Proposed Accounting Standards Update, Intra-Entity Asset Transfers
(File Reference No. 2015-200)

Dear Ms. Cosper:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), Intra-Entity Asset Transfers (the Proposed Standard), from the Financial Accounting Standards Board (FASB or Board).

We support the FASB’s objective in its simplification initiative to reduce the cost and complexity of financial reporting while improving or maintaining the usefulness of the information provided to financial statement users. We believe the current intercompany tax accounting exception that prohibits companies from recognizing in the income statement the income tax effects on sales or transfers of assets among members of a consolidated group is a source of cost and complexity in US GAAP. While many preparers have dedicated considerable resources to establishing accounting policies, systems, processes and controls to address the exception, we believe that the exception continues to be a source of complexity for many companies. In our experience, the application of the exception continues to be one of the leading contributors to income tax accounting errors.

As a result, we support the FASB’s proposal while acknowledging that the proposal does not eliminate complexity. In addition, if the FASB decided not to move forward on this proposal, we would encourage the FASB to pursue standard setting to clarify the scope and application of the exception, albeit outside of its simplification initiative.

Our responses to the questions posed in the Proposed Standard are set out in Appendix A of this letter, and other general comments on the Proposed Standard are included in Appendix B.

We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP
Appendix A – Responses to questions raised in the Proposed Accounting Standards Update, 
Intra-Entity Asset Transfers

**Question 1:** Should the current and deferred income tax consequences of an intra-entity asset transfer be recognized when the transfer occurs? If not, why?

We believe that Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, was originally intended to address the income tax consequences of intercompany sales of inventory and similar tangible assets (e.g., sales between tax jurisdictions of a product that will be sold to a third party or will be used and depreciated). Many preparers that apply the exception to intercompany sales of inventory and similar tangible assets (e.g., fixed assets) do not find its application challenging. However, we have seen an increase in recent years of more complicated, cross-border intercompany transactions, particularly those involving intangible assets such as intellectual property. The intellectual property may or may not have an associated book basis (e.g., internally developed intellectual property). Further, if it does have a book basis, the intellectual property may have a definite or indefinite life. In addition, because the guidance simply refers to “... assets remaining within the consolidated group ...”, questions have arisen as to whether the exception applies to any intercompany transfer of any asset (e.g., the transfers of subsidiaries within the consolidated group) and, if it does apply, how to compute the income tax effects. We are skeptical that the original standard setter contemplated the application of ARB 51 to these more complex transactions.

Our experience indicates that, due to the evolution of intercompany transactions and the limited guidance associated with the exception, the exception is a source of cost and complexity in US GAAP. We believe the cost and complexity begins with questions related to scope and how the standard is to be applied and further translates into process complexity. In our experience, the exception continues to be a leading contributor to income tax accounting errors.

*Scope and application*

Questions have arisen related to the scope of the exception, including whether the exception applies to the following types of intercompany transactions:

- Sales of assets with no book basis
- Sales of indefinite-lived intangible assets
- Licensing agreements (including evaluations of whether they do or do not qualify as sales)
- Transfers or contributions of assets between entities
- Sales of stock of subsidiaries
- Contributions and transfers of subsidiaries
- Sales, transfers and contributions of financial instruments (including intercompany financial instruments)
While some have suggested the Board simply limit the exception to intercompany transfers of inventory (e.g., using the definition of inventory in the Master Glossary), we would caution against that approach without further exploring the role of intellectual property in inventory (e.g., whether the intercompany sale of a manufactured product with an accompanying explicit or implied license is effectively a sale of a component of the underlying intellectual property) as well as the conceptual basis for the exception. While we recognize and support the premise for eliminating intercompany profit (i.e., a transaction with a third party has not occurred, and as a result, the financial position of the consolidated entity is unchanged), the tax consequences of intercompany transactions often have real economic consequences, that under the exception, are not recognized when they occur (e.g., the payment of taxes to a taxing authority and a corresponding receipt of tax basis in a different tax jurisdiction or the change in tax basis due solely to different rates in the buying and selling jurisdictions).

With respect to application of the exception, there are questions regarding the accounting in both the seller's and buyer's jurisdictions. For example, in the seller's jurisdiction, questions have been raised about the time period over which the prepaid tax (i.e., the tax paid in the selling jurisdiction) should be recorded in the income statement (e.g., when the transferred intangible asset has an indefinite-life or no consolidated book balance resulting in no asset life for book purposes). In the buyer's jurisdiction, questions have been raised about the period in which the tax benefits associated with the resulting step-up in tax basis should be recognized in the consolidated financial statements (e.g., for amortizing assets with different book and tax lives). Questions also arise as to how to measure the tax consequences of the transfer. In addition, depending on how the initial scoping questions are answered, each of the example transactions noted above would introduce added application complexity. Further, questions have arisen regarding the interaction of this exception with the accounting for outside basis differences in foreign and domestic subsidiaries and the accounting for valuation allowances.

Process

Some preparers also struggle with the mechanical application of the exception. In addition to eliminating the pretax income on an intercompany sale or transfer of an asset, an entity must record a journal entry to eliminate the income tax expense in the seller's jurisdiction and record an asset (e.g., a prepaid asset) for the taxes paid. An entity also must reduce the tax basis in the buyer’s jurisdiction for financial reporting purposes so that no deferred tax asset is recorded for the difference between the buyer’s tax basis and consolidated book basis.

Despite these challenges, many companies have developed robust accounting policies, systems, processes and controls to identify intercompany transactions and apply the exception. We understand that many of these companies no longer find the exception to be challenging. Thus, these companies may not view the proposal as a means to reduce cost and complexity in US GAAP.

We do believe that the proposed amendments would introduce different complexity in US GAAP. For example, companies will have to establish processes and controls to verify that changes in tax basis are identified timely for transactions that are eliminated in consolidation. In addition, an intercompany transaction may have income tax effects beyond the direct effects of the transaction. For example, an intercompany transaction may change the foreign tax credits generated by a foreign subsidiary or may change the rate at which a dividend from a foreign subsidiary is taxed in the parent’s jurisdiction.
Additionally, we note that the Proposed Standard would align US GAAP with IFRS because International Accounting Standards (IAS) 12, *Income Taxes*, does not include the exception that exists in Accounting Standards Codification (ASC) 740, *Income Taxes*.

After thoughtful consideration of the above considerations, based principally on the issues and errors we have seen related to the scope and application of the exception, we support the Board's proposal to eliminate the exception.

As part of the Board’s review of comment letters, we encourage the Board to carefully consider feedback from financial statement users about whether the Proposed Standard would improve or maintain the usefulness of the information provided to users. Users may raise concerns that the Proposed Standard could reduce the usefulness of information included in the financial statements, which could outweigh the benefits of the proposal.

**Question 2:** If the income tax consequences should not be recognized when the transfer occurs, should the income taxes payable or paid upon transfer be expensed as incurred? If not, how should income taxes payable or paid be recognized?

We support the Board’s proposal that income tax consequences should be recognized in the income statement when intercompany transactions occur. See response to Question 1 above.

**Question 3:** Should the proposed guidance be applied on a modified retrospective basis? Are the transition disclosures appropriate?

Yes. We agree that the proposed guidance should be applied on a modified retrospective basis. We generally believe that the costs of full retrospective application would outweigh the benefits. Additionally, full retrospective application might require the use of hindsight (e.g., to evaluate deferred tax assets for realizability in prior periods).

We agree with the transition disclosure requirements subject to certain clarifications (see Appendix B).

**Question 4:** Should the amendments in this proposed Update be effective for:

a. Public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2016

b. All other entities for annual periods beginning after December 15, 2017, and interim periods in annual periods beginning after December 15, 2018, with early adoption permitted, but not before the effective date for public business entities?

We support the proposed effective dates.
Appendix B – General comments about the Proposed Standard

We have the following general comments, and below each point, we recommend language to address our concerns.

► The Proposed Standard does not address how preparers should consider the tax effects of intercompany sales or transfers of assets when estimating annual effective tax rates in interim periods. We believe that a company should evaluate intercompany transactions in accordance with the general principles of ASC 740-270 when determining whether the tax effects of those transactions should be included in a company’s estimate of its annual effective tax rate. We believe that ASC 740-270 should be amended to make this clear, and we propose the following change:

740-270-25-2A: While the pre-tax effects of intra-entity transactions are eliminated in the consolidated financial statements, and thus excluded from income (or loss), an entity shall consider the tax effects of intra-entity transactions when estimating its annual effective tax rate in a manner consistent with principles of this Subtopic.

► ASC 740-10-25-20(i) refers to a “taxpaying entity.” To be more consistent with the terminology used in ASC 740, we suggest these references be changed to “tax-paying component” (e.g., see ASC 740-10-30-5).

740-10-25-20(i): The difference between the tax basis of the asset in the buyer’s tax jurisdiction and the cost of the asset reported in the consolidated financial statements as a result of an intra-entity asset transfer from one taxpaying entity tax-paying component to another taxpaying entity tax-paying component of the same consolidated group.

► ASC 740-10-25-22 refers to examples provided in ASC 740-10-25-21. We believe the intended reference is to ASC 740-10-25-20.

740-10-25-22: This Topic refers collectively to the types of differences illustrated by the examples in paragraph 740-10-25-20 740-10-25-21 and the ones described in paragraph 740-10-25-24 as temporary differences.

► ASC 740-10-65-4(d) as currently written would permit entities other than public business entities to early adopt the guidance as of an interim period. This point is reinforced by the language in ASC 740-10-65-4(g). Because the Proposed Standard would change how an entity recognizes financial statement amounts, we believe that entities should be required to adopt the proposed guidance as of the beginning of an annual period. We believe that it would likely be confusing to users for an entity that early adopts the new guidance as of an interim period to have two different accounting policies within the same annual period related to the recognition of financial statement amounts (i.e., income taxes in this case), as well as a cumulative-effect adjustment to retained earnings within an annual period.

740-10-65-4(d): For entities other than public business entities, early application of the pending content that links to this paragraph is permitted, but not before the effective date for public business entities and provided that the guidance is applied from the beginning of the
annual period of adoption. If an entity other than a public business entity elects to early adopt the pending content that links to this paragraph, it must also elect to early adopt the pending content that links to paragraph 740-10-65-5.

- The proposed guidance does not state explicitly that entities should assess the realizability of any deferred tax assets recognized upon adoption of the Proposed Standard. In the absence of clarification, we believe that entities may overlook this requirement within ASC 740. Additionally, we believe that the guidance should clarify that any valuation allowance recorded against deferred tax assets recognized on the adoption date should be part of the cumulative-effect adjustment to retained earnings. Therefore, we believe that ASC 740-10-65-4(e) should be amended as follows.

> 740-10-65-4(e): The pending content that links to this paragraph shall be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption for the recognition of the income tax consequences of intra-entity asset transfers occurring before the effective date. Any deferred tax assets recorded on the date of adoption shall be assessed for realizability in accordance with the provisions of Topic 740. Any valuation allowance recognized on the date of adoption for deferred tax assets recognized as a result of the adoption of the pending content shall be recorded as part of the cumulative-effect adjustment to retained earnings.

- We believe the transition disclosures described in paragraph 740-10-65-4(f) should be provided in the period the entity adopts the Proposed Standard. We believe the language, as currently drafted, could be interpreted to mean that disclosures are required in the first annual period after the period that includes the adoption, rather than in the annual period of adoption. In addition, we suggest deletion of the phrase that would require disclosures in each interim period within the annual period of adoption. With the deletion, the disclosure requirement would align with the requirements in ASC 250, Accounting Changes and Error Corrections, and the Proposed ASU, Balance Sheet Classification of Deferred Taxes.

> 740-10-65-4(f): In the first interim and annual period of after adoption, and the interim periods within that first annual period, a public business entity shall disclose the following:

1. The nature of and reason for the change in accounting principle

2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item(s), and any affected per-share amounts for the current period

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.