THOUGHT LEADERSHIP FROM THE BDO NATIONAL TAX ASC 740 SPECIALTY SERVICES

BDO KNOWS:

ASC 740

▶SUBJECT

ACCOUNTING ALERT

FASB Issues Exposure Draft on Tax Recognition for Intra-entity Asset Transfers and Balance Sheet Classification for Deferred Tax Items

SUMMARY

The FASB (or "Board") issued on January 22, 2015 an Exposure Draft (ED) to solicit public comments on two proposed changes to ASC 740, Income Taxes: (1) remove the intra-entity asset transfer exception, and (2) remove the "current" classification of deferred taxes. The Board also decided on a transition method, transition disclosure, and an effective date. The Board is seeking comments on the ED by May 29, 2015.

ELIMINATION OF THE INTRA-ENTITY ASSET TRANSFER EXCEPTION (PAR. 740-10-25-3(e)) (F/K/A "PAR. 9(e)" IN FAS 109)

Currently, this exception prohibits immediate recognition of the income tax effects from intra-entity transfers of assets. That is, the tax expense of the entity transferring or selling an asset is deferred on the balance sheet and amortized to income tax expense over the remaining recovery period of the asset and the tax basis step-up to the entity receiving or buying the asset is not recognized (i.e., the tax basis step-up would be tracked off-balance sheet). The Board is proposing to eliminate this exception.

ELIMINATION OF "CURRENT" CLASSIFICATION OF DEFERRED TAXES (PARS. 740-10-45-4 THROUGH 45-10)

This proposal would only affect entities which present a classified statement of financial position. Deferred income taxes are currently presented in a classified balance sheet as "current" and "noncurrent" based on the classification of the underlying asset or liability for which a deferred tax is recognized. Deferred tax assets ("DTAs") for income tax attribute carryforwards (for example, net operating losses ("NOLs"), income tax credits and the Alternative Minimum Tax credit) are classified based on their expected reversal pattern (i.e., their expected tax return utilization period). The Board is proposing to eliminate "current" classification and require "noncurrent" classification for all balance sheet deferred tax items. If this proposed change is finalized, the requirement to allocate a valuation allowance between current and noncurrent assets would no longer be necessary, since all deferred tax assets and liabilities would be classified as "noncurrent."

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TRANSITION METHOD

The Board is proposing a modified retrospective transition with a cumulative catch-up adjustment to opening retained earnings for the first proposal (the elimination of the intra-entity asset transfer exception), and a prospective transition period for the second proposal (the elimination of "current" classification).

TRANSITION DISCLOSURE

With respect to the first proposal, all entities will be required to disclose (1) the nature and reason for the change in accounting principle, (2) the cumulative effect to be recognized in the adoption year through an adjustment to opening retained earnings (for deferred tax charges existing as of the adoption date), (3) the effect on the year of adoption's results (i.e., tax expense with the intra-entity transfer exception vs. tax expense without the intra-entity transfer exception) and any affected per-share amounts for the current year. Public entities must provide the disclosures in the annual period in which they adopt the proposal and in the interim periods within that annual period. Private entities must provide the disclosures in the annual period in which they adopt the proposal.

With respect to the second proposal, all entities would be required to disclose (1) the nature of and reason for the change in accounting principle, and (2) that prospective adoption of "noncurrent" classification results in a lack of comparability with prior periods. This requirement is met by including a statement that prior periods were not restated to remove "current" classification of deferred taxes. Public entities must provide the disclosures in the annual period of adoption and in the first interim period within that year. Private entities must provide the disclosures in the annual period of adoption.

EFFECTIVE DATE

Public entities' effective date is the annual and interim periods, beginning after December 15, 2016. Private entities will have an additional year to adopt the proposals with respect to annual reports (i.e., annual periods beginning after December 15, 2017) and another year after adoption to take the proposals into account for interim reports (i.e., interim periods beginning after December 15, 2018). Private entities will be allowed to early-adopt the proposals (same period applicable to public entities). However, public entities are not allowed early adoption.

ADDITIONAL BACKGROUND

The key argument for proposing to remove the exception for intra-entity transfer of assets is the purported complexity when intangible assets are transferred or sold in intra-entity transactions. For example, intra-entity transfer of indefinite-lived intangible assets and goodwill may trigger a net tax effect to be deferred on the balance sheet and amortized into income tax expense over the remaining amortization period (if any) or economic useful life. When the intangible asset or goodwill is not amortized for book or tax, the deferred tax charge is either suspended indefinitely or until the asset is impaired or disposed of. Another question in practice is whether the release of a valuation allowance occurring in conjunction with intra-entity transfers should also be suspended. Further, there is an argument that the recognition of the income tax effects from intra-entity asset transfers in the period in which the transfer occurs is a better reflection of the economic consequences compared to current accounting.

The Board believes that recognition of current income tax paid or payable would better enable users to compare current tax expense and the effective tax rate to cash paid for income taxes. However, the ED acknowledges that the elimination of the recognition exception for intra-entity transfers of assets might (a) necessitate making changes in processes and systems to track additional temporary differences and (b) introduce greater volatility in earnings. The Board nevertheless believes that removing the exception is more beneficial than providing incremental clarifying guidance.

The reason for proposing "noncurrent" classification of all deferred taxes is to simplify the presentation of deferred taxes and thus reduce complexity. The Board noted the classification requirement does not provide useful information because it "generally does not reflect when a temporary difference will reverse and become a taxable or deductible item." Therefore, "current" classification of deferred taxes is not always an accurate estimate of deferred tax balances expected to reverse within the next accounting period. Additionally, some preparers question the usefulness of the "pro rata" allocation of valuation allowance between current and noncurrent gross DTAs when only some (but not all) deferred tax balances require a valuation allowance (e.g., a capital loss carryforward or a particular state or foreign country net operating loss carryforward).

BDO COMMENTS

BDO supports initiatives to reduce or eliminate unnecessary complexity from current U.S. GAAP. However, we question whether other areas in Topic 740 might warrant relief for a wider population of entities - for example, addressing common practice issues associated with valuation allowances and uncertain tax positions ("FIN 48 liabilities").

Stakeholders are encouraged to submit comment letters by the May 29, 2015 deadline.