrospective basis for all periods presented or a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption.

How we see it

Because a franchise tax may be imposed in multiple state, local and foreign tax jurisdictions, companies will need to first identify all jurisdictions that impose taxes based on the greater of two tax computations that they currently account for using the legacy guidance. If the number of these types of taxes or amounts are significant, implementing the new franchise tax guidance may be challenging and may require an entity to change its accounting systems and processes.

Accounting for a step-up in the tax basis of goodwill

Certain jurisdictions allow corporate taxpayers to elect to step up the tax basis of certain assets in exchange for a current payment to the taxing authority or in exchange for existing tax attributes (e.g., NOL carryforwards). Under the legacy guidance in ASC 740-10-25-54, when the tax basis step-up relates to goodwill from an earlier business combination that was not deductible, a deferred tax asset is not recorded for the increase in tax basis except for any amount of newly deductible goodwill that exceeds the remaining balance of book goodwill.

Stakeholders indicated that, in some situations, applying the guidance in ASC 740-10-25-54 does not represent the economics of the transaction, particularly when the step-up in the tax basis of goodwill occurred as a result of the entity using cash or existing tax attributes.

The new guidance clarifies the existing guidance and requires an entity to determine whether the step-up in tax basis relates to (1) the business combination in which the book goodwill was initially recognized, in which case no deferred tax asset would be recorded for the increase in basis (except for any amount of newly deductible goodwill that exceeds the balance of book goodwill), or (2) a separate transaction, in which case a deferred tax asset would be recorded for the entire amount of the newly created tax deductible goodwill, subject to a valuation allowance.

The new guidance lists factors that may indicate that the step-up in tax basis relates to a separate transaction. These factors include, but are not limited to, the following:

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

Codification improvements

The new guidance also made other improvements to ASC 740. It specifies in ASC 718-740-45-7 that the tax benefit of tax-deductible dividends on allocated and unallocated employee stock ownership plan shares must be recognized in continuing operations. It also corrects an error in the example in ASC 323-740-55-8 of the accounting for an investment in qualified affordable housing projects accounted for using the equity method, among other things.

Effective date and transition

For public business entities (PBEs), the guidance is effective for fiscal years beginning after 15 December 2020 and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021 and interim periods within fiscal years beginning after 15 December 2022.

Early adoption is permitted in interim or annual periods for which PBEs have not yet issued financial statements and all other entities have not made financial statements available for issuance. Entities that elect to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, entities that elect early adoption must adopt all the amendments in the same period.

Entities will apply the amendments prospectively, except for the following amendments:

- The election to allocate a tax provision to the separate financial statements of legal entities that are both not subject to tax and disregarded by the taxing authority, which is applied retrospectively for all periods presented
- The guidance on ownership changes to a foreign equity method investment or foreign subsidiary, which is applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption
- The guidance on franchise taxes that are partially based on income, which is applied either retrospectively for all periods presented or using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption

The guidance requires entities to make certain transition disclosures.

How we see it

- Entities may want to consider early adopting the guidance because it will simplify the accounting for income taxes, especially in the areas where exceptions to the general approaches in ASC 740 were eliminated.
- Entities should consider whether changes to their processes and internal controls are needed to implement the amendments.

Endnote:

[1] Accounting Standards Update (ASU) 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes.*