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THOUGHT LEADERSHIP FROM THE BDO NATIONAL TAX ASC 740 SPECIALTY SERVICES

BDO KNOWS: ASC 740

SUBJECT

INCOME TAXES

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

SUMMARY:

On October 22, 2014, the FASB (or "Board") affirmed an earlier decision to propose (1) the removal of the intra-entity asset transfer exception, and (2) the removal of the "current" classification of deferred taxes. The Board also decided on a transition method, transition disclosure, and an effective date. These proposals would be included in a single exposure draft ("ED") expected to be issued in early 2015, followed by a 120-day comment period.

Elimination of the intra-entity asset transfer exception (par. 740-10-25-3(e)) (F/K/A "par. 9(e)" in FAS 109)

This exception to comprehensive recognition of income tax 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 reaffirmed its earlier decision to eliminate this exception.

Elimination of "current" classification of deferred taxes (pars. 740-10-45-4 through 45-10)

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 reaffirmed its earlier decision to eliminate "current"

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classification and require "noncurrent" classification for all balance sheet deferred tax items. If this proposed change is eventually issued as an accounting standards update ("ASU"), 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."

Transition Method

The Board decided to require 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

The Board decided to require all entities to disclose (1) the nature and reason for the changes, (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 (4) interim period disclosure. All entities would also be required to disclose that prospective adoption of "noncurrent" classification results in a lack of comparability with balance sheet classifications of deferred taxes presented in comparative prior periods.

Effective Date

The Board decided that public entities must adopt both proposals no later than the fiscal year beginning after Dec. 15, 2016 (i.e., calendar year 2017), while private entities will have an additional year to adopt the proposals with respect to annual reports (i.e., calendar 2018) and another year after adoption to take the proposals into account for interim reports. Private entities will be allowed to early-adopt the proposals (same period applicable to public entities).

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 reason for proposing "noncurrent" classification of all deferred taxes is that "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).

During the October 22nd meeting, some on the Board questioned the benefit of the proposal to eliminate the exception for intra-entity transfer of assets, arguing that the proposed change does not simplify the standard, nor would it provide useful information to users. One concern raised was that entities would be required to track more temporary differences, which under current accounting may not be tracked in certain entities' systems, and that recognition of a DTA by the entity receiving or buying the asset would potentially neutralize (apart from any tax rate difference) the tax expense recognized by the entity transferring or selling the asset. Board members supporting the elimination acknowledged that while the change might not simplify the accounting for preparers and users, it would provide relief for auditors who have argued that applying the exception is complex.

Additionally, some Board members felt the proposal to eliminate "current" classification of deferred taxes might result in replacing an imperfect accounting principle with another imperfect accounting principle, because it would be misleading

to classify deferred taxes that are expected to reverse within a 12-month or operating cycle as "noncurrent". As such, the ED is expected to include the alternative views of dissenting Board members.[1]

BDO Comments. Earlier in the year, the FASB issued its response and recommendation to the findings of the "FAS 109 Post Implementation Review (PIR)" conducted by the Financial Accounting Foundation (FAF), which is the FASB's governing entity. The FASB decided that it will not make income tax accounting a priority agenda item and instead consider making limited changes as part of its "accounting simplification" agenda item.

BDO supports initiatives to reduce or eliminate unnecessary complexity from current U.S. GAAP *(e.g., the FASB's October 8, 2014 decisions related to share-based payments which are covered here.)*

However, BDO poses the following questions for consideration:

- Is a "piece meal" approach to reducing complexity and increasing the decision-information usefulness of ASC 740 beneficial and will it accomplish the intended objectives?
- Are there more pressing and complex provisions in ASC 740 which can be simplified and/or clarified (e.g., valuation allowance accounting and the measurement step in FIN 48)?
- Are business entities and their auditors resource-constrained with the current pace of accounting standard changes? Would they benefit from a "lull" to be able to focus on large changes (e.g., the new revenue standard)?
- Would eliminating the "tax deferral" rule related to intra-entity transfers of assets cause some entities to reconsider tax planning structures that entail intra-entity transfer of assets? What impact would the removal of this rule have on reducing overall complexity in ASC 740?

Eliminating "current" classification would certainly require less work in preparing a classified balance sheet, but this change could raise additional questions:

- Are there conceptual merits for keeping "current" classification? For example: deferred taxes meet the conceptual definition of assets and liabilities and arguably would have the same classification guidance of the underlying pretax assets and liabilities; deferred taxes have an impact on current cash tax outlays, and "current" classification for uncertain tax benefits (FIN 48 reserves) is required if the expected timing of settlement payment falls within the next fiscal period.
- Are significant costs incurred to estimate the amount of a net operating loss or income tax credit carryforward expected to be utilized within the next fiscal year?
- If the FASB decides to eliminate "current" classification, would incremental disclosure be necessary to provide an estimate of the deferred tax balance that is expected to reverse and impact cash tax outlays within the next fiscal period?

BDO will continue to monitor and report new developments and progress related to this FASB project.

[1] One alternative would require current classification if a deferred tax item is expected to reverse, based on management's best estimate, within 12 months or an operating cycle. Another view would require no classification of deferred taxes, although the details of this approach are currently unclear.

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