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## ▶SUBJECT

# INCOME TAXES

## Income Tax Accounting Question & Answer Series #2 – Balance Sheet Presentation of Unrecognized Tax Benefits Pursuant to Accounting Standards Update (“ASU”) 2013-11

### PREFACE:

This Income Tax Accounting Question & Answer segment explains and illustrates the requirements of ASU 2013-11. The ASU principally concerns the balance sheet presentation of unrecognized tax benefits (“UTBs”), which are liabilities for income-tax-related positions which may be challenged on audit and ultimately disallowed in whole or in part. Generally, reporting entities are required to reduce a deferred tax asset (“DTA”) for a net operating loss (“NOL”), a similar tax loss (explained in Q&A 2 below), or an income tax credit carryforward (collectively referred to in this Q&A segment as a “Tax Attribute DTA”) by a UTB. However, there are important exceptions to the netting requirement, which are discussed in more detail below.

### Q&A 1: Why has the Financial Accounting Standards Board (“FASB”) issued ASU 2013-11, and when is it effective?

The FASB’s objective in issuing this ASU is to eliminate the diversity in how reporting entities have been presenting UTBs on their balance sheet. Since the implementation of FASB’s Financial Interpretation No. 48 (a/k/a FIN 48, which is now part of ASC 740), questions have arisen about the balance sheet presentation of UTBs when a Tax Attribute DTA would potentially be available to offset the tax if the UTBs were settled at their book values before the utilization of the Tax Attribute DTA. Some entities presented <u>all</u> UTBs as a reduction of a Tax Attribute DTA if the Tax Attribute DTA could offset the tax due on the settlement of UTBs (*i.e.*, “net presentation”). Other entities presented UTBs as liabilities and not as a reduction of the Tax Attribute DTA (*i.e.*, “gross -


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presentation"), unless the UTBs increased the Tax Attribute DTA; in that case, "net presentation" was used. The FASB's decision as reflected in the ASU is to require a balance sheet presentation that is consistent with how the entity expects to report the resolution of uncertain positions in its tax returns.

For public entities, the ASU is effective for fiscal years (and interim periods within those years) beginning after December 15, 2013. Hence, calendar year-end public entities must apply the ASU beginning in 2014. For non-public entities, the provisions of the ASU are effective for fiscal years (and interim periods within those years) beginning after December 15, 2014. Early adoption of this ASU is permitted.

The requirements of the ASU must be applied prospectively to all UTBs that exist as of the effective date; however, retrospective application is permitted.

### Q&A 2: What is meant by the phrase "a similar tax loss"?

The phrase "a similar tax loss" is not defined in the ASU. However, this term should include, for example, a DTA for a charitable contribution deduction carryforward, capital losses (which would require capital gain income in the United States jurisdiction), capital allowance deductions in certain foreign jurisdictions (such as the United Kingdom), and qualified deficits under section 952(c)(1)(B) of the Internal Revenue Code (*i.e.*, the "subpart f" rules). These types of losses, or tax attributes, are generally reported on a company's tax return as available to reduce taxable income but are effectively "suspended" from use pending the generation of a certain type or amount of taxable income. These suspended deductions are available to reduce incremental taxable income and the taxes that would be owed as a result of the disallowance of UTBs of the same character, and therefore were highlighted by the FASB for balance sheet netting treatment. As an example, subpart f qualified deficits may only be used to the extent the company earns subpart f income from the same qualified activity that generated the deficit. Therefore, a "qualified deficit" DTA would only be reduced by a subpart f income UTB from the same qualifying activity.

### Q&A 3: What are the balance sheet presentation requirements of ASU 2013-11?

A Tax Attribute DTA must be reduced by a UTB, unless: (1) the Tax Attribute DTA is not available at the reporting date, per the relevant tax law, to settle any additional income tax liability that would result from the disallowance of an uncertain tax position, (2) the relevant tax law does not require the entity to use, and the entity does not intend to use, the Tax Attribute DTA to offset the UTB, or (3) the UTB is also considered a deferred tax liability ("DTL") because it arises from a taxable temporary difference (see Q&A 5 which explains this "netting" exception).[1]

In all circumstances, UTBs may only be used to offset the specific DTAs identified in the ASU (*i.e.*, Tax Attribute DTAs). No other deductible temporary differences (*i.e.*, the excess of tax bases over book bases in assets and liabilities) may be offset.

The assessment of whether the relevant tax law allows for the utilization of a Tax Attribute DTA to offset a UTB should be made as of the reporting date by presuming that the tax position would be disallowed as of that date. This assessment should not consider or anticipate the effect of expiration of any statute of limitations or whether the DTA may otherwise be used to reduce taxable income or may expire prior to the settlement of the UTB. By assuming only facts that exist as of the reporting date, rather than requiring anticipation of future developments and their likelihood of occurrence, the analysis should be more straightforward and simpler to perform.

It is conceivable that an NOL carryforward which may be entirely reduced by a UTB liability in one or more accounting periods may reemerge in a later period if the UTB is recognized due to statute of limitation expiration or effective settlement (as defined in ASC 740) before the NOL is utilized. In this situation, the UTB liability that was netted against the DTA would be derecognized with a corresponding tax benefit. Conversely, an NOL carryforward may be entirely reduced by a UTB liability in one or more periods until it is utilized, at which time the UTB liability would reemerge (*i.e.*, the DTA would be derecognized with a corresponding deferred tax expense).

[1] ASC 740-10-45-10A.

## Q&A 4: What are other tax accounting interactions from adopting the requirements?

UTBs represent an "entity's potential future obligation to the taxing authority" for tax return positions, previously taken or expected to be taken, whose benefit cannot (or partially cannot) be recognized in the financial statements.[2] When the scheduling of temporary differences is necessary to determine the availability of future taxable income, UTBs should also be considered as they might affect the availability of taxable income in a carryback period and in future periods.[3] Therefore, practice has been to consider UTBs as a potential source of taxable income to support the realizability of a tax loss or an income tax credit carryforward, although UTBs are not specifically listed in ASC 740-10-30-18 along with the four listed sources of income potentially available to avoid a valuation allowance.

Interest accrued on a tax deficiency (if required by relevant tax law) would not be affected when an entity adopts this ASU. Entities that previously followed "gross presentation" were required to consider the availability of an NOL or an income tax credit carryforward to offset the additional tax for purposes of recognizing and measuring interest and penalties. If an income tax carryforward would be available to offset the tax that would be incurred on the settlement of UTBs under the provisions of the relevant tax law, the interest calculation would reflect that potential offset.[4] The ASU effectively conforms the balance sheet presentation of UTBs and available NOLs to the income statement recognition and measurement of interest related to UTBs.

The following example illustrates the requirements of the ASU and the interaction with a valuation allowance analysis and the recognition and measurement of interest and penalty:

Company A is a United States multinational public entity which has a $12.5 million capital loss carryover which originated in the prior year (20x1) and has a five-year carryforward period. The company's applicable United States tax rate is 40% and its capital loss DTA is $5 million. Company A had appropriately recognized a valuation allowance of $5 million inasmuch as it had neither capital gain in any carryback year permitted by United States federal tax law nor tax planning strategies to generate capital gain income.

**The following journal entries were made in 20x1:**

| | | |
|---|---|---|
| Debit: Capital Loss DTA | $5 million | |
| Credit: Deferred Income Tax Benefit | | ($5 million) |
| (20x1 entry to recognize a capital loss DTA) | | |

| | | |
|---|---|---|
| Debit: Deferred Income Tax Benefit | $5 million | |
| Credit: Capital Loss Valuation Allowance | | ($5 million) |
| (20x1 entry to recognize a valuation allowance) | | |

In the current year (20x2), Company A has taken a position that it has sufficient tax basis in one of its foreign subsidiaries to classify a $20 million current-year distribution from that subsidiary as a nontaxable reduction in its subsidiary stock basis, rather than as capital gain. The tax return position is not considered sustainable based on technical merits.

**20x2 Analysis:**

The $20 million return of basis is recognized as a UTB of $8 million ($20 million times 40%) in the current year because the position fails recognition on technical merits. The relevant United States tax law requires Company A to use its capital loss carryover to offset the capital gain income from the uncertain position and management intends to utilize the capital loss if needed to offset the tax from the UTB. Therefore, Company A has appropriately released a valuation allowance of $5 million in the current year (it is assumed, for this example, that the current year distribution is based on new information that was not available as of last year when Company A analyzed its valuation allowance requirements).

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[2] ASC 740-10-25-16.
[3] ASC 740-10-55-21.
[4] ASC 740-10-25-56. An entity begins recognizing interest expense in the first period the interest would begin accruing according to the provisions of the relevant tax law.

**The following journal entries were made in 20x2:**

| | | |
|---|---|---|
| Debit: Income Tax Expense | $8 million | |
| Credit: FIN 48 Liability | | ($8 million) |

(20x2 entry to recognize the UTB)

| | | |
|---|---|---|
| Debit: Capital Loss Valuation Allowance | $5 million | |
| Credit: Deferred Income Tax Benefit | | ($5 million) |

(20x2 entry to recognize the benefit from the $12.5 million capital loss carryforward)

**Balance Sheet Presentation, Interest on UTB, and Tax Footnote Disclosure:**

Prior to the adoption of the ASU, Company A's policy had been to follow "gross presentation" unless the UTB increased an operating or capital loss deduction. In this circumstance, the capital loss DTA and the UTB would have been separately presented on the balance sheet because they are two unrelated positions.

Under ASU 2013-11, Company A must offset the $5 million capital loss DTA with the $5 million capital gain UTB ("net presentation"), even though they are unrelated positions. This presentation is required because the relevant tax law requires Company A to utilize its capital loss to offset the capital gain income that would be generated assuming the UTB was settled at its book value as of the end of the current year. Hence, Company A appropriately released the valuation allowance of $5 million in the current year.

The remaining $3 million capital gain UTB would be presented in other liabilities, which is the balance sheet line item in which Company A presents its FIN 48 liabilities. Company A would measure and recognize interest on the $3 million UTB amount that is not offset by a capital loss carryforward DTA.

The tax footnote table disclosure of the significant components of deferred taxes would not include a capital loss DTA of $5 million because the DTA is reduced by a $5 million UTB. Company A would nonetheless disclose in the narrative of the tax footnote the existence of a $12.5 million capital loss tax carryforward with its remaining carryforward period of three years. Company A's UTBs rollforward table disclosed in the tax footnote would include an $8 million current year increase in UTB.

If Company A were to generate capital gain income in subsequent years from a disposal of an asset while the capital gain UTB is still outstanding, a deferred tax expense would be determined as if the DTA was never reduced by a UTB and the capital gain UTB of $5 million that has been netted against the DTA would then be presented "gross" within other liabilities (a total of $8 million capital gain UTB).[5] For example, if in the subsequent year (20x3) Company A were to generate $12.5 million of capital gain income from an asset disposal, it would make the following entries:

| | | |
|---|---|---|
| Debit: Deferred Income Tax Expense | $5 million | |
| Credit: Capital Loss DTA | | ($5 million) |

(20x3 entry to recognize tax expense from a new source of capital gain income and the utilization of a capital loss carryforward DTA)

Conversely, if the UTB is effectively settled (or the relevant statute of limitation expires) before the utilization of the capital loss DTA, Company A would recognize an income tax benefit of $8 million from the reversal of the FIN 48 liability and a deferred tax expense of $5 million from restoring a capital loss valuation allowance of $5 million, absent a new source of capital gain income. The following is an example of the journal entries the company would make:

[5] Note that if Company A generates future ordinary losses or credits that can be carried back to 20x2 to offset the capital gain UTB, then these would be netted with the UTB.

| | | |
|---|---|---|
| Debit: FIN 48 Liability | $8 million | |
| Credit: Income tax benefit | | ($8 million) |

| | | |
|---|---|---|
| Debit: Deferred Tax Expense | $5 million | |
| Credit: Capital Loss Valuation Allowance | | ($5 million) |

(20x3 entry to derecognize the UTB and reestablish a valuation allowance)

Note that the netting of the FIN 48 liability against the DTA does not change how the company determines deferred tax expense or benefit, and also that the characterization of the income statement expense or benefit depends on the specific asset/liability that is being adjusted (whether DTA, valuation allowance, or UTB) and not on the net balance sheet presentation.

## Q&A 5: What is a UTB related to a taxable temporary difference and why is it not allowed to reduce a Tax Attribute DTA?

Uncertain tax positions taken *or expected to be taken* on tax returns may affect the timing of income or loss as well as tax bases in assets or liabilities. Temporary differences are differences between the book basis of assets and liabilities and their tax basis *as determined under the recognition and measurement principles of ASC 740*.[6] A UTB that arises from a taxable temporary difference is classified as a DTL.[7]

For example, a business entity based in the United States may emerge from bankruptcy and thus be allowed to avoid paying its debt. The canceled debt results in taxable income which in a bankruptcy setting is "paid" by reducing tax bases of certain assets which survived the bankruptcy. The entity expects to take a tax return position related to tax basis reduction, which is not considered sustainable based on the position's technical merits. The entity expects to claim the tax basis carryover as of the date of emergence from bankruptcy, amortized over time. However, because the position is not considered sustainable, the tax basis expected to be amortized in future periods is a UTB and also a DTL inasmuch as it arises from taxable temporary differences. The UTB DTL would be reclassified to UTB income tax payable as the entity deducts the basis in future tax returns.

The ASU does <u>not</u> permit UTBs that are also DTLs to reduce a DTA for a Tax Attribute DTA because the presumed disallowance of such UTBs would not result in additional taxable income as of the reporting date (rather, the additional income would be generated in future periods as future tax deductions would be subject to disallowance).

UTBs that are also DTLs would be included in the income tax footnote disclosure of the UTB rollforward table (for public entities).

## Q&A 6: What are the income tax footnote disclosure implications related to the UTB rollforward table and the disclosure of significant components of deferred tax assets?

The ASU does not require new recurring disclosures in the financial statements, nor does it affect the UTB rollforward table that is required to be disclosed in the tax footnote (for public entities). UTBs that are required to reduce DTAs for NOLs, similar losses, or tax credit carryforwards should still be shown at their <u>gross amount</u> in the UTB rollforward table of the tax footnote (for public entities). However, a Tax Attribute DTA would be presented in the *component of deferred taxes* table <u>net</u> of the UTBs that are required to reduce the DTA. The sum of all deferred taxes presented in the *component of deferred taxes* table should be the same as the total of all deferred taxes presented on the balance sheet. It may also be useful to disclose in the footnote narrative the gross amount of the tax attributes (NOL, credit carryforward, etc.) per the tax return.

[6] ASC 740-10-25-17.
[7] ASC 740-10-45-12.

## Q&A 7: Is there a similar requirement under International Financial Reporting Standards ("IFRS")?

IFRS takes a different approach. Accordingly, deferred tax assets are recognized only to the extent that it is probable that taxable profit will be available against which deductible temporary differences, tax losses and tax credits can be utilized. That is, a single net amount is included on the balance sheet, with disclosures being made of the amount and expiration date (if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no asset has been recognized.

When determining the threshold for recognition of deferred tax assets, the most common approach is to interpret "probable" as meaning "more likely than not" (that is, greater than 50% probability), which is consistent with how that definition is used elsewhere in IFRS.

During 2014, the IFRS Interpretations Committee has been discussing a request to clarify the accounting for assets and liabilities arising from UTBs. The Committee has noted that a key issue is the measurement of those assets and liabilities, and it has tentatively decided to proceed with a project on this topic. At future meetings, the Committee will discuss:

- The scope of the project;
- The unit of account for measurement of UTBs; and
- The possible approach for the measurement method(s).

For measurement method(s), the Committee has noted that guidance for measurement of uncertain amounts, contained in the recently released IFRS 15, *Revenue from Contracts with Customers* (with which ASU 2014-09 *Revenue from Contracts with Customers (Topic 606)* is fully converged), could be relevant when developing the proposals for UTBs.

In addition, the Committee has discussed the extent to which detection risk should be reflected in the measurement of tax assets and liabilities arising from UTBs. Its tentative conclusion is that 100% detection risk should be assumed, meaning it should be assumed that the tax authorities will have full knowledge of all relevant information and will examine the amounts reported to them.

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