AUGUST 2014
www.bdo.com

THOUGHT LEADERSHIP FROM THE BDO NATIONAL TAX ASC 740 SPECIALTY SERVICES

BDO KNOWS:
ASC 740

SUBJECT
INCOME TAXES

Income Tax Accounting Question & Answer Series - Tax Accounting Implications from Deferred Tax Liabilities Related to Indefinite-Lived Assets or "Naked Credits"

PREAMBLE

Deferred tax assets ("DTAs") are required to be assessed for recoverability or realization (*i.e.*, whether or not they expect to reduce or save cash tax outlays in future periods and/or carryback periods). To be recognized, the likelihood that DTAs will be realizable must exceed 50% based on weighing all available evidence. DTAs are reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized. The need for a valuation allowance is assessed based on the gross available DTAs. In making this assessment, a company should consider the existence of sufficient taxable income (of the appropriate character, *i.e.*, ordinary vs. capital gain) from four possible sources: future reversals of existing taxable temporary differences ("TTDs"), future taxable income exclusive of reversing temporary differences (income forecast), taxable income in carryback years if carryback is permitted, and tax planning strategies.[1] As explained in this Q&A, the reversal of TTDs related to indefinite-lived assets cannot (in most cases) be determined or scheduled, thereby precluding them from being considered as one of the four permissible sources of income for valuation allowance purposes.

Q&A 1: What is a "naked credit" and when would they exist?

A "naked credit" is a deferred tax liability ("DTL") for an indefinite-lived asset, *i.e.*, the asset is not amortizable or depreciable for book accounting purposes. Examples of assets which may trigger a "naked credit" effect include tax-

[1] ASC 740-10-30-18.

CONTACT:

National Tax Service - Topic 740 Group

YOSEF BARBUT
Tax Partner
ybarbut@bdo.com / 212-885-8292

STEPHEN ARBER
Senior Manager, International Tax
sarber@bdo.com / 212-885-7355

MATTHEW BECKER
Tax Regional Managing Partner
mkbecker@bdo.com / 616-802-3413

WILLIAM CONNOLLY
Tax Senior Director
wconnolly@bdo.com / 617-239-4127

National Assurance Group

ADAM BROWN
National Director of Accounting
abrown@bdo.com / 214-665-0673

DEBRA MACLAUGHLIN
National Assurance Partner
dmaclaughlin@bdo.com / 312-616-4656

deductible goodwill, Federal Communications Commission licenses, trade names and trademarks, certain acquired in-process research and development, and even land, where the tax basis of the asset is less than its book basis. A “naked credit” effect generally arises when an entity has a partial or full valuation allowance against its net deferred tax assets, and the amortizable tax basis in an indefinite-lived asset is less than its book basis.

There is an accounting assumption that the book values of assets will be recovered over time (*i.e.*, an asset is depreciated or amortized over time as it generates revenue), thereby causing taxable or deductible reversals of temporary differences.[2] Generally, TTDs constitute a source of income to support the realization of DTAs, and should reduce the valuation allowance amount that is otherwise required.[3] Specifically, TTDs that reverse within the reversal periods of deductible temporary differences and within the carryforward and carryback periods of a net operating loss (“NOL”) or tax credit carryforward represent available sources of income. However, recovery of the book values of indefinite-lived intangible assets and land generally do not occur through depreciation or amortization but through impairment or disposal (however, refer to Q&A 7 which discusses the goodwill accounting alternative for non-public entities). Therefore, the reversal of DTLs related to indefinite-lived intangible assets (or land) cannot be determined or scheduled and cannot (in most cases) be considered a source of income for valuation allowance purposes (*i.e.*, DTLs that cannot be netted with reversing DTAs of the same jurisdiction or tax paying entity). This accounting results in a valuation allowance in excess of **net** DTAs and a net credit balance, or a “naked credit” DTL.

Q&A 2: What are the income statement and balance sheet consequences of a “naked credit” DTL?

When an entity maintains a valuation allowance, a “naked credit” effect manifests itself as a tax expense despite having a loss for the year (*i.e.*, a negative effective tax rate). This occurs because current tax amortizations which contribute to an NOL attract a valuation allowance, while the “naked credit” DTL that is accreted up for tax amortization of indefinite-lived intangible assets yields a deferred tax expense. This phenomenon results in a balance sheet “gross-up” of the valuation allowance account and a net credit balance, even though total DTAs exceed total DTLs.

The following example illustrates the income statement and balance sheet implications from a “naked credit” effect:

Company X, a United States corporation, has significant negative evidence for the first time, including a cumulative loss primarily driven by a very significant current year loss and expected future losses which preclude it from relying on a forecast of income to avoid a valuation allowance. As of the end of the current year, Company X does not have a tax-planning strategy or carryback capacity. Therefore, a full valuation allowance is required on gross DTAs absent sufficient reversing DTLs, which are one of four sources of income that must be considered under ASC 740-10-30-18(a).

Company X’s current-year pre-tax loss is $400, unfavorable permanent items are $50, and net favorable book-tax differences are $150 (inclusive of goodwill tax amortization). Its taxable loss is therefore $500. Assume Company X’s applicable combined federal and state tax rate is 40%.

As of the end of the current year, Company X has $300 of reversing DTAs (inclusive of an NOL carryforward DTA) and $80 of reversing DTLs related to depreciable property (the beginning balance is $60). In addition, Company X has a $120 DTL resulting from the excess of its book basis of goodwill over its tax basis. The goodwill is amortized for tax purposes over a 15-year period at a rate of $100 per year. Consequently, Company X’s net DTA before valuation allowance is $100, with all deferred tax balances being considered noncurrent.

The table below is a summary of Company X’s deferred taxes as of the end of the current year:

DTA / (DTL)	Beginning of the Year	Current Year Activity	End of the Year
DTA (NOL and other)	$100	$200	$300
DTL – amortizable assets	($60)	($20)	($80)
DTL – goodwill	($80)	($40)	($120)
Net DTA (DTL)	($40)	$140	$100

[2] ASC 740-10-25-20.
[3] ASC 740-10-30-18(a).

In this circumstance, Company X would need to recognize a valuation allowance of $220 instead of $100 due to a "naked credit" DTL of $120. Note that a "naked credit" results in a dollar-for-dollar increase to the tax expense, as seen in the journal entry examples below.

Tax Accounting Journal Entries:

Debit – NOL DTA	$200
Credit – Deferred Tax Benefit	($200)

(40% times $500 current-year NOL)

Debit – Deferred Tax Expense	$60
Credit – DTL	($60)

(40% times $150 of net favorable basis differences)

Debit – Deferred Tax Expense	$220
Credit- Valuation Allowance	($220)

($300 reversing DTAs less $80 reversing DTLs)

Rate Reconciliation:	Tax Expense (Benefit)	Percentage
Pre-tax income (loss)	($160) [40% * $400]	40% (benefit)
Unfavorable permanent items	$20 [40% * $50]	5% expense ((20/160)*40%)
Valuation allowance	$220	55% expense ((220/160)*40%)
Net tax expense	$80	20% expense

Effective tax rate (20%) ($80 expense divided by $400 pre-tax loss)

In this circumstance, the "naked credit" effect has resulted in an additional valuation allowance of $120 and thus contributed to a negative effective tax rate for the current year. Had the $120 DTL for the goodwill asset not been considered a "naked credit" DTL, the valuation allowance expense would be $100, resulting in a tax benefit for the year of $40 (*i.e.*, a positive effective tax rate of 10%).

The noncurrent deferred tax account (which might be included in other liabilities, if deferred taxes are included with other liabilities or assets under Securities and Exchange Commission balance sheet presentation guidance) would have a net credit balance of $120 instead of a zero balance because of the "naked credit" DTL and its gross-up effect on valuation allowance:

Net DTA	$100 ($300 noncurrent DTAs less $200 noncurrent DTLs)
Valuation allowance	($220) (allocated to noncurrent)
Net credit balance	($120)

If Company X continues to generate losses and thus maintains a valuation allowance, annual tax amortization of goodwill would result in a tax expense due to the accretion of a "naked credit" DTL. For example, if in the following year Company X has a pre-tax loss from continuing operations of $1,000, no permanent differences, and net favorable book-tax differences of $150 including annual amortization of goodwill (*i.e.*, $100), the combined effect of these items would cause a negative effective tax rate of 4% ($40 deferred tax expense divided by $1,000 pre-tax loss). This occurs because the $100 goodwill amortization (a $40 expected benefit) claimed on the current year tax return is added to the NOL which is fully offset by an incremental valuation allowance, while the $40 deferred tax expense results in a "naked credit" DTL which cannot be considered a source of income to avoid an equivalent amount of valuation allowance or $40. This results in a further "gross-up" of deferred taxes on the balance sheet as explained above.

The table below is a summary of Company X's deferred taxes as of the end of the subsequent year:

DTA / (DTL)	Beginning of the Year	Current Year Activity	End of the Year
DTA (NOL and other)	$300	$460	$760
DTL – amortizable assets	($80)	($20)	($100)
DTL – goodwill	($120)	($40)	($160)
Net DTA (DTL)	$100	$400	$500
Valuation allowance	($220)	($440)	($660)
Net credit balance	($120)	($40)	($160)

Tax Accounting Journal Entries in Subsequent Year:

Debit – NOL DTA $460
Credit – Deferred Tax Benefit ($460)
(40% times $1,150 current-year NOL)

Debit – Deferred Tax Expense $60
Credit – DTL ($60)
(40% times $150 of net favorable basis differences)

Debit – Deferred Tax Expense $440
Credit – Valuation Allowance ($440)
($760 reversing DTAs ($300 from prior years plus $1,150 current year x 40%) less $100 reversing DTLs less $220 opening valuation allowance)

Rate Reconciliation:

Pretax income (loss)	($400) [40% times pre-tax loss of $1,000]
Valuation allowance	$440
Net tax expense	$40
Effective tax rate	(4%) [$40 tax expense divided by $1,000 pre-tax loss]

Q&A 3: Why is this deferred tax accounting necessary when the entity maintains a valuation allowance?

Accreting up a DTL for the tax amortization of goodwill (or any other indefinite-lived asset that is amortized for tax purposes) is required under Topic 740 even when there is a full valuation allowance. This accounting cannot be skipped on the misguided notion that "it does not matter in a full valuation allowance situation" and that the accounting can be "cleaned up" when the valuation allowance is no longer required. The eventual release of valuation allowance (attributable to an NOL from tax amortization of indefinite-lived assets) should result in the recognition of a tax benefit. It is not appropriate to set up a DTL for the first time to offset the release of the valuation allowance and thus have a zero tax effect when the release occurs. While the deferred tax effects from accreting up a DTL for prior years' tax amortizations might be immaterial to each individual year, the catch-up adjustment can be material to the current year.

Q&A 4: Can "naked credit" DTLs be used as a source of income for *any* indefinite-lived DTAs?

There are two acceptable views in practice. Under one view, a "naked credit" DTL can be considered a source of income to support an indefinite-lived DTA which has no expiration period provided they both arise in the same jurisdiction or tax-paying entity and have the same character. Examples would be DTAs for the United States federal alternative minimum tax credit carryforward, the California research and development credit carryforward, and an NOL carryforward with no expiration period (*i.e.*, in certain foreign countries). In those circumstances, a valuation allowance would not be required against indefinite-lived DTAs (even though it is required for other DTAs not recoverable by reversing DTLs). Deferred tax balances with indefinite-lived duration would offset each other on a hypothetical "final" tax return. For example, if an entity were to liquidate in a taxable manner, an offset of an indefinite-lived DTL and indefinite-lived DTA would technically occur on a final tax return. Under a second view, an indefinite-lived DTA is not considered realizable because utilization through offsetting a "naked credit" DTL cannot, in general, be planned or anticipated to occur in the foreseeable future. Accordingly, the availability of an infinite carryforward period is not sufficient to cause realization.

Q&A 5: Can the reversal of a "naked credit" DTL be accelerated so that the DTL can be considered a source of income for valuation allowance purposes?

An entity cannot anticipate impairment of indefinite-lived assets. However, an entity might have a prudent and feasible tax-planning strategy to transfer, in an intra-entity transaction, an indefinite-lived asset and thus trigger a taxable gain. As explained in ASC 740-10-30-18(d)(1), tax-planning strategies that would, if necessary, be implemented to accelerate taxable amounts to utilize expiring carryforwards should be considered when assessing the need for and the amount of a valuation allowance. Entities relying on a tax-planning strategy involving an intra-entity transfer of indefinite-lived asset should be cautioned to avoid potential double counting of income (and understating the valuation allowance) when the transfer price valuation of the asset is not sufficient to support the recovery of the entire net DTA balance (*i.e.*, the asset valuation does not provide sufficient "head-room" to support a growing net DTA balance). In those circumstances, a partial valuation allowance might be required and determined based on the anticipated gain which would already reflect the income associated with the reversal of the "naked credit" DTL.

For example, a United States entity having an applicable tax rate of 40% has a DTA balance of $300 and a DTL balance of $200, which includes a $150 DTL for a trademark that is fully amortized for tax purposes but has a book value of $375. In assessing the need for a valuation allowance, the entity is relying on reversing DTLs of $50 and a tax-planning strategy which would entail a taxable transfer of the trademark to a controlled foreign holding company (the future action is considered prudent and feasible and is primarily within the entity's control). The entity expects that an arm's-length transfer price for the trademark would be its current book value of $375. Under this assumption, the entity still needs a valuation allowance of $100 as the tax planning strategy is merely allowing for the trademark DTL to be considered a source of income. If the transfer-price estimate for the trademark is, for example, $525 (presumably supported by a current valuation analysis), the strategy would be expected to result in additional income over book value to support a partial valuation allowance. In this example, the additional income is $150 (current transfer-price estimate of $525 in excess of book value of $375) and a partial valuation allowance of $40 would be required. That is, a net DTA of $100 would require at least $250 of future income exclusive of reversing TTDs to avoid a valuation allowance and the income from the tax-planning strategy would only be considered to the extent of any excess over book value. Said differently, the gain that would be triggered for the book value is already accounted for in the trademark DTL.[4]

Q&A 6: How is the "naked credit" tax effect recognized throughout the year?

An entity which prepares interim financial statements would technically recognize the "naked credit" tax expense effect throughout the year using an effective tax rate ("ETR") approach for the jurisdiction in which the "naked credit" effect arises; however, the rate would be a negative tax rate. For all other jurisdictions in which the entity has income and a tax expense and/or losses with a tax benefit, the entity would maintain a single global annual ETR as required in Subtopic 740-270. Discrete period recognition of the "naked credit" effect (*e.g.*, based on the incremental tax amortization amount or one-fourth of the annual tax amortization) might be more appropriate when (a) the ETR estimate is not considered "reliable" (as would be the case when anticipated small variations in forecasted pre-tax income (loss) would cause significant tax rate increase or decrease), or (b) the entity is unable to reliability estimate pretax income (loss) or/and tax effects.[5]

Q&A 7: How does the Private Company Council ("PCC") accounting alternative for goodwill affect this deferred tax accounting?

Non-public entities can elect to amortize goodwill on a straight-line basis over a period of ten years, or over a shorter period if a more appropriate useful life can be demonstrated. Entities need to review the "public business entities" definition in the Codification Master Glossary (recently amended by the Financial Accounting Standards Board) to

---

[4] This Q&A does not discuss the requirement of ASC 740-10-25-3(e) which provides an exception to recognition of a net tax effect from intra-entity transfers of assets. Proper consideration, beyond the scope of this Q&A, of the exception is required if a tax-planning strategy entails an intra-entity transfer of an asset.

[5] For further discussion, refer to Subtopic ASC 740-270, pars. 25-2, 25-9, 25-14, 30-6 through 30-8, 30-16 through 30-19, and 30-35 through 30-36.

determine whether they qualify as "non-public entities" and can elect to apply the PCC's accounting alternatives. The goodwill accounting alternative is generally effective beginning in calendar year 2015 (for private entities using calendar years) and amortization would be required, if elected by an entity, prospectively for all goodwill balances existing as of the beginning year of the effective date. Non-public entities that elect to amortize (for purposes of United States generally accepted accounting principles) tax-deductible goodwill will no longer consider the DTL that would arise from the book-tax basis difference in goodwill as a "naked credit" DTL. If adoption of the accounting alternative would result in releasing a valuation allowance previously recognized due to a "naked credit" DTL, the release will be recognized in income tax expense from continuing operations in the period of adoption. Such DTL would be considered to have a pre-defined reversal period and therefore would be considered a source of income to support realization of all DTAs (definite-lived and indefinite-lived DTAs). It should be remembered that ASC 740 prohibits recognition of a DTL for nondeductible goodwill.[6] Therefore, electing the goodwill amortization accounting alternative for nondeductible goodwill will result in an unfavorable effective tax rate impact, inasmuch as book amortization would not be deductible (*i.e.*, it will be added back to taxable income or reduce taxable loss). For more information on the PCC goodwill alternative, see our January 2014 Financial Reporting Letter.[7]

Q&A 8: What should be disclosed in the financial statements when an entity has a "naked credit" effect?

All entities are required to disclose in annual financial statements the components of deferred taxes, the types of significant temporary differences, the changes in valuation allowances, and the significant components of income tax expense from continuing operations.[8] Public entities should also disclose the anticipated tax effect of significant temporary differences and a reconciliation schedule of the applicable tax rate to the effective tax rate. Non-public entities are required to disclose the nature of significant tax rate reconciling items.[9] All entities are also required to disclose the nature and effect of any other significant matter affecting comparability of information for all periods presented, if the information is not otherwise evident from required disclosures.[10] In interim period financial statements, the reasons for significant variation in the customary relationship between income tax expense and pre-tax accounting is required to be disclosed if it is not otherwise apparent from the financial statements.[11] When the "naked credit" effect has a significant impact on tax expense and balance sheet presentation of deferred taxes, the disclosures required by ASC 740 are expected to provide information useful to understanding the impact. This typically involves separately captioning the goodwill item in the deferred tax table, as well as addressing the issue in the results of operations and potentially in the tax rate reconciliation schedule for public entities.

This publication has been produced with the assistance of BDO's National Assurance Group.

---

[6] ASC 740-10-25-3(d).
[7] This document may be accessed at www.bdo.com/download/3044.
[8] ASC 740-10-50-2.
[9] ASC 740-10-50-11 through 50-13.
[10] ASC 740-10-50-14.
[11] ASC 740-270-50-1.