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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO **FLASH** REPORT

FASB

SUBJECT

RECLASSIFICATION OF CERTAIN TAX EFFECTS CAUSED BY THE TAX CUTS AND JOBS ACT FROM ACCUMULATED OTHER COMPREHENSIVE INCOME TO RETAINED EARNINGS

SUMMARY

The FASB issued ASU 2018-02[1] to provide entities an option to reclassify certain "stranded tax effects" resulting from the recent U.S. tax reform from accumulated other comprehensive income to retained earnings. This new standard is available **here**, and it takes effect for all entities in fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted.

DETAILS

Background

Under ASC 740, the enactment of the Tax Cuts and Jobs Act ("tax reform") on December 22, 2017 requires an entity to remeasure all U.S. deferred income taxes using a new 21 percent rate, a significant reduction from the previous corporate income tax rate of 35 percent. The cumulative deferred income tax adjustment is recognized as a component of income tax expense from continuing operations. However, deferred income taxes originally recognized through OCI were initially measured at the previous income tax rate of 35 percent. Therefore, recognizing the cumulative tax rate adjustment through income tax expense would result in a disproportionate tax balance remaining in AOCI (i.e., "stranded tax effect") that would be recycled to earnings in future periods.

The FASB was informed this accounting outcome may be confusing to financial statement users and also have a negative impact on regulatory capital for banks.

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1 Income Statement—Reporting Comprehensive Income (Topic 220): *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*

Main Provisions

Under the ASU, reporting entities will select an accounting policy to either reclassify all stranded tax effects caused by tax reform from AOCI to retained earnings, or continue recycling stranded effects (including those caused by tax reform) through earnings in future periods. Further, disclosure of either policy is required in all cases.

The reclassification from AOCI to retained earnings is presented in the statement of shareholders equity.

If elected as a policy, the reclassification entry should include the following:

a. The effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of tax reform related to items remaining in AOCI. The effect of the change in the U.S. federal corporate income tax rate on gross valuation allowances that were originally charged to income from continuing operations shall not be included.

b. Other income tax effects of tax reform on items remaining in AOCI (e.g., state taxes) that an entity elects to reclassify, consistent with the required disclosure of such other tax effects.

Required Disclosures

All entities must disclose their accounting policy for releasing stranded tax effects from AOCI, i.e., either to retained earnings or income tax expense (benefit). As part of this, entities should also disclose whether the policy for releasing income tax effects from AOCI occurs on an individual item or portfolio basis.

The policy election must be disclosed when the ASU is adopted. That is, an entity electing to reclassify must disclose both of the following items in the period of adoption:

1. A statement that an election was made to reclassify the income tax effects resulting from tax reform from AOCI to retained earnings, and
2. A description of the other income tax effects, if any, from tax reform that are reclassified from AOCI to retained earnings.

Alternatively, an entity must disclose in the period of adoption that it has not elected to reclassify these amounts to retained earnings.

Lastly, an entity electing to reclassify stranded tax effects retrospectively (see below) is also required to disclose the following in the first interim and annual period of adoption:

1. The nature of and reason for the change in accounting principle
2. A description of the prior period information that is retrospectively adjusted, and
3. The effect of the change on the affected financial statement line items.

EFFECTIVE DATE AND TRANSITION

The ASU is effective for all entities in fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.

Early adoption is permitted for public business entities for which financial statements have not yet been issued, and for all other entities for which financial statements have not yet been made available for issuance.

Entities have the option to record the reclassification either retrospectively to each period in which the income tax effects of tax reform are recognized, or at the beginning of the annual or interim period in which the amendments are adopted.

For example, Company “X” is a calendar year entity that does not elect early adoption in the 2017 annual financial statements, or in any interim period in the 2018 calendar year. Consequently, X will adopt the ASU in the first interim period of the 2019 calendar year. If X elects to reclassify stranded tax effects caused by tax reform, it can make the equity reclassification in the opening balances on 1/1/2019, or in the equity balances of the first comparative period presented.

BDO Observation: Reporting entities need to evaluate whether a reclassification within equity will provide relevant information to users by avoiding the future disproportionate impact on income tax expense when the underlying gains and losses are released from AOCI. A prospective effective date (i.e., calendar 2019) provides entities with time to evaluate the optional reclassification approach and to quantify the associated journal entry, if it is elected.

An entity will need to determine not only the stranded effect caused by the corporate income tax rate reduction, but also any other stranded tax effects attributable to tax reform such as potentially the transition from a worldwide tax system to a territorial system and state income taxes.

The effect of a valuation allowance on the reclassification amount must be carefully evaluated.

When a full or partial valuation allowance was previously maintained, or is maintained as of the enactment date, it is essential to determine what portion was or is currently recognized or adjusted through OCI versus income tax expense.

For example, there is no stranded effect as of the enactment date when a deferred tax asset in OCI is fully offset by a valuation allowance that was also recognized in OCI because the income tax rate differential impact on the gross deferred tax asset is offset by an equal impact on the gross valuation allowance. That is, there is no net tax-related balance in OCI for this deferred tax asset as of the enactment date.

Similarly, there is no stranded effect when a deferred tax asset and valuation allowance for the same amount were originally recognized through OCI, but subsequently the valuation allowance was released through income tax expense. This is because the income tax rate differential impact on the gross deferred tax asset is offset by an equal impact on the gross valuation allowance in OCI. That is, there is no net tax-related balance in OCI for this deferred tax asset as of the enactment date.

Conversely, a stranded tax effect exists for a deferred tax asset that was originally recognized in OCI with no valuation allowance (i.e., there was “initial recognition” of a tax benefit in OCI), but the valuation allowance was subsequently recognized in income tax expense. In this example, there is a tax-related balance in OCI as of the enactment date. If elected as an accounting policy, a reclassification entry would be required for the income tax rate differential on the gross deferred tax balance.