

THOUGHT LEADERSHIP FROM THE BDO NATIONAL ASSURANCE DEPARTMENT

# BDO KNOWS:

## ASC 740



### SUBJECT

## INTRA-ENTITY TRANSFERS OF ASSETS OTHER THAN INVENTORY

### SUMMARY

The FASB issued ASU 2016-16<sup>1</sup> in October 2016 eliminating the existing exception in GAAP that prohibits the recognition of income tax consequences for most intra-entity asset transfers. The exception has been retained for intra-entity asset transfers of inventory only. As a result, entities will now be required to recognize current and deferred income tax consequences of intra-entity asset transfers (other than those of inventory) when the transfer occurs.

The new standard takes effect in 2018 for public companies and is available [here](#). Early adoption is permitted in the first interim period of the annual period in which the ASU is adopted. On adoption, the unamortized deferred tax on intra-entity asset transfers would be charged to opening retained earnings, avoiding the income tax expense that would otherwise be recognized. Additionally, an unrecognized deferred tax asset from intra-entity asset transfers, net of any valuation allowance, would also be initially recognized through retained earnings. Reporting entities should begin to plan for transition.

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<sup>1</sup> Intra-Entity Transfers of Assets Other Than Inventory

## DETAILS

### *Background*

Under current accounting, the income tax effects (i.e., current and deferred) from all intra-entity transfers of assets (i.e., transfers between members of a consolidated reporting entity)<sup>2</sup> are deferred and generally either amortized into income tax expense over the economic useful life of the asset, or recognized when the asset is sold outside the reporting entity or impaired. The entity transferring an asset (“seller”) records the net tax effect (i.e., current plus deferred) on the balance sheet as a prepaid tax,<sup>3</sup> and the tax basis step-up in the entity receiving the asset (“buyer”) is not recognized in the reporting entity’s consolidated financial statements.<sup>4</sup> Generally, intra-entity tax consequences arise in transfers between different tax paying entities or tax-paying components (an individual entity or group of entities that is consolidated for tax purposes)<sup>5</sup> included in the reporting entity’s consolidated financial statements. If a FIN 48 uncertain tax benefit liability arises from an intra-entity asset transfer, it is also required to be deferred and amortized into income tax expense over the economic useful life or until settlement is reached if sooner.

This rule is an exception to the comprehensive recognition principle of all income tax effects in ASC 740. The recognition exception effectively normalizes the tax rates when an asset is initially transferred and in subsequent periods as the related income is recognized.

Below is an example that illustrates the consolidated financial reporting implications from an intra-entity asset transfer under current accounting:

U.S. domestic entity A (“seller” or “A”) and foreign entity B (“buyer” or “B”) are members of the same consolidated reporting entity. A’s tax rate is 40% (federal and state) and B’s tax rate is 15% and both are taxpayers (i.e., no valuation allowance). Entity A has net operating loss (NOL) carryforwards of \$150 million which it has been utilizing in recent years (i.e., A has had pre-NOL taxable income in all recent years). In the current period, A transfers to B a previously acquired amortizable intangible asset having a book value of \$100 million and zero tax basis in a taxable transaction (the remaining book amortization period is 3 years). Entity A maintains a deferred tax liability of \$40 million (taxable difference of \$100 million times 40%). The transfer pricing is \$120 million which reflects the current fair market value. Entity A has no current tax liability since its pre-NOL taxable gain (selling price of \$120 million) is offset by an equivalent amount of NOL carryforwards. The transfer, however, results in a deferred tax benefit of \$40 million (a deferred tax liability of \$40 million is released) and a deferred tax expense of \$48 million for the utilization of NOL carryforwards. Therefore, A’s net tax effect from the intra-entity transfer of the intangible asset is \$8 million (a deferred expense of \$48 less a deferred benefit of \$40). Entity B is allowed a tax basis step-up in its jurisdiction for the purchase price of \$120 million which yields a deferred tax benefit of \$3 million (purchase price of \$120 million less book basis of \$100 million times 15%). The intra-entity transaction is considered sustainable (based on technical merits) at the more likely than not level of confidence.

<sup>2</sup> The ASC’s Master Glossary defines the term intra-entity as: “Within the reporting entity. This could be transactions or other activity between subsidiaries of the reporting entity, or between subsidiaries and the parent of the reporting entity. Also called intercompany.”

<sup>3</sup> Prepaid tax or “deferred charge” is an asset representing a past tax event, and is thus not subject to revaluation for tax rate changes or to the realizability evaluations of ASC 740.

<sup>4</sup> ASC 810-10-45-8 requires that taxes paid on intra-entity profits on assets remaining within the consolidated group be deferred and any intra-entity profits be eliminated in consolidation, while ASC 740-10-25-3(e) provides an exception to the general recognition rule for deferred tax assets for basis differences related to intra-entity asset transfers.

<sup>5</sup> ASC 740-10-30-5

## Journal Entries (in '000,000):

Debit: Deferred Tax Expense	\$48	
Credit: Deferred Tax Asset		\$48

(Entry to recognize deferred tax expense in A's jurisdiction for NOL utilization)

Debit: Deferred Tax Liability	\$40	
Credit: Deferred Tax Benefit		\$40

(Entry to recognize the release of the previously recorded deferred liability in A's jurisdiction)

Under the existing accounting exception, the deferred tax asset of \$3 million resulting from the tax basis step-up in B's jurisdiction of \$120 million is not allowed to be recognized in the consolidated financial statements. Instead it is effectively tracked "off-balance sheet" while it is being utilized on B's local income tax return (tax amortization is also assumed to be three years for simplicity).

Over the remaining recovery period of three years, the consolidated financial statements would reflect the amortization of the prepaid tax (\$8 million) and the utilization of the off-balance sheet deferred tax benefit (\$3 million) in the following manner:

Debit: Income tax Expense	\$2.6	
Credit: Prepaid Tax		\$2.6

(Entry to amortize 1/3 of the prepaid tax or \$8 divided by 3)

Debit: Income Tax Payable	\$1	
Credit: Income Tax Expense (Benefit)		\$1

(Entry to recognize 1/3 of the tax basis step-up or \$3 divided by 3 in the buyer's jurisdiction)

Under current accounting, there is no impact on the effective tax rate in the period of transfer as the pretax income/gain of \$20 million is eliminated and the net tax effect of \$5 million is deferred in consolidation. This is changed by ASU 2016-16 as explained below.

### **History of ASU 2016-16:**

The FASB had twice considered eliminating the exception but eventually decided to retain the accounting due to significant concerns from various stakeholders. However, in 2014 the FASB decided to reconsider the exception as part of its Simplification Initiative. The initial proposal issued in early 2015 required recognition of both the current and deferred income tax consequences of *all* intra-entity asset transfers (i.e., including transfers of inventory) when the transfer occurs, which would conform U.S. GAAP to IFRS. However, after receiving many comments, the FASB reached a final decision in 2016 to retain the exception for inventory assets only, while eliminating it for all other assets.<sup>6</sup>

### **BDO OBSERVATION**

In our comment letter, we generally supported the FASB's original proposal to eliminate the exception for intra-entity transfers of all assets including inventory, or alternatively to leave prior GAAP unchanged. However, under the ASU, retaining the exception for inventory transfers, but eliminating it for all other assets, will require detailed tracking, which may be challenging in practice. Reporting entities will need to closely monitor their intra-entity transfers of inventory to ensure they defer all income tax effects until the inventory is sold outside the group or impaired. See below for additional discussion on inventory transfers.

<sup>6</sup> The Board determined that eliminating the exception for inventory transfers would not have resulted in significantly more useful information for users of financial statements to justify the considerable implementation costs.

**ASU 2016-16 Main Provisions:*****Elimination of the Existing Exception for Non-Inventory Assets***

The ASU eliminates the exception for intra-entity asset transfers other than inventory so that an entity's consolidated financial statements reflect the current and deferred tax consequences of intra-entity asset transfers (other than those of inventory) when the transfer occurs. That is, intra-entity asset transfers including intangible assets, property, plant and equipment, real estate, and financial assets are subject to the change. Inventory, as defined in the ASC Master Glossary, is excluded. Generally, tax consequences arise in asset transfers between different tax paying entities (or different tax consolidation groups) of a consolidated reporting entity.<sup>7</sup>

While the tax effects are now required to be recognized, the pretax profit from all intra-entity transfers is still required to be deferred or eliminated under the consolidation procedures of Topic 810.

To account for these tax consequences:

1. A current tax liability should be recognized for the estimated taxes payable on tax returns for the current year; and
2. A deferred tax asset (DTA) should be recognized for the estimated future tax effects attributable to the temporary difference between the buyer's tax basis in the asset and the book basis as reported on the consolidated financial statements (i.e., the seller's book basis).

If the intra-entity transfer also results in an uncertain tax position, the associated FIN 48 uncertain tax benefit liability is required to be recognized (i.e., it is no longer deferred).

The following example illustrates the change:

U.S. domestic entity X has a \$10 million cost basis in an intellectual property asset for which the tax basis is zero. In the current period, Entity X transfers the asset in a cross-border intra-entity transaction to a related foreign entity (a different tax-paying component) for \$20 million. Entity X's tax rate is 40% (federal and state) and the foreign subsidiary's tax rate is 10%. Entity X has a deferred tax liability of \$4 million when the asset is transferred to the foreign subsidiary. Entity X's tax liability is \$8 million (transfer price of \$20 million less zero tax basis times 40%). The foreign subsidiary obtains a tax basis of \$20 million. The intra-entity transaction is considered sustainable (based on technical merits) at the more likely than not level of confidence.

The following entries should be made when the transfer occurs (in '000,000):

Debit: Income Tax Expense	\$8	
Credit: Current Tax Payable		\$8
(Entry to recognize the estimated current U.S. tax liability)		
Debit: Deferred Tax Liability	\$4	
Credit: Income Tax Expense		\$4
(Entry to release U.S. deferred tax liability)		
Debit: Deferred Tax Asset	\$1	
Credit: Deferred Tax Expense		\$1
(Entry to recognize a foreign deferred tax asset)		

<sup>7</sup> ASC 740-10-30-5

As illustrated above, under ASU 2016-16, the net tax effect of an intra-entity asset transfer (except inventory) is required to be recognized in the period of transfer (i.e., it is no longer deferred).

The deferred tax asset, which under current accounting is not allowed to be recognized, is recognized under ASU 2016-16 for the difference between the buyer's tax basis (\$20 million in this example) and the consolidated book basis (\$10 million in this example). The book basis is not affected by the intra-entity transfer (i.e., book basis in consolidated financial statements is unchanged).

Unlike the current accounting, under ASU 2016-16 the consolidated effective tax rate will be affected in the period of transfer, because the net tax effect is required to be recognized (instead of deferred), while the pretax gain is still required to be eliminated.

In this example, this intra-entity transfer results in a net tax expense of \$3 million that increases the effective tax rate in the period of transfer (i.e., a permanent effect on the rate). In contrast, when the intra-entity profit is recognized in the consolidated income statement (in this example, there is an estimated profit of \$10 million when the asset is consumed in the consolidated group), there will be no tax effect to match against the income since the net tax effect has already been recognized. However, a consolidated profit exceeding \$10 million would result in a 10% tax effect. For example, if Entity X is able to generate \$25 million revenue from customers, there would be additional profit of \$5 million and a tax expense of \$500 thousand (10% times \$5 million) assuming foreign earnings are reinvested outside the U.S. This illustrates how the entity reduced its overall income tax by shifting excess profit to a lower tax jurisdiction.

Public business entities will have to disclose these tax effects in the tax rate reconciliation disclosure and related MD&A discussion.

### *Retention of Exception for Inventory Property*

For intra-entity asset transfers of inventory only, recognition of current and deferred income tax consequences will continue to be deferred until the inventory has been sold to an outside party or otherwise has left the group (e.g., impaired and/or discarded). The FASB does not expect that entities will have substantial difficulty distinguishing those assets that meet the GAAP definition of inventory,<sup>8</sup> for which the exception is retained, versus those assets that are non-inventory in character and should be accounted for under the ASU's new requirement.

When inventory is transferred in an intra-entity transaction involving two tax-paying entities, ASC 740-10-25-3(e) will continue to preclude the recognition of a DTA for the difference between the tax basis in the buyer's tax jurisdiction and the cost as reported in the consolidated financials. The tax basis in the buyer's jurisdiction must be tracked off-balance sheet. Similarly, ASC 810-10-45-8 will continue to preclude recognition of an expense incurred (or sometimes a tax benefit if inventory is transferred at below book and tax basis) as a result of the intra-entity inventory transfer. Rather, the tax expense to the seller would be deferred on the balance sheet in consolidation (as a "prepaid tax" or "deferred charge") and recognized in income tax expense when the inventory is sold outside the group or is impaired.

The following example illustrates the application of the retained exception to intra-entity transfer of inventory between a U.S. parent of the consolidated reporting entity ("USC") and its foreign subsidiary ("FC"):

USC owns inventory with a cost basis of \$10 million and tax basis of \$12 million (excess tax basis due to tax requirement to capitalize certain costs that were expensed for book). In the current period, USC transfers the inventory to FC for \$13 million. In the subsequent period, FC sells all of the inventory to customers in its jurisdiction for a 20% markup or a selling price of \$15.6 million.

<sup>8</sup> The ASC's Master Glossary defines the term inventory as: "The aggregate of those items of tangible personal property that have any of the following characteristics: (a) held for sale in the ordinary course of business, (b) in process of production for such sale, or (c) to be currently consumed in the production of goods or services to be available for sale." See appendix for an expanded definition.

USC's combined federal and state tax rate is 40%. USC is a current taxpayer (no losses or valuation allowance) and it maintains a deferred tax asset of \$800 thousand for the excess tax-over-book basis in the inventory. FC's tax rate is 10% and its tax basis in the inventory immediately after the transfer is the transaction's transfer price of \$13 million which is assumed to be a sustainable pricing position under U.S. and international transfer pricing rules.

The intra-entity inventory transfer triggers (1) a U.S. current tax expense of \$400 thousand (selling/transfer price of \$13 million less tax basis of \$12 million times 40%), (2) a U.S. deferred tax expense of \$800 thousand and (3) a foreign deferred tax benefit of \$300 thousand (tax basis of \$13 million in excess of book basis of \$10 million times 10%). The subsequent sale to customers triggers a foreign tax expense of \$260 thousand (selling price of \$15.6 million less tax basis of \$13 million times 10%).

USC would also recognize pretax income of \$3 million in its separate general ledger. However, in consolidation the pretax income is eliminated pursuant to the consolidation requirements in Topic 810 (the recognition and elimination of pretax income is not illustrated in this example).

The following tax adjustments should be made when the transfer occurs (in '000):

Debit: Income Tax Expense	\$400	
Credit: Current Tax Payable		\$400
(Entry to recognize the estimated current U.S. tax liability)		
Debit: Deferred Tax Expense	\$800	
Credit: Deferred Tax Asset		\$800
(Entry to reverse U.S. deferred tax asset previously recorded)		
Debit: Prepaid Tax	\$1,200	
Credit: Income Tax Expense		\$1,200
(Consolidation entry to defer recognition of USC's net tax expense) <sup>1</sup>		

In this illustration, the intra-entity profit (\$3 million) is eliminated and the related U.S. tax effect (\$1.2 million) is deferred in consolidation. Further, FC's tax basis step-up is not allowed to be recognized in the consolidated financial statements (see footnote 8).

The following entries should be made in the subsequent period when FC sells the inventory to its customers (in '000):

Debit: Income Tax Expense	\$1,200	
Credit: Prepaid Tax		\$1,200
(Entry to release the deferred charge to income tax expense)		
Debit: Current Income Tax Expense	\$260	
Credit: Current Tax Payable		\$260
(Entry to recognize the current foreign tax liability)		

In the period the inventory is sold to customers, the reporting entity would recognize pretax profit of \$5.6 million (selling price of \$15.6 million less book basis of \$10 million) and a total tax expense related to the sold inventory of \$1.46 million (an effective tax rate of about 26%).<sup>9</sup> In this example, the intra-entity transfer of inventory resulted in tax savings due to booking incremental profit of \$2.6 million in the foreign jurisdiction where the tax rate is 10% (assuming the intra-entity transfer pricing is acceptable under relevant transfer pricing rules and USC permanently reinvests accumulated foreign earnings).

#### **BDO OBSERVATION**

While the recognition exception for intra-entity transfers of assets has been a long-standing U.S. GAAP rule, care should be exercised now that the FASB has decided to retain the recognition exception only for inventory. The inventory illustration above highlights the need to track the deferred tax charge and release it to income tax expense when the inventory is sold outside the group or is impaired. This could be challenging when the inventory disposal cycle straddles two or three accounting periods (i.e., tracking requirements for inventory would now be different than non-inventory). Reporting entities should have robust internal controls over this aspect of the income tax provision process. Another important aspect of retaining the recognition exception for inventory transfers is the consideration of valuation allowance accounting. One complexity that was supposed to be resolved with the elimination of the exception was whether the release of a valuation allowance concurrent with an intra-entity transfer of an asset which generates a taxable gain should also be deferred. The ASU does not address this complexity and therefore professional judgment will be required to determine whether the release of a valuation allowance due to taxable income from intra-entity transfers of inventory should also be deferred.

#### ***Outbound Transfers of Intangible Property under Section 367(d)***<sup>10</sup>

The ASU is responsive to increasingly common cross-border outbound transfers of intellectual property. U.S. tax rules governing cross-border transfers of intangible assets are complex and unique. For example a U.S. entity can elect to treat an outbound transfer of intellectual property as an outright sale or as a “delayed recognition” transaction for U.S. federal tax purposes. Outright sale treatment triggers taxable income recognition in the period of transfer, whereas a deferred gain transaction requires inclusion of U.S. taxable income in future periods. The latter treatment is governed by Internal Revenue Code section 367(d) which requires the U.S. entity to include “deemed royalties” throughout the economic useful life of the intangible asset. Furthermore, the “deemed royalties” must be “commensurate with income,” which generally means royalties must reflect the income producing capacity of the intangible asset. That is, the U.S. entity is taxed annually on deemed royalties which must reflect arm’s length transfer pricing.<sup>11</sup>

A question arises as to how to account for the future income tax consequences of outbound transfers of intellectual property transactions governed by section 367(d). The ASU does not address this question and professional judgment is required as in many of these outbound transfers neither the book basis nor the U.S. tax basis changes.

One view is to accept the tax law construct of delayed recognition and recognize income tax expense in future periods as the deemed royalties are included in the U.S. tax return. That is, there would be no income tax accounting to record in the period of transfer since there is no taxable temporary difference to account for. This view is premised on the fact that for U.S. income purposes, the U.S. tax liability is not considered “fixed and determinable” at the time of the transfer. Under this view, income tax expense is matched with income generated from consumption of the asset and it requires no adjustment (unless deemed royalties in this situation are considered an uncertain tax position/benefit).

<sup>9</sup> The effective tax rate of 26% is comprised of (i) consolidated pretax income of \$5.6 million, less (ii) US tax expense of \$1.2 million, less (iii) foreign tax expense of \$560 thousand minus unrecorded tax benefit from the tax basis step-up of \$300 thousand for a total foreign tax expense of \$260 thousand.

<sup>10</sup> Transfers of intangible property (within the meaning of Internal Revenue Code section 936(h)(3)(B)) by a U.S. person to a related foreign corporation in a non-recognition exchange described in section 351 or 361 are treated as a sale in exchange for payments contingent upon the productivity, use, or disposition of the asset.

<sup>11</sup> U.S. transfer pricing rules under Internal Revenue Code section 482 apply to these transactions.

There might be other acceptable views. Reporting entities undertaking outbound transfers of intellectual properties should consult with their financial statement auditors and tax advisors to determine the most appropriate treatment when they adopt the ASU.

### *Interim Reporting*

The FASB indicated in the ASU's basis for conclusions that reporting entities will be required to determine whether the income tax effects from intra-entity transfers should be included in the estimate of the annual effective tax rate from continuing operations or recognized as a discrete period tax effect. As such, reporting entities will need to consider the guidance in paragraphs 740-270-30-12 through 30-13 which require the exclusion of significant unusual or infrequently occurring items from the estimated annual effective tax rate from continuing operations and determine whether the income tax effects from intra-entity transfers qualify for exclusion and should be accounted for discretely. Due consideration should also be given to internal controls over income taxes to ensure these transactions are timely identified and evaluated to determine the appropriate treatment.

### *Effective Date and Transition Method*

#### *Mandatory Effective Date*

The ASU is effective for public business entities for annual reporting periods beginning after December 15, 2017 and interim reporting periods within those fiscal years. It is effective for private entities for annual reporting periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019.

#### *Early Adoption*

An entity may elect early adoption, but it must do so in the first interim period of an annual period if it issues interim financial statements. Therefore, calendar year public business entities cannot early adopt the ASU in calendar year 2016. Such entities can elect to early adopt in calendar year 2017. In contrast, a reporting entity with a September 30 fiscal year end can elect early adoption of the ASU since it can still apply it in the first interim period ending December 31.

#### *Transition Method*

The ASU is applied on a modified retrospective basis in the period of adoption. This means the unamortized balance of a prepaid tax/deferred charge (seller's tax) due to a prior intra-entity asset transfer is derecognized through an adjustment to opening retained earnings, avoiding the impact on income tax expense that would have resulted absent adoption of the ASU. Conversely, the remaining off-balance sheet deferred tax asset (from the buyer's tax basis step-up) is recognized, net of any valuation allowance, through opening retained earnings. That is, if a valuation allowance is initially required on a newly recognized deferred tax asset, it is also recognized through opening retained earnings. However, subsequent release of a valuation allowance initially recognized through retained earnings is generally recognized as income tax benefit in the period of release. That is, the release is not allowed to be "traced" back to retained earnings.

In summary, all of the effects of initial adoption are recognized through opening retained earnings as part of a cumulative-effect adjustment as of the beginning of the period of adoption. The comparative prior period's financial statements should not be restated.

For example, a calendar year public entity which adopts the ASU in its 2018 annual period would adjust opening retained earnings (i.e., January 1, 2018) for any unamortized prepaid tax/deferred charge balance and any unrecognized deferred tax asset, net of valuation allowance. The 2016 and 2017 comparative periods would not be adjusted for the adoption of the ASU. If the entity elects to early adopt in calendar year 2017, it would adjust its opening retained earnings (i.e., January 1, 2017) for any unamortized prepaid tax/deferred charge balance and any unrecognized deferred tax asset, net of the valuation allowance. The 2015 and 2016 comparative periods would not be adjusted for the adoption of the ASU.

### *Transition Disclosure*

All entities should provide the following transition disclosures in the annual period of adoption and the interim periods within that first annual period: (i) the nature of and reason for the change, (ii) the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item(s), any affected per-share amounts for the current period, and (iii) the cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.

### **APPENDIX**

**Inventory** - The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventory excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

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