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Accounting for Income Taxes

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Notice

The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

1. Current environment
2. Income taxes in interim periods
3. Valuation allowance
4. ASU 2019-12: Simplifying the Accounting for Income Taxes
5. Tax accounting implications of rising tax rates
6. Acquisitions & Acquisition Accounting

The current environment:

COVID-19 and CARES Act (Coronavirus Aid, Relief, and Economic Security Act)

Federal income tax changes

Key items

- Temporary adjustments to net operating loss rules
- Changes to limitations on interest expense deductibility
- Acceleration of available refunds for alternative minimum tax credit carryforwards

Key impacts

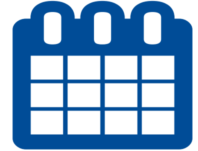
- Q1 accounting event for calendar-year companies
- Changes not anticipated to be so difficult to apply that a SAB 118-style deferral would be necessary

Resources

- KPMG WNT: Tax Provisions in the CARES Act: Preliminary Analysis and Observations

Federal income tax changes:

Timing of recognition



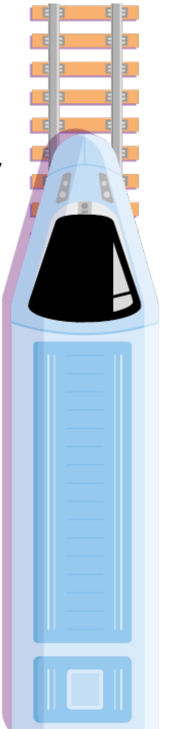
Date of enactment = March 27, 2020

- Recognize retroactive changes in income tax expense (benefit) from continuing operations as of 3/27/2020
- Recognize retroactive impacts to income taxes receivable (payable) in the estimated annual effective rate beginning in the interim period which includes 3/27/2020
- Re-measure DTAs/DTLs to reflect the effects of changes in tax laws as of 3/27/2020
  - Reflect impact of re-measurement entirely within the interim period that includes 3/27/2020 and allocate directly to income tax expense (benefit) from continuing operations
  - We believe the portion of the deferred tax re-measurement to be recognized discretely may be based on balances either at 3/27/2020 or the beginning of the year – should be a consistent accounting policy choice

Federal income tax changes:

Temporary adjustments to NOL rules

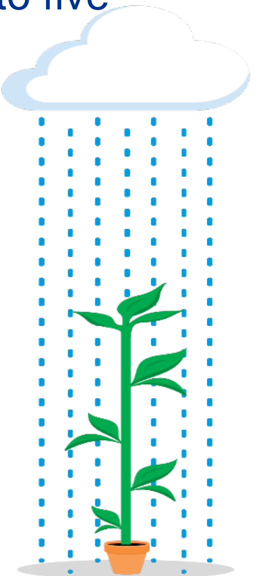
- Permits a five year carryback of net operating losses (NOLs) arising in tax years beginning after December 31, 2017 and before January 1, 2021
- Further relaxes the 80% taxable income limitation imposed under current US federal tax law to permit a full offset for the carryback of those losses
  - An entity may have less carryforwards now and the reversal of existing temporary differences may result in a change in the valuation allowance
  - Consider rate differential: generally realize 35% benefit from NOLs if it carries them back to a tax year in which 35% was the enacted tax rate



Federal income tax changes:

Changes to limitations on interest expense deductibility

- Under current US federal tax law, interest expense is generally deductible to the extent it does not exceed 30% of adjusted taxable income for the respective tax year
- Temporarily relaxes the section 163(j) limitation on deductible interest and increases the limit from 30% to 50% for tax years beginning in 2019 and 2020
- Increasing the limitation on the deductibility of interest expense may provide an immediate tax impact for entities, either through increasing an NOL in the 2019 or 2020 tax years (which can be carried back up to five years) or reducing the tax liability
  - May reduce interest carryforwards generated and the related DTAs
  - Existing valuation allowance judgments should be reassessed to determine the realizability of the remaining DTAs
  - May need to revise scheduling of the reversal of temporary differences



Federal income tax changes:

Acceleration of refunds for AMT credit carryforwards

- Remaining AMT credit refunds accelerated to 2019 from 2021
- Entities generally reflect any remaining AMT credits as either an income tax receivable or as a deferred tax asset
  - As remaining minimum tax credit carryforwards will be realized either as a reduction of income taxes payable or as a refundable amount, existing deferred tax assets related to minimum tax credit carryforwards may be reversed and an income taxes receivable recognized
- Any income taxes receivable recognized is presented as a current receivable as the expected timing of receipt would be anticipated to be within 12 months or the operating cycle
  - If an entity previously recognized a noncurrent receivable for the portion of the AMT credit expected to be refunded in 2021, a reclassification should be made from noncurrent to current

State income tax considerations

Conformity

- Generally, states adopt a rolling conformity or a fixed conformity to the federal code.
- Rolling conformity states typically incorporate all changes to the federal code as passed by Congress unless the state passes legislation to decouple from specific provisions.
- Fixed conformity typically conform as of a particular date.

Nexus

- Employees working from home in response to COVID-19 creates potential for new nexus risk.

Apportionment

- Income tax apportionment sourcing – sales factor for services may be based (at least in part) on where the person is performing the service.

Accounting for income taxes in interim periods

Overview of interim tax reporting

ASC 740-270 provides guidance on accounting and disclosure for income taxes in interim periods

- Based on the view that each interim period is an integral part of the annual period
- Income tax expense (benefit) related to ordinary income (loss) is computed at an estimated annual effective tax rate
- Income tax expense (benefit) related to items other than ordinary income is individually computed and recognized as the items occur
- The complexity of the estimated annual effective tax rate calculation will depend upon:
  - The number of tax jurisdictions in which the company operates,
  - The nature and extent of reconciling items within the annual effective tax rate, and
  - The ability to make reliable estimates

Overview of interim tax reporting

Ordinary income (loss)

Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items

Discontinued operations and cumulative effects of changes in accounting principles are excluded from this term

The term is not used in the tax law context of ordinary income versus capital gain

Unusual nature = a high degree of abnormality and unrelated to typical activities of the entity, considering the environment in which the entity operates

Infrequency of occurrence = would not reasonably be expected to recur in the foreseeable future, considering the environment in which the entity operates

Estimated annual effective tax rate

- Total income tax expense (benefit) for the year results from separate calculations of current tax expense (benefit) and deferred tax expense (benefit)

- Estimates of both current and deferred tax expense (benefit) attributable to ordinary income will be required to calculate the estimated annual effective tax rate on ordinary income for the year

$$\text{Estimated annual effective tax rate} = \frac{\text{Estimated annual income tax expense (benefit) on ordinary income (loss)}}{\text{Estimated annual pretax ordinary income (loss)}}$$

Estimated annual effective tax rate

Assumptions used in calculating the estimated annual effective tax rate should be based on fairly predictable future occurrences (for instance, reliable budget systems)

Includes, but is not limited to, anticipated tax credits, foreign tax rates, capital gain rates, Subpart F income, GILTI inclusions and alternative tax systems (including BEAT)

The estimated annual effective tax rate (ETR) should not anticipate future events that are not primarily within management's control

Used to allocate expected annual income tax expense (benefit) related to ordinary income to interim periods

Estimated annual effective tax rate

Items excluded from the estimated annual effective tax rate include, but aren't limited to, the following:

- Tax effects of significant unusual or infrequently occurring items, including tax-only items, that are separately reported
- Items reported net of their related tax effect
- The effects of changes in judgment about beginning-of-year valuation allowances
- The effects of changes in tax law or rates
- Taxes related to an employee share-based payment award when the deduction for tax purposes does not equal the cumulative compensation cost recognized for financial reporting purposes

Items excluded from the estimated annual effective tax rate are commonly referred to as *discrete items*

Estimated annual effective tax rate

Facts

- At March 31, 20X1, Company A estimates that ordinary income for the year will be $1,000
- The estimated ordinary income for 20X1 includes $100 of nondeductible expenses and $100 of tax-exempt income
- Company A estimates that its net deductible temporary differences will increase $200 during 20X1
- Company A assumes a statutory tax rate of 25% and that $30 of tax credits are estimated to be generated in 20X1
- No valuation allowance is considered necessary

Question

- What is the estimated annual effective tax rate for Company A?

Estimated annual effective tax rate

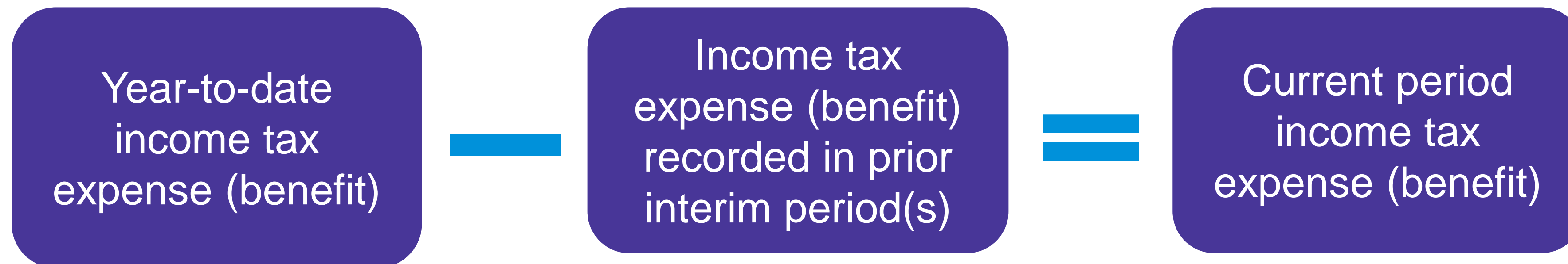
	Current	Deferred	Total
Estimated pretax ordinary income	$1,000	–	$1,000
Permanent differences:			
Life insurance premium	100	–	100
Tax-exempt income	(100)	–	(100)
Temporary differences:			
Depreciation expense	(100)	100	–
Litigation reserves	300	(300)	–
Taxable income	$1,200	$(200)	$1,000
Tax rate	25%	25%	25%
Tax before credits	$300	(50)	250
Less tax credits	(30)	–	(30)
Income tax expense (benefit)	$270	$(50)	$220
Estimated annual effective tax rate	27%	(5%)	22%

Application of estimated annual effective tax rate

Applied to year-to-date ordinary income to arrive at year-to-date income tax expense (benefit)

Estimated annual effective tax rate is reviewed and revised, on an as needed basis, each interim period

— The cumulative effect of a change in the estimated annual effective tax rate from the prior quarter is reflected in the interim period in which the change arises



Application of estimated annual effective tax rate example

Facts

- Dallas Corporation earns $10,000 of ordinary income in Q1 20X7
- At Q1 20X7, the company estimates that ordinary income for the year will be $50,000, which includes $5,000 of nondeductible expenses

The annual effective tax rate is calculated as follows:

	Amount	Explanation
Estimated annual ordinary income	$ 50,000	
Nondeductible expenses	5,000	
Estimated annual taxable income	55,000	
Statutory enacted tax rate	21%	
Estimated annual tax expense (benefit)	$ 11,550	
Estimated annual effective tax rate	23.1%	$11,550 / 50,000 ordinary income

Question

- What is the income tax expense (benefit) for the period ended Q1 20X7?

Application of estimated annual effective tax rate example

Dallas Corporation's Q1 20X7 income tax expense is $2,310

	Amount	Explanation
Q1 20X7 actual ordinary income	$ 10,000	
Estimated annual effective tax rate	23.1%	$11,550 / 50,000 ordinary income
Q1 20X7 income tax expense (benefit)	$ 2,310	

Application of estimated annual effective tax rate example

- Dallas Corporation's Q2 20X7 ordinary income was $5,000
- The full year forecasted ordinary income was adjusted to $30,000 from the $50,000 estimated at Q1 20X7 and still includes $5,000 of nondeductible expenses

	Amount	Explanation
Estimated annual ordinary income	$ 30,000	
Nondeductible expenses	5,000	
Estimated annual taxable income	35,000	
Statutory enacted tax rate	21%	
Estimated annual tax expense (benefit)	$ 7,350	
Estimated annual effective tax rate	24.5%	$7,350 / 30,000 ordinary income

Question

- What is the income tax expense (benefit) for the period ended Q2 20X7?

Application of estimated annual effective tax rate example

— Dallas Corporation’s Q2 20X7 income tax expense is $1,365

	Amount	Explanation
Q2 20X7 actual YTD ordinary income	$ 15,000	
Estimated annual effective tax rate	24.5%	$7,350 / 30,000 ordinary income
Q2 20X7 YTD income tax expense (benefit)	3,675	
Less: Q1 20X7 income tax expense (benefit)	(2,310)	
Q2 20X7 income tax expense (benefit)	$ 1,365	

— Dallas Corporation’s Q2 20X7 effective tax rate is 27.3 percent ($1,365 income tax expense over $5,000 ordinary income)

Operations taxable in multiple jurisdictions

- An entity subject to tax in multiple jurisdictions should generally compute one overall estimated annual effective tax rate related to consolidated ordinary income (loss)
- The ordinary income (loss) and related income tax expense (benefit) in a jurisdiction should be excluded from the overall estimated annual effective tax rate computation if one of the following criteria are met
  - An ordinary loss is anticipated for the fiscal year or has an ordinary loss year-to-date in a separate jurisdiction for which no tax benefit can be recognized
  - The entity is unable to estimate an annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its ordinary income or of the related tax expense (benefit) in a jurisdiction

Operations taxable in multiple jurisdictions example

Facts

— Phoenix Corporation is a US corporation with several foreign subsidiaries

— Phoenix's foreign subsidiaries operate in multiple tax jurisdictions and have historically been profitable, with the exception of Berlin Corporation, a German subsidiary

— Berlin continues to anticipate losses and concludes it is not more likely than not that its deferred tax assets will be realized

Question

— Should Berlin's operations be included or excluded from Phoenix's estimated annual effective tax rate?

Operations taxable in multiple jurisdictions example

Berlin's operations should be excluded from the estimated annual effective tax rate

— As Berlin anticipates an ordinary loss for the year for which no benefit may be recognized, the earnings and related income tax expense (benefit) should be excluded from Phoenix's estimated annual effective tax rate

Loss jurisdiction

In certain situations, the loss jurisdiction may provide a benefit in another jurisdiction

— For instance, a tested loss may result in a reduction in a US shareholder's GILTI inclusion

Method A	Method B
• The loss jurisdiction is excluded from the overall estimated annual ETR if no benefit can be realized in **any jurisdiction**	• The loss jurisdiction is excluded from the overall estimated annual ETR if no benefit can be realized in the **foreign jurisdiction**

Inability to make reliable estimates

If the annual effective tax rate cannot be reliably estimated, the actual effective tax rate for the year-to-date period may be the best estimate of the annual effective tax rate

— Generally occurs when an entity expects near break-even operations such that a small change in the entity's estimated ordinary income could result in a large change in the estimated annual effective tax rate

If an entity is unable to reliably estimate individual items within ordinary income (loss), the income tax expense (benefit) related to those items would be recognized in the interim period in which the items are reported

— Examples may include, in certain circumstances, the receipt of tax-exempt interest income or foreign exchange gains (losses)

Tax effect of losses

- A tax benefit may be recognized for a loss that arises early in a fiscal year if it is expected to:
  - Be realized during the year, or
  - Be recognizable as a deferred tax asset at the end of the year
- An established seasonal pattern of losses in early interim periods offset by income in later interim periods may provide sufficient evidence
- If tax effects of losses are not recognized in early interim periods, tax effects of income in later interim periods are not recognized until previous interim losses are utilized

Tax effect of losses

If the early portion of a fiscal year is profitable, but later losses are expected to equal or exceed current profits, then:

- Taxes are calculated using the estimated annual effective tax rate provided for interim periods that present profit, and
- Tax benefits of later losses should be recognized in the interim periods the losses are incurred

If an entity has a year-to-date ordinary loss and expects an ordinary loss for the year, then:

- If the year-to-date ordinary loss exceeds the anticipated ordinary loss for the fiscal year, the tax benefit recognized for the year-to-date is limited to the tax benefit determined based on the year-to-date ordinary loss

Tax effect of losses example

Facts

- Vegas Corporation estimates that it will generate an ordinary loss for 20X7 of $100,000 and ordinary income and loss in interim periods
- Assume a 25 percent statutory rate for 20X7
- Vegas has the ability to realize $50,000 of the 20X7 loss and will require a valuation allowance on the remaining $12,500 ($50,000 x 25%) of deferred tax assets related to NOL carryforwards

Quarter	Period	YTD
Q1	$(20,000)	$(20,000)
Q2	(120,000)	(140,000)
Q3	70,000	(70,000)
Q4	(30,000)	(100,000)
Total	(100,000)	

Question

- What is the income tax expense (benefit) for each interim period?

Tax effect of losses example

The income tax expense (benefit) for each interim period is as follows for 20X7:

Quarter	Period	YTD	ETR	YTD Tax Expense	Limitation	Previously Provided	Period
Q1	$ (20,000)	$ (20,000)	12.5%	$ (2,500)	$ (12,500)	$ -	$ (2,500)
Q2	(120,000)	(140,000)	12.5%	(17,500)	(12,500)	(2,500)	(10,000)
Q3	70,000	(70,000)	12.5%	(8,750)	(12,500)	(12,500)	3,750
Q4	(30,000)	(100,000)	12.5%	(12,500)	(12,500)	(8,750)	(3,750)
Total	$ (100,000)						$ (12,500)

Share-based compensation

Excess tax benefits (deficiencies) are recognized discretely within the interim period that the amount of the deduction is determined

- Excluded from the estimated annual effective tax rate on ordinary income
- Policy choice for indirect effects of excess tax benefits (deficiencies)

Excess tax benefits (deficiencies) exist when the deduction for a share-based award for tax purposes does not equal the cumulative compensation cost of the award recognized for financial reporting purposes

Changes in valuation allowance

The income statement effect of a change in a valuation allowance should be recognized in interim periods as described below

Discrete item	Estimated annual effective tax rate
An increase or decrease in the beginning-of-year valuation allowance is caused by a change in judgment about the realizability of deferred tax assets in future years	A benefit expected to be realized because of current year ordinary income
	A valuation allowance expected to be necessary at the end of the year for deductible temporary differences originating during the current year

Entity may elect to recognize changes to acquirer's valuation allowance on its deferred tax assets that result from acquisition accounting as discrete items or through a revision to estimated annual effective tax rate

Changes in valuation allowance example

Facts

- As of January 1, 20X7, ABC Corp. had deferred tax assets of $10,000 and a full valuation allowance
- During Q2 20X7, ABC signed a significant new contract that caused the company to change its judgment about the realizability of deferred tax assets
- The company expects that $2,000 of the net deferred tax asset that existed as of January 1, 20X7 will be used to reduce income tax expense attributable to 20X7 ordinary income
- The remaining $8,000 of net deferred tax assets will be realized in future periods

Question

- How should ABC recognize the change in valuation allowance judgment in Q2 20X7?

Changes in valuation allowance example

Solution

— ABC should record a tax benefit in the second quarter as a discrete item to reduce the valuation allowance related to the $8,000 of deferred tax assets that are expected to be realized in future periods

— The benefit from the release of $2,000 of the valuation allowance for deferred tax assets expected to be realized in the current year should be recognized as an adjustment to the annual effective income tax rate used to calculate income tax expense for 20X7

Changes in tax laws or rates

Discrete item	Estimated annual effective tax rate
— Effects of changes in tax laws or rates on existing deferred tax assets (liabilities) allocated to income tax expense (benefit) from continuing operations in the interim period that includes the enactment date of the changes - Compute effects using enactment date or beginning-of-year approach — Effects of a retroactive change in tax laws or rates on taxes currently payable or refundable for a *prior year* as of the enactment date as tax expense (benefit) of the current year	— Effects of changes in tax laws or rates on taxes currently payable (receivable) for the *current year,* recognized in the latter of the interim period of enactment or the interim period that includes the effective date - The estimate of taxes currently payable or refundable would be adjusted after the effective date, if the legislation has a future effective date

Changes in tax laws or rates

Consider the following example:

- Assuming that a federal income tax rate change was enacted in Q2 and is effective retroactively to the beginning of the year. The discrete deferred tax adjustment as a result of the change in tax law could be computed as follows:

	Old Tax Law	New Tax Law
Net taxable temporary difference at the beginning of the year	20,000	20,000
Tax rate	21%	20%
Deferred tax liability	4,200	4,000

- The change in tax law results in a tax benefit of $200 recorded in Q2 as part of deferred tax expense (benefit) along with any impact on taxes currently receivable (payable) and any revisions to deferred tax expense (benefit) for current year activity.

Changes in tax status

The effect of a change in tax status on existing deferred tax assets and liabilities is a discrete event and should be recorded in the interim period that includes:

- The date that the election is filed if approval from the taxing authority is not required
- The date that the taxing authority approves the change if approval is required

Changes related to foreign subsidiaries

Taxable temporary differences associated with investments in foreign subsidiaries

- We believe the entire effect should be recognized as a discrete item in the interim period of the change in an entity's assessment of the indefinite reversal assertion
- It would also be acceptable to recognize the deferred tax effects of a change in judgment on the indefinite reversal assertion as follows:

Outside basis difference	Interim methodology
Existing at beginning-of-year	Discrete item in period of change
Arising during current year	Adjustment to estimated annual effective tax rate

Changes related to all subsidiaries

Deductible temporary differences associated with investments in all subsidiaries

— When the tax benefit is allocated to continuing operations, we believe the tax benefit is recognized as follows

Outside basis difference	Interim methodology
Existing at beginning-of-year	Discrete item in period of change
Arising during current year	Adjustment to estimated annual effective tax rate

Changes in judgment related to unrecognized tax benefits

- Changes in judgment that result in subsequent recognition, derecognition, or remeasurement of tax positions taken in prior annual periods should be recognized as a discrete item in the interim period in which the change in judgment occurs
  - Impact of such changes is not reflected in the estimated annual effective tax rate (not spread over future interim periods)
- Changes to unrecognized tax benefits established in an earlier interim period within that same annual period are reflected in the estimated annual effective tax rate to be applied to year-to-date ordinary income
- Interest and penalties are not considered as part of the estimated annual effective tax rate

Estimates versus errors

- ASC 250 defines a change in accounting estimate as a change that results from new information and is accounted for in the period of change
- ASC 250 defines a correction of an error in previously issued financial statements as a change that results from mathematical mistakes, mistakes in applying US GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared
  - Accounted for through a restatement of prior periods (if material)
    - The interim period calculations of income taxes requires an entity to make a series of judgmental estimates that may change in future periods
  - When the changes arise, an entity needs to evaluate whether the changes result from new information or information that existed and was reasonably knowable at the balance sheet date
    - If a correction of an error is immaterial for which the entity has concluded that no restatement is necessary, the change would be recognized in the period of change.

COVID-19 impacts:

Income taxes in interim periods (ASC 740-270)

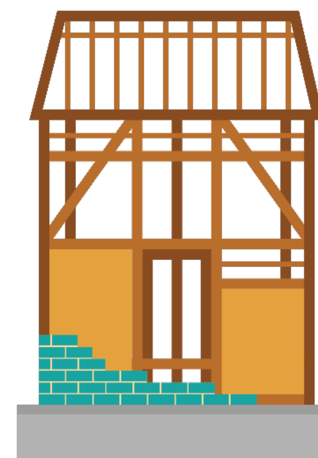
- **25-2** The tax (or benefit) related to ordinary income (or loss) shall be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items shall be individually computed and recognized when the items occur.
- **25-3** If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Estimating the annual effective tax rate:

- Inability to make reliable estimates
- Items excluded from ordinary income
- Apportionment

Interim period losses

Interim period losses only in certain tax jurisdictions



Valuation allowances

General concepts on valuation allowance

- Must be recognized to the extent that it is more likely than not that some or all of the deferred tax asset (DTA) will not be realized
- Should reduce deferred tax assets to the amount that is more likely than not to be realized
- Recognition or nonrecognition is not optional
- Must be adjusted as circumstances change
- Deferred taxes, including valuation allowances, are determined separately for each tax-paying component in each jurisdiction

ASC 740-10-30-5(e): Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.

Realization of deferred tax assets

Realization of tax benefits of deductible temporary differences (DTDs) and carryforwards is dependent on taxable income being:

Sufficient in amount;

Of an appropriate character; and

Within the statutory carryback or carryforward periods.

Level of analysis

- The need for a valuation allowance typically is determined separately for each tax-paying component
  - There may be multiple tax-paying components that file in the same tax jurisdiction
- Even within a single tax-paying component, the need for a valuation allowance with respect to different types of carryovers must often be evaluated individually due to different carryback or carryforward periods and limitations on utilization

Steps in determining valuation allowance

1. Determine gross amount of deferred tax assets (liabilities)
2. Determine amount of taxes paid during available carryback period
3. Obtain a general understanding of the pattern and timing of reversals of temporary differences, any limitations under the tax law, and length of available carryback or carryforward periods
4. Determine extent to which it is more likely than not that tax benefits of DTDs and carryforwards will be realized through carryback or through offsetting taxable temporary differences (TTDs)
5. Determine amount and timing of future taxable income exclusive of reversing temporary differences and carryforwards that is necessary to realize remaining balance of the deferred tax asset

Steps in determining valuation allowance

6. Determine whether positive evidence exists to support conclusion that it is more likely than not that future taxable income will be sufficient to allow realization of remaining deferred tax assets

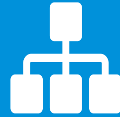
7. If necessary, consider availability of prudent and feasible tax-planning strategies

8. Consider existence of negative evidence concerning realizability of deferred tax assets

9. Reach an overall conclusion about the amount of valuation allowance required to reduce the deferred tax asset to the amount that is more likely than not to be realized

Sources of income

Taxable income in prior carryback years if carryback is permitted by tax law



Future reversals of existing taxable temporary differences

Future taxable income exclusive of reversing temporary differences and carryforwards

Additionally, tax-planning strategies generally do not represent a source of taxable income by themselves but instead, if executed successfully, increase the amount of taxable income from the three sources of taxable income above

Taxable income in prior carryback years

— Taxable income in prior carryback years, if carryback is permitted by the tax law, is an objectively verifiable source of taxable income

— The fundamental assumption in calculating taxable income in prior carryback years is that in the future period in which the deferred tax asset reverses, the related tax loss becomes available for carryback; in other words, taxable income is zero other than the tax loss arising from the reversal of the deferred tax asset

— If that tax loss, caused solely by the reversal of the existing deferred tax asset, can, under the tax law in the relevant jurisdiction, be carried back to recover the taxes paid in prior years, then no valuation allowance for that portion of the deferred tax asset is needed or permitted

— However, we would also accept a view that a deferred tax asset is only supported by carryback availability to the extent a taxable loss is forecasted

Future reversals of existing taxable temporary differences

- Future reversals of existing taxable temporary differences may support the realization of deferred tax assets
- Future tax losses should not be anticipated when assessing the need for a valuation allowance based on the reversal of existing taxable temporary differences
  - For example, if existing deferred tax liabilities are expected to reverse within the carryforward period of existing NOLs and the taxable income generated from those reversals would be sufficient to use those carryforwards after considering annual limitations, a valuation allowance is not appropriate even if the NOL carryforwards are not expected to be used because future tax losses are expected to be in excess of the reversing existing deferred tax liabilities

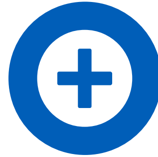
Scheduling temporary differences

- An exercise or analysis performed to determine the pattern and timing of reversal of temporary differences
- Scheduling is typically required when evaluating carryback availability or reversing taxable temporary differences
- ASC 740 does not require an entity to perform detailed scheduling of its temporary differences; however, it may be necessary to estimate the pattern and timing of the reversal to determine the need for a valuation allowance
- The timing of reversal generally coincides with the period in which the underlying assets are recovered or liabilities are settled
- Methods employed should be systematic, logical, and applied consistently from year to year
- Degree of detail is a matter of professional judgment

Scheduling temporary differences

In estimating reversal patterns, consider the following:

Pattern and time period



Remaining carryforward and carryback periods

Indefinite reversals

Tax-planning strategies

Character of taxable and deductible amounts

Limitations on the use of certain deductions, tax credits, carrybacks, or carryforwards

Only existing temporary differences

Scheduling exercise

- Assume that X has a deferred tax asset of $21 attributable to a $100 DTD expected to reverse next year and a deferred tax liability of $21 attributable to a $100 TTD expected to reverse next year. Assume that the deferred tax asset and deferred tax liability relate to the same tax-paying component and are of the same character. Is a valuation allowance needed?
  - Assume carryback is not permitted, no future taxable income exclusive of reversing temporary differences and carryforwards, and no tax-planning strategies are available.
- Would your answer change if the DTD was not expected to reverse until five years in the future?

Future taxable income exclusive of reversing items

- Exclusive of reversing temporary differences and carryforwards
- Ability to estimate future income

Subjectivity generally increases as the number of years increase:

- One year of profit doesn't necessarily equate to a 20-year trend

Consider historical ability to forecast income:

- Corporate budget cycle, industry business cycle, and impairment analysis may indicate appropriate number of years

Best estimate of future amounts should consider as many years as practical (not limited to a rolling fixed number of years)

- Evaluation of significant assumptions
- Consistency of budgets or forecast with other information
- Partial valuation allowances are among the most judgmental areas in accounting for income taxes

Future originating temporary differences and estimates of future taxable income

Estimates of future taxable income should consider the effect of temporary differences that originate in the future (future originating temporary differences) and related reversals

- In some cases it may be unnecessary to schedule these items and estimated pretax book income adjusted for permanent differences may be used as an estimate of future taxable income
- However, because the actual timing of tax deductions and taxable income may be a critical factor in evaluating whether the benefit of an existing deferred tax asset will be realized, judgment is required in determining the extent to which the origination and reversal of future temporary differences is considered in an analysis of future taxable income

Tax-planning strategies

Tax-planning strategy: an action (including elections for tax purposes) that meets certain criteria (see paragraph 740-10-30-19) and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires. Tax-planning strategies are considered when assessing the need for and amount of a valuation allowance for deferred tax assets.

Qualifying tax-planning strategies are:

- Prudent and feasible
- Actions an entity ordinarily might not take, but would take to prevent an operating loss, tax credit carryforward, or other tax benefit from expiring unused, and
- Results in realization of deferred tax assets

Sometimes the goal is to alter timing or character of future taxable income or deductible expenses

Reasonable effort must be made to identify tax-planning strategies prior to concluding a valuation allowance for a deferred tax asset is necessary

Tax-planning strategies

- Tax benefit must be reduced by net-of-tax amount of costs or losses that would be recognized if strategy were implemented
- Measurement of the tax benefit should be consistent with more likely than not threshold
- Examples of potential tax-planning strategies:
  - Sale and leaseback of plant and equipment (if overall appreciation in company net assets)
  - Switch from tax-exempt to taxable investments
  - Disposition of obsolete or excess inventory
  - Extinguishing liabilities that give rise to tax deductions upon payment
- Tax-planning strategies must provide sufficient evidence that gains or additional income would generate positive taxable income and not solely reduce a taxable loss

Evidence for valuation allowances

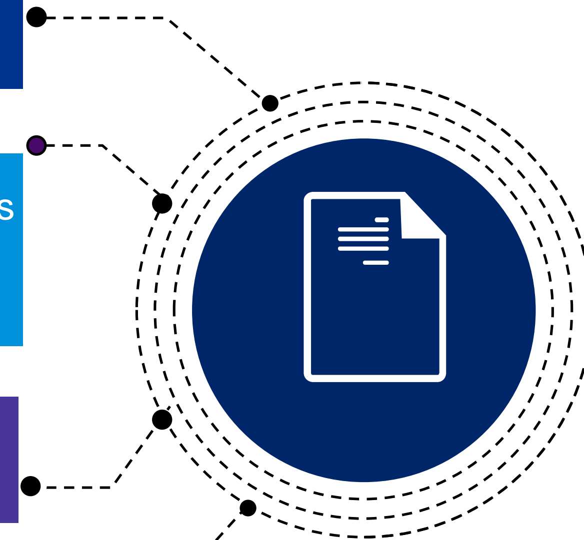
If evidence of one or more sources of taxable income is sufficient to support a conclusion that no valuation allowance is needed, it is generally not necessary to consider other potential sources of taxable income

Carryback availability and future reversals of taxable temporary differences (TTD) are generally more **objective** than projections of future taxable income

All available evidence, both positive and negative, should be identified and considered

Weigh positive evidence (indicating deferred tax assets will be realized) against negative evidence (indicating deferred tax assets will **not** be realized)

- Weight given to evidence should be commensurate with the extent it can be **objectively verified**



Examples of positive and negative evidence

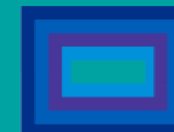
Positive evidence	Negative evidence
— Strong earnings history — Appreciated net asset values — Taxes paid in potential carryback years, if carryback permitted — Availability of tax-planning strategies — Favorable recent developments (for example, significant new customer) — Sales backlog expected to produce taxable income	— Cumulative losses in recent years — Past or expected future losses — Brief carryback and carryforward periods — Special character of income (e.g., capital gains, foreign source income) required to realize tax benefits — History of carryforwards expiring unused — Management has historically been unable to accurately forecast future earnings — Unfavorable trends, developments, or contingencies — Going-concern issues

Cumulative losses in recent years

Cumulative losses in recent years is a significant piece of negative evidence that is difficult to overcome

"Cumulative losses" is generally based upon pretax income (loss), including results of discontinued operations but excluding the cumulative effects of accounting changes

In practice, "recent years" is generally interpreted to be the current and prior two years



We believe an entity also should consider the effects of permanent differences and amounts in other comprehensive income when evaluating its cumulative profile

In practice, a result adjusted for permanent differences, including excess tax benefits, and tax credits should generally be given more weight than unadjusted pretax income (loss)

Accounting for valuation allowances

Change in valuation allowance	Balance sheet impact	Income statement impact
Increase in valuation allowance	Decreases net amount of deferred tax assets or increases net amount of deferred tax liabilities	Generally increases income tax expense and decreases net income
Decrease in valuation allowance	Increases net amount of deferred tax assets or decreases net amount of deferred taxes liabilities	Generally decreases income tax expense and increases net income

Valuation allowance exercises

1. A historically profitable company has TTDs in excess of DTDs + carryforwards within the same tax jurisdiction. Could a valuation allowance be needed?

1. A company that has historically been unprofitable and anticipates losses continuing for several years sets up a valuation allowance equal to the full amount of the gross deferred tax asset. Is such treatment appropriate?

Net operating losses

- Limits utilization to 80 percent of taxable income for losses arising in tax years beginning after December 31, 2017
- Repeals ability to carryback net operating losses, except for certain farming losses, for losses in years ending after December 31, 2017
- Permits indefinite carryforward of losses in years ending after December 31, 2017

Accounting for income taxes considerations:

— Net operating loss carryforwards arising in tax years ending after December 31, 2017 may be supported with reversing taxable temporary differences differently than older losses

— Valuation allowance judgment

  - Scheduling may be required for net operating loss limitation in determining the amount of deferred tax assets supported by reversing deferred tax liabilities
  - Support of indefinite life deferred tax assets with indefinite life deferred tax liabilities
  - We believe tax-planning strategies are required to be considered for carryforwards with an indefinite life

COVID-19 impacts:

Valuation allowance

— Most vulnerable deferred tax assets:
  - Those that expire in the near term
  - Those that are capital in nature and therefore rely on capital gains for support (e.g. DTAs due to unrealized losses on investment securities)

— A company recognizes a change in the valuation allowance in an interim period **through its estimate of the annual ETR** if the change relates to:

1. deferred tax assets originating during the year; or
2. deferred tax assets existing at the beginning of the year that are expected to be realized as a result of current year ordinary income.

— A company recognizes a change in the valuation allowance **entirely in the interim period** if the change relates to deferred tax assets existing at the beginning of the year that are expected to be realized in future years.

Scheduling | Sources of Taxable Income | Disclosures

COVID-19 impacts:

Goodwill impairment

Determining the carrying amount of a reporting unit

- Finalize valuation allowance assessment first
- Assign DTAs and DTLs to reporting units

Determining fair value of a reporting unit

- Determine whether hypothetical disposition is taxable or nontaxable

Measuring impairment when the reporting unit has tax-deductible goodwill

- A company may need to calculate the final impairment loss and the related deferred tax effect using the simultaneous equation that is used in business combinations if all or a portion of first component financial statement goodwill is impaired (see below)

Allocating impairment when the reporting unit has tax-deductible goodwill

- We believe a company may elect to allocate the impairment loss:
  - first to second component financial statement goodwill, if any, and second to first component financial statement goodwill; or
  - on a pro rata basis to first and second component financial statement goodwill.

ASU 2019-12 - *Simplifying the Accounting for Income Taxes*

FASB simplifications ASU

Certain exceptions removed

Change in when to include certain effects of enacted tax law change in annual effective tax rate calculation

Change in accounting for franchise taxes

Required evaluation of whether a step up in tax basis of goodwill is a separate transaction

Policy election on allocation of taxes to certain legal entities in separate financial statements

Intraperiod tax allocation – Loss from continuing operations

Before simplification

- Exception to the step-by-step tax allocation approach
- Required to consider tax effects all components
- Impact:
  - Complexity
  - Diversity in practice

After simplification

- One less exception to step-by-step tax allocation approach
- Only consider tax effects of items in continuing operations
- Impact:
  - Reduced complexity
  - Less diversity

Intraperiod tax allocation – Loss from continuing operations

Facts:

$5,000 loss from continuing operations

$1,000 gain from discontinued operations

No current tax

21% tax rate

Full valuation allowance needed at both beginning and end of year

Before simplification:

- $210 income tax benefit to continuing operations
- $210 income tax expense to discontinued operations

After simplification:

- $0 income tax benefit to continuing operations
- $0 income tax expense to discontinued operations

Intraperiod tax allocation – Loss from continuing operations

Facts:

$10,000 ↓ loss from continuing operations ($2,100 deferred tax asset)

$1,000 ↑ deferred tax liability created from a beneficial conversion feature

21% tax rate

Only 80% of taxable income associated with reversal of DTL will support DTA

Before simplification, with policy election to consider all amounts in equity:

- $800 income tax benefit to continuing operations
- $1,000 income tax expense to equity

After simplification:

- $0 income tax benefit to continuing operations
- $200 income tax expense to equity

Ownership changes in investments

Foreign subsidiary becomes equity method investment

Before simplification

— Non-recognition of existing outside basis difference could continue

After simplification

— Indefinite reversal criterion cannot be applied

Foreign equity method investment becomes subsidiary

Before simplification

— Indefinite reversal criterion cannot be applied to the existing outside basis difference

After simplification

— Indefinite reversal criterion can be applied

Interim reporting

Effect of change in tax laws or rates on amounts currently payable - effective date after enactment date

Before simplification

- Reflected in annual effective tax rate beginning in interim period that includes **effective** date

After simplification

- Reflected in annual effective tax rate beginning in interim period that includes **enactment** date

Year-to-date loss exceeds anticipated full year loss

Before simplification

- Tax benefit limited to amount recognizable at end of year

After simplification

- No limitation

Franchise tax partially based on income

Before simplification

- Specifically excluded from ASC Topic 740 to the extent based on capital and there is no additional tax based on income
- Account for any incremental amount based on income as an income tax within the scope of ASC Topic 740

After simplification

- Recognize in accordance with ASC Topic 740
- Account for any incremental amount as a non-income-based tax.

Franchise taxes, example

Facts:

$10,000	Net taxable capital
$1,000	Net taxable earned surplus (income tax)

Taxed at the greater of .25% of net taxable capital and 4.5% of net earned surplus

Before simplification:

- $25 franchise tax as a component of operating expense
- $20 as a component of income tax expense

After simplification:

- $0 franchise tax as a component of operating expense
- $45 as a component of income tax expense *

*** After simplification, deferred taxes are provided for temporary differences assuming the entity will pay the income-based tax**

Step up in tax basis of goodwill

New requirement to determine whether step up relates to the business combination or is a separate transaction

- Related to business combination in which book goodwill was originally recognized
  - No deferred tax asset recorded unless newly deductible goodwill exceeds remaining balance of book goodwill
- Separate transaction
  - Deferred tax asset recorded

Separate financial statements

Policy election on whether to allocate tax expense in separate financial statements of certain legal entities that are:

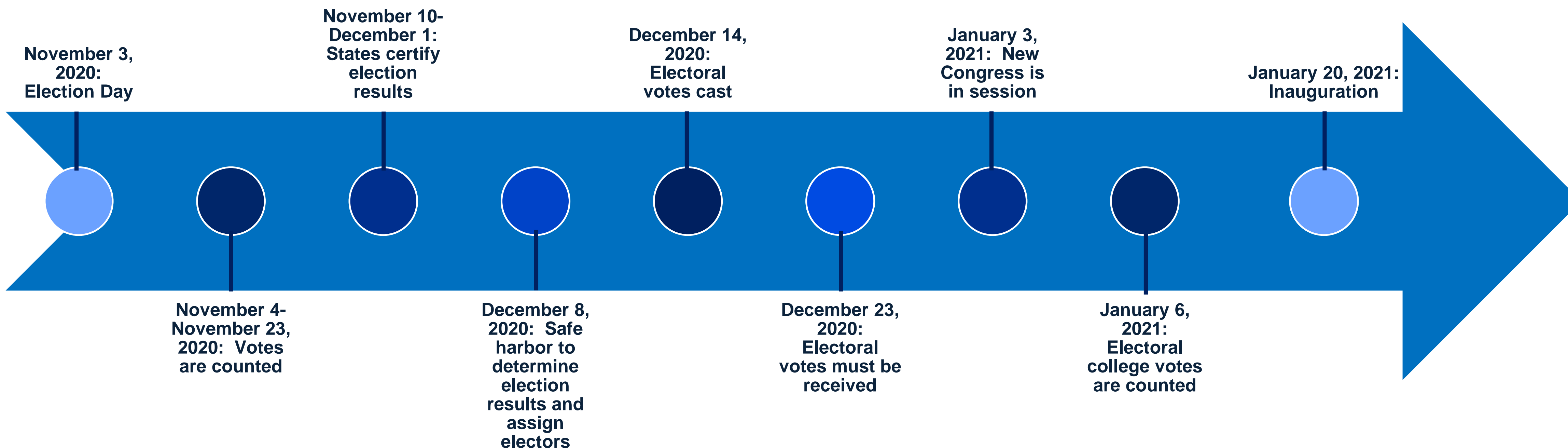
- Members of a group that files a consolidated tax return
- Not subject to tax and disregarded by the taxing authority
  - Example - a disregarded entity such as a single-member limited liability company

Effective dates

	Public business entities	All other entities
Annual periods – Fiscal years beginning after	December 15, 2020	December 15, 2021
Interim periods – In fiscal years beginning after	December 15, 2020	December 15, 2022
Early adoption allowed?	Yes, in periods for which financial statements have not been issued (or made available for issuance). An entity that elects early adoption in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. An entity must adopt all the amendments at the same time.	

Tax accounting implications of rising tax rates

Election 2020: Key Dates

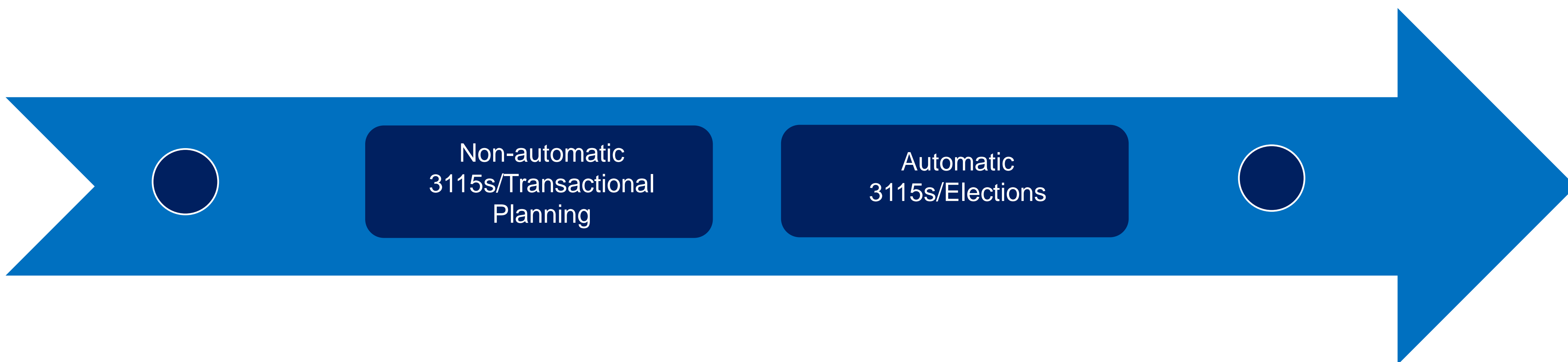


Rising tax rates:

ASC 740 Considerations

- Post Reporting Period/Pre-Issuance Reminders
- Disclosures
- Valuation Allowance
  - Scheduling
- Regulatory Considerations

Accounting Methods Planning - Timeline



Form 3115 - Timing of Recognition

Paragraph 3.064 - Automatic Changes

If an entity is changing a tax accounting method that is eligible for automatic consent procedures, whether from a permissible method or from an impermissible method, the entity should account for the change (including avoiding an IRS initiated tax accounting method change in the earliest open year and the related interest and penalties) when it commits to making the change. Consistent with the application of ASC subparagraph 740-10-25-7(b) (FIN 48) in other situations involving self-reporting to the taxing authority (see the discussion beginning in Paragraph 3.023), because the change in tax accounting method is contingent on receipt of a copy of the Form before an IRS audit is announced, we generally expect that an entity's commitment to making the change would be supported by preparing and submitting a copy of the Form 3115 before the period-end financial statements are issued (i.e., before Form 10-Q or 10-K is filed for public companies) or are available to be issued (for private companies).

Source: KPMG Accounting for Income Taxes Handbook

Paragraph 3.065 - Non Automatic Changes

If an entity is changing a tax accounting method from either a permissible or impermissible tax accounting method that is not automatic, the entity should apply the provisions of ASC Subtopic 740-10 (FIN 48) at the balance sheet date to determine whether it is appropriate to account for the change (including avoiding an IRS initiated change) before receipt of a consent letter. The entity would need to determine whether the requested change is more likely than not of being sustained as well as whether it is more likely than not that the taxing authority will not initiate a tax accounting method change in the earliest open year. In evaluating whether the change is more likely than not, the entity should consider the administrative practices and precedents of the taxing authority (see Paragraphs 3.023 and 3.123). If the entity cannot conclude it is more likely than not that the change in tax accounting method will be sustained, the entity should account for the change when new information is available, generally in the period in which the IRS issues its consent letter.

Acquisitions and acquisition accounting

Scope

ASC 805, *Business Combinations*, applies to all transactions or other events in which an acquirer obtains control of one or more businesses

- ASC 805 defines a business as an integrated set of activities and assets that is capable of being conducted and managed for the purposes of providing a return
  - Integrated sets must have inputs and processes that have the ability to contribute to the creation of outputs
  - Integrated sets must be capable of being conducted as a business by a market participant
- All business combinations will be accounted for under the acquisition method

Types of acquisitions

	Nontaxable transaction	Taxable transaction
Tax basis of assets acquired and liabilities assumed	Tax basis is generally carried over from the acquiree	Tax basis is stepped up to fair value; therefore, the initial tax basis may equal the initial book basis
Temporary differences	Temporary differences arise at the date of acquisition due to differences in the financial statement carrying amounts and the tax basis	Values assigned to individual assets and liabilities may differ for financial reporting and tax purposes and result in temporary differences at the date of acquisition Additionally, temporary differences may arise subsequent to the date of combination
Acquiree's tax attributes (including operating loss and credit carryforwards)	Deferred tax assets should be recognized and measured in accordance with ASC 740 at the date of acquisition	The acquiree's tax attributes generally do not survive; therefore, no related deferred tax asset will typically exist at the date of acquisition

Acquisition accounting

- Recognize fair values of identifiable assets acquired and liabilities assumed (ignoring the tax basis)
- Identify tax basis of assets acquired and liabilities assumed
- Compare recognized amounts of assets acquired and liabilities assumed with tax bases to determine temporary differences
- Recognize deferred tax assets and deferred tax liabilities on temporary differences of identifiable assets acquired and liabilities assumed
- Recognize deferred tax assets for the tax benefits of operating loss and tax credit carryforwards
- Recognize valuation allowance on deferred tax assets (acquired and existing), with changes to existing deferred tax assets recognized outside of acquisition accounting
- Recognize current and noncurrent taxes (income taxes receivable (payable)), including obligations for unrecognized tax benefits
- Recognize goodwill for residual purchase price over the acquisition date amounts of identifiable net assets acquired (if fair value of net assets acquired is greater than purchase price, then record a bargain purchase gain)
- Recognize a deferred tax asset and an adjustment to goodwill for excess tax deductible goodwill

Acquisition accounting example

Facts

Company A, a calendar year corporation, acquires Company B on January 1, 20X1, for $1,000,000 in a nontaxable transaction that is accounted for as a business combination.

Company A has no temporary differences or carryforwards prior to the acquisition.

The enacted tax rate for 20X1 and all future years is 25%.

Identifiable assets acquired and liabilities assumed have the following fair values and tax bases:

	Fair Value	Tax Basis	Deductible (Taxable) Temporary Difference
Inventory	$300,000	$350,000	$ 50,000
Property, plant, and equipment	800,000	400,000	(400,000)
Liabilities, excluding warranty reserve and deferred taxes	(200,000)	(200,000)	—
Warranty reserve	(100,000)	—	100,000
Identifiable net assets acquired	$800,000	$550,000	$(250,000)

All deductible temporary differences reverse in the same periods as at least an equivalent amount of taxable temporary differences.

Company B has no operating loss or tax credit carryforwards.

Acquisition accounting example

Final allocation:	
Inventory	$300,000
Property, plant, and equipment	800,000
Deferred tax asset	37,500
Goodwill	262,500
Warranty reserve	(100,000)
Other liabilities	(200,000)
Deferred tax liability	(100,000)
Purchase price	$1,000,000

The deferred tax asset of $37,500 results from the sum of the deductible temporary differences ($50,000 attributable to inventory and $100,000 of warranty reserve), multiplied by the enacted tax rate of 25%.

The deferred tax liability of $100,000 results from the $400,000 taxable temporary difference between the assigned value and the tax basis of the property, plant, and equipment, multiplied by the enacted tax rate of 25%.

No valuation allowance is required since deductible temporary differences will offset with taxable temporary differences.

No deferred taxes are recorded for the goodwill as ASC 740 specifically provides an exception when amortization is not deductible

Goodwill

Goodwill: an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized

Goodwill is measured as the excess of the fair value of the consideration transferred, noncontrolling interest, and previously held interests over the net amount of recognized identifiable assets acquired and liabilities assumed

Goodwill represents the remaining (residual) value, if any, after identifying and valuing all assets acquired and liabilities assumed, including intangible assets, that meet the recognition criteria

The amount recognized as goodwill includes acquired assets that are not individually identified and separately recognized

Goodwill

Goodwill	Definition	Deferred taxes at the date of acquisition
First component	Lesser of book or tax goodwill	No deferred taxes are provided, as there is no basis difference at the date of acquisition
Second component	Excess book or tax goodwill	Excess book goodwill (nondeductible goodwill) – A deferred tax liability is not recognized for goodwill for which amortization is not deductible for tax purposes
		Excess tax goodwill – A deferred tax asset is recognized for excess tax deductible goodwill over financial reporting goodwill

Goodwill

Illustration:

	Example A		Example B		Example C		Example D	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
1st Component	$ 600	$ 600	$ 600	$ 600	$ —	$ —	$ —	$ —
2nd Component	—	200	200	—	800	—	—	800
Total Goodwill	$ 600	$ 800	$ 800	$ 600	$ 800	$ —	$ —	$ 800

Deferred taxes at the date of acquisition:

First component goodwill - No deferred taxes would be provided

Second component financial reporting goodwill - No deferred tax liability would be provided in Examples B and C

Second component tax goodwill – A deferred tax asset would be provided in Examples A and D

Bargain purchases

Bargain purchases occur if the acquisition date amounts of the identifiable assets acquired and liabilities assumed exceed the consideration transferred, noncontrolling interest, and previously held interests

Requires the recognition of a gain for a bargain purchase since a bargain purchase represents an economic gain, which should be immediately recognized by the acquirer in earnings

Bargain purchase gain is determined after deferred taxes have been established in acquisition accounting

Bargain purchase gain results in an outside basis difference, for which the tax effects, if any, are recognized outside of the acquisition accounting

Acquisition-related uncertainties

Tax uncertainties may be assumed from the seller or created by the transaction

Uncertainties in *acquired tax positions* may include questions regarding:

Tax bases of the acquired assets and liabilities,

Existence of acquired carryforwards,

Sustainability of prior tax-return positions of the acquired entity and the primary obligor for those positions, and

Tax treatment of acquisition costs

The tax bases used in the calculation of deferred tax assets (liabilities), as well as current and noncurrent receivables from (payables to) taxing authorities related to prior tax returns of the acquired entity, are determined pursuant to the guidance in ASC 740 rather than the amounts reported or expected to be reported on the tax return

Measurement period

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts to reflect new information obtained about facts and circumstances that existed as of the acquisition date

The measurement period ends as soon as the acquirer receives the information it was seeking or learns that more information is not obtainable, but cannot exceed one year from the acquisition date

After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error

If the initial accounting for a business combination is incomplete, the acquirer shall disclose:

The reasons why the initial accounting is incomplete

The items for which the initial accounting is incomplete

The nature and amount of any measurement period adjustments

Measurement period

Changes in deferred taxes, valuation allowances, and acquired unrecognized tax benefits within the measurement period are recognized as follows:

New information about facts and circumstances	Recognized in:
Existing at the acquisition date	Acquisition accounting in goodwill (or net income if adjusting a bargain purchase gain)
Not existing at the acquisition date	Earnings or as a direct adjustment to contributed capital

All other changes are reported in earnings (or contributed capital)

Acquisition-related costs

Acquisition-related costs are costs the acquirer incurs to effect a business combination

Treatment of acquisition-related costs under US GAAP:

Accounted for as expenses in the periods in which the costs are incurred and services are received

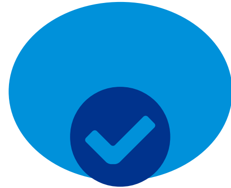
Acquisition-related costs

Treatment of acquisition-related costs for tax purposes:

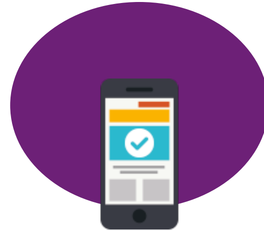
May be immediately deductible, capitalized, included as part of the tax deductible goodwill or included in the basis of the stock acquired

The ultimate tax treatment will depend upon:

The final structure of the acquisition



Whether the acquisition is consummated



The type of service provided and the type of documentation that is provided by the service providers

The taxing jurisdictions involved

When in the transaction timeline they were incurred

Acquisition-related costs

Accounting for the deferred tax effects of acquisition-related costs incurred in the pre-combination period under US GAAP

There are two alternatives to accounting for the deferred tax effects of such costs

The use of an approach is an accounting policy election that, once made, should be applied consistently to all acquisitions

The deferred tax effects related to acquisition-related costs should always be recognized outside of acquisition accounting.

Acquisition-related costs

View A

In the pre-combination period, the reporting entity should consider:

The likelihood that the business combination will be consummated

Whether the business combination will be treated as taxable or nontaxable

Pre-Combination Period		
	Consummation Expected	Consummation Not Expected
Taxable	Recognize a DTA	Recognize a DTA
Nontaxable	Recognize a DTA only if expected to meet recognition conditions (deductible outside tax basis)	Recognize a DTA

Acquisition-related costs

View B

In the pre-combination period, the reporting entity may consider that it cannot assume a business combination will be consummated

Therefore, recognize a deferred tax asset for all costs incurred in the pre-combination period (assuming they would be deductible if the business combination failed)

Upon consummation, depending upon the type of transaction, the deferred tax asset may need to be adjusted

Upon Consummation	
Taxable	DTA recognized in pre-combination period remains on the books
Non-Taxable	Write-off DTA recognized in pre-combination period, unless DTA meets recognition conditions (deductible outside tax basis)

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