Dear Ms. Cosper,

FASB’s proposed accounting standard update (ASU) to simplify Topic 740, *Income Taxes* (Topic 740) is a good step toward achieving further simplification of a very complex accounting topic. It is also a testament of FASB’s commitment to solicit input from stakeholders and reduce complexity and cost of complying with the requirements of Topic 740. These proposals, if finalized, should help reduce complexity and improve the information usefulness of financial accounting for income taxes.

However, some corrections and additional improvements are necessary prior to issuing a final ASU.

**Question 1:** Do you agree that the amendments in this proposed Update would simplify the accounting for income taxes? If not, please explain which proposed amendment(s) you disagree with and why.

**Question 1 Response:** Generally, yes. However, the following improvements and corrections should be considered:

**Goodwill Tax Accounting**

An amendment should be added to allow private entities to elect recognition of a deferred tax liability (DTL) for nondeductible goodwill. FASB’s attempting to incorporate indicators of a tax basis in goodwill misses the real issue which is the asymmetrical tax accounting treatment of nondeductible goodwill. The recognition exception in paragraph 850-740-25-3 complicates the accounting for “day 2” (i.e., post-acquisition date) events such as tax elections, disposals, sales, and impairments. The exception leads to increased financial accounting compliance cost with no apparent information benefit to users of financial statements.

Conceptually, nondeductible goodwill should not have a special deferred tax treatment than other nondeductible intangible assets and property, plant and equipment acquired in a stock acquisition. Future reduction in book carrying values for disposals, impairments, and amortization, for private entities electing the goodwill amortization accounting alternative,
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should be matched with a reduction of a DTL (or an adjustment to deferred tax asset, DTA, as may be appropriate).

Removing the DTL recognition exception in ASC 850-740-25-3 for private entities that elect goodwill amortization will simplify the accounting and reduce cost. It will also improve the information usefulness of a tax rate reconciliation (for private entities that provide a rate reconciliation) when nondeductible goodwill is amortized, disposed, or impaired. The spike in the effective tax rate caused by the recognition exception would be avoided, narrowing the difference between an entity’s financial-book and statutory tax rates.

Deferred tax accounting for goodwill is riddled with challenges due to varied tax laws and complex pretax accounting.

The proposed list of indicators to consider when evaluating whether tax basis arises from a “separate transaction” (proposed paragraph 740-10-25-54) could lead to greater professional judgement, more complexity, higher cost, and inconsistent application. It is also not possible to contemplate all permutations available in many jurisdictions’ current and future tax laws to fully address what is a “unit of account” issue.

Also, it is not clear why the “day 2” tax accounting for goodwill, but not for other acquired assets, necessitates prescribing new rules or indicators.

Instead of proposing “indicators”, FASB should consider removing the current guidance in paragraph 740-10-25-54 in its entirety. This is a legacy accounting guidance from before the revisions of the business combination accounting literature. Under old U.S. tax law preceding the issuance of statement FAS 109, goodwill was nondeductible; however, a subsequent tax legislation authorized amortization over a period of 15 years. In response, FASB issued incremental guidance to FAS 109 to deal with the change in goodwill tax law which was codified in paragraph 740-10-25-54. These tax accounting rules were written in the context of “old” business combination accounting.

The revised business combination accounting (a/k/a FAS 141R) completely changed the accounting model, rendering the guidance in paragraph 740-10-25-54 unnecessary. Goodwill is measured and recognized at fair value and changes (affecting pretax and income tax) related to the acquired business’ net assets cannot be traced back to goodwill, unless they qualify as measurement period adjustments. Therefore, the incremental guidance in paragraph 740-10-25-54 is arguably unnecessary for proper application of the revised business combination accounting. Removing the legacy guidance for goodwill should reduce complexity and increase

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1 Grossing up goodwill should mechanically not be more complex than grossing down goodwill for excess tax-over-book basis, nor would it be significant issue for private entities that elect goodwill amortization.

2 For example, a tax election to step up tax basis of goodwill could, in a particular jurisdiction, be a viable option on acquisition date, at any date within a maximum one-year measurement period, and after one year from acquisition date.

3 Congress added Code Section 197 with the passage of the Omnibus Budget Reconciliation Act of 1993.
Intraperiod Allocation

FASB’s proposed elimination of the “with and without” intraperiod exception in paragraph 740-20-45-7 is welcomed for reasons noted in the basis for conclusion.

However, FASB’s proposed change to Example 2, Case A, paragraphs 740-20-55-11 to 740-20-55-12 is problematic and counterintuitive. The actual tax rate at which the loss from continuing operations benefited earnings is not reflective in the proposed change and could lead to unintended errors by preparers.

In the U.S. jurisdiction, corporations receive no preferential tax treatment for capital gains which are added to a corporation’s ordinary income and taxed at a single tax rate of 21 percent. However, net capital loss (capital loss in excess of capital gain) may be carried back three years to offset capital gains and then carried forward five years.

The proposed change results in grossing up income tax benefit in continuing operations from $150 (the current example) to $200 with an equal offset in discontinued operations (tax expense of $320 instead of $270).4

The very same problem that FASB is proposing a solution for - i.e., eliminating the distortion created in the current exception’s gross-up of income tax expense or benefit within comprehensive income, is being perpetuated with the proposed change to Example 2. It also exacerbates the disconnect between income tax expense from continuing operations and income tax payable, a problem FASB is considering in its current proposal on income tax disclosure improvements.

The tax return reality is the loss from operations provides a benefit at 30 percent and there is no indication in Example 2 how exactly the loss from operations is expected to provide a 40 percent benefit. While the operative rule in par. 740-20-45-7 limits consideration of income and losses that are recognized only in continuing operations, the tax effect should be measured at the rate at which the item is affecting or expected to affect taxes payable and refundable.5

Assuming Example 2 pertains to a jurisdiction whose tax law allows carryback and carryforward of net capital losses and unlimited carryforward of a net operating loss, similar to U.S. federal laws, and that the entity does not have net capital loss in future years to carryback and recover ordinary loss of $500. In such circumstance, after three years the accumulated earnings from continuing operations would be overstated by $50.

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4 Tax expense (benefit) allocable to a gain (loss) from discontinued operations is effectively a “plug”.
5 ASC 740-10-30-8 provides guidance on applicable tax rate(s) to measure deferred income taxes. ASC 740-10-55-24 provides implementation guidance on measurement of deferred income taxes when there is more than one applicable tax rate.
FASB can fix Example 2 by either (1) change the capital gain tax rate to 40 percent (or the ordinary income tax rate to 30 percent); (2) retain the current measurement of income tax effects at 30 percent with additional explanation of measurement considerations\(^6\); or (3) retain the proposed change but add narrative in proposed par. 740-20-55-10(e ) (or elsewhere in Example 2) to explain that the relevant tax laws would permit carryforward of ordinary loss and carryback of capital loss and the entity expects to avail itself of a tax election to amend its prior-year tax returns, etc. (however, the third option is further complicated by operational and conceptual challenges from forecasting capital losses).

**Allocation of Consolidated Tax Expense to Separate Financial Statements**

FASB’s the proposed amendment to paragraph 740-10-30-27 (as articulated in basis for conclusion paragraph BC #13) is not consistent with the U.S. federal tax treatment of single member LLCs. Under IRS rules, the owner and the LLC are viewed as “one and the same”, notwithstanding the legal “separation” of LLC’s liability from the owner. The assets and liabilities of a single member LLC are included in a consolidated corporation income tax return, no different than assets and liabilities of wholly owned subsidiary that is a Subchapter C corporation. The income tax treatment of consolidated LLCs is quite different than that of consolidated partnerships and the accounting for LLCs in separate financial statements should reflect this difference. FASB’s proposed amendment effectively eliminates this difference.

Alternatively, FASB could amend paragraph 740-10-30-27 to allow an accounting policy election to not allocate income tax expenses to LLCs when income tax expense is not germane to the intended purpose and users of the separate financial statements.\(^7\) In such circumstances, prepares could elect an accounting policy to follow “tax legalistic” view of LLCs in separate company financial statements and not have to allocate income tax expense.

This alternative approach would effectively codify existing practice.

If FASB retains the proposed amendment, it should consider clarifying whether the election to allocate income taxes can also be made in separate financial statements of a consolidated partnership. This is necessary because there is no single international definition of “disregarded by the taxing authority”. A clarification would be needed in the codification (e.g., paragraph 740-10-30-27) not just in basis for conclusion.

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\(^6\) Retaining the current measurement is consistent with how deferred taxes would be measured in the current period if the gain were unrealized but expected to be realized in the following period and be partially offset by the loss carryforward (i.e., both DTA for loss carryforward and DTL for unrealized gain measured at 30%).

\(^7\) This is more of a principle-based approach that acknowledges LLCs included in consolidated tax group do incur entity-level tax (unlike partnerships).
Hybrid Tax Laws (Income and non-income based taxes)

FASB’s proposed amendment to paragraph 740-10-15-4(a) and the implementation guidance should reduce complexity and compliance cost when income tax exceeds tax determined on non-income base. In such circumstances, the reporting entity incurs an income tax.

However, it is not clear whether the same can be said when non-income tax (e.g., franchise tax based on capital) exceeds income tax (except when income tax is nil). When income tax is not zero, the proposed amendment would effectively require recognition of income tax expense even when the reporting entity incurs the higher, non-income tax. That is, FASB’s proposal will require recognition of income tax expense even when there is no “excess”. For example, if tax based on capital is $100 and tax based on income is $20, under current accounting, there is no income tax expense. However, under proposed amendment there would be a $20 income tax expense and $80 capital tax recognized in pretax earnings.

FASB could consider whether a binary model is more appropriate for hybrid tax laws. The character of the tax incurred would determine whether it is recognized in pretax earnings or in income tax expense. Deferred income taxes would be determined for assets and liabilities and the net change either recognized in pretax earnings or income tax, depending on the higher tax ultimately incurred.

If FASB finalizes this proposed amendment, it should consider replacing the proposed wording change in paragraph 740-10-30-27 from “incremental” back to “excess” which is more appropriate to describe the impact of “a higher tax amount” in hybrid tax laws.

Outside Basis Difference in Foreign Investee

FASB’s proposed amendment to paragraphs 740-30-25-15 and 740-30-45-3 would result in removing a useful principle than fixing a “problematic exception”. Generally, a change in the investor’s investment status in a foreign entity from a subsidiary to an equity method investment triggers the need to recognize deferred income tax for the outside-basis difference. The status change itself, oftentimes, makes it “apparent” that the investor’s equity in the undistributed earnings will be remitted and trigger income tax because the investor no longer controls the timing and manner by which the outside-basis temporary difference would reverse.

However, there are commercial arrangements that result in the investor losing financial control necessary for accounting consolidation but still retains control or influence over the expected manner of recovery and whether income tax would ultimately be triggered. For example, an

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8 Paragraphs 740-10-55-26 and 740-10-55-139 through 55-144 and Example 17
9 The word “incremental” is misleading to describe two different bases and computations.
10 Deferred income tax is recognized and measured for equity method investment depending on the investor’s expected manner of recovering its investment (i.e., dividends vs. sale). The **facts & circumstance** should be evaluated to determine the investor’s expected manner of recovery (paragraph 740-10-55-24)
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investor might reduce its investment below common financial controlling interest and deconsolidate a foreign entity investee but might retain certain rights and powers to decide whether the foreign entity can pay dividends (i.e., an ability to block dividends) or liquidate. Or the controlling and non-controlling investors might contractually agree to not take dividends from the foreign investment, while sales of any interest would not have capital gain tax consequence.\textsuperscript{11}

FASB already acknowledged the validity of this logical principle as stated in the middle of paragraph 740-30-25-15: “The change in the status of an investment would not by itself mean that remittance of these undistributed earnings shall be considered apparent.”

This logical principle is also consistent with the accounting for equity method investments in foreign corporate joint ventures that are considered permanent in duration (paragraph 740-30-15-18), which is an “exception” to full recognition of deferred income taxes for equity method investments.\textsuperscript{12}

Unlike the obvious need to eliminate the exception in paragraph 740-30-25-16 (change from equity method to subsidiary) which FASB is rightfully proposing, the FASB should leave paragraph 740-30-25-15 “as is” because it provides a logical principle that is consistent with guidance on expected manner of recovery and corporate joint ventures that are permanent in duration.

\textbf{Interim Period Accounting for Tax Legislation \& Loss Limitation}

FASB’s proposed amendment to align the timing of interim period recognition of current and deferred income taxes from a tax legislation enactment is welcomed (proposed amendments to paragraphs 740-270-25-5 and 740-270-30-11).

However, some safeguard is required to prevent unintentional recognition of tax effects with a prospective effective date beginning with a future fiscal year (i.e., an annual period after a tax legislation is enacted). For example, if a tax legislation is enacted in Q1-X9 but has an effective date of 1/1/X10, the annual effective tax rate from recurring operation for X9 should not be affected by the tax legislation enacted in Q1-X9.\textsuperscript{13} FASB should add clarification given that tax legislations with a prospective date beginning in a future fiscal year (e.g., subsequent year) were historically enacted and more are likely to occur in the future.

For example, FASB could consider the following language to par.740-270-25-5:

“The effects of new tax legislation shall not be considered prior to enactment date. The tax effect of a change in tax laws or rates on current-year taxes payables or refundable shall be recognized in the annual effective tax rate beginning in the interim period which includes the

\textsuperscript{11} There are more examples, especially with consolidation and deconsolidation of a variable interest entity (VIE)

\textsuperscript{12} Deferred income taxes are generally required for equity method investments (par. 740-30-25-5(b))

\textsuperscript{13} The only impact on X9 provisions would be an adjustment to deferred income taxes recognized in Q1-X9
enactment date, except for a tax legislation with a prospective effective date beginning after the current year. The effect of a change in tax laws or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate and must be recognized in the enactment-date interim period.”

A similar clarification is needed in paragraph 740-270-55-49 (Example Case A). For example, at the end of the proposed revision and before “Accordingly”, FASB should add: “legislation, except for a tax legislation with a prospective effective date beginning after the current year”.

Also, FASB should keep the last sentence in paragraph 740-270-30-30-11 being a valuable cross-reference to the recognition-timing requirement in paragraph 740-270-25-5. Retaining the last sentence is needed especially if FASB finalizes the proposed amendment without the clarifications suggested herein.

FASB’s proposed elimination of the “loss limitation” rule in paragraph 740-270-30-28 is welcomed as it is certain to reduce complexity and cost of complying with interim period tax accounting without sacrificing useful information.

Question 2: Do the proposed amendments maintain or improve the usefulness of information provided to users? Alternatively, would the proposed amendments result in the elimination of decision-useful information? Please explain why or why not.

Question 2 response: Generally, yes.

However, the proposed amendment to the presentation of income taxes in separate financial statements of a single-member LLC (i.e., paragraph 740-10-30-27) will eliminate the impact of income tax on cash flows from operation (arguably, useful information for some users of separate company financial statements). FASB should consider a disclosure requirement to explain that income taxes are not allocable to the separate financial statements of an LLC because it does not file an income tax return, etc.

For example, paragraph 740-10-50-17 could be expanded with subparagraph “c” to state this: “A single-member LLC that files separate company financial statements should disclose the fact that it is not considered a member of a group that files a consolidated tax return (it is not a taxpaying entity) and is not allocated current and deferred income taxes, except for when it elects to allocate income taxes under paragraph 740-10-30-27.”

Also, as indicated in “Question 1 Response”, eliminating the guidance in paragraphs 740-30-25-15 and 740-30-45-3 would force recognition of deferred income tax liabilities when a subsidiary investment is changed to an equity method investment, even when the facts and circumstance support nonrecognition. For this reason, the guidance in these paragraphs should be retained.

Question 3: Are the proposed amendments operable and auditable? If not, which aspects pose operability or auditability issues and why? Would any of the proposed amendments impose
significant incremental costs? If so, please describe the nature and extent of the additional costs.

**Question 3 Response**: FASB’s proposed list of “separate transaction” indicators (proposed amendment to paragraph 740-10-25-54) cannot possibly address all permutations and could lead to greater professional judgement and implementation challenges. Eliminating the legacy guidance in paragraph 740-10-25-54 will lead to more consistent application of business combination accounting guidance to all “day 2” events and transactions.

**Question 4**: Are the transition requirements and transition disclosures for the proposed amendments appropriate? If not, what transition approach or transition requirements would be more appropriate and why?

**Question 4 Response**: Yes

**Question 5**: How much time would be needed to adopt the proposed amendments? Should early adoption be permitted? Should entities other than public business entities be provided with an additional year to implement the proposed amendments? Why or why not?

**Question 5 Response**: Early adoption should be permitted for entities that want to avoid complexities and cost earlier than the mandatory adoption date. For example, a reporting entity that has current fiscal year operating loss but a gain in another component could avoid the requirements (and complexity and cost) of applying the intraperiod allocation exception starting in the current fiscal year if it elects early adoption.

FASB has generally been granting nonpublic business entities additional time to implement accounting standards updates and changes and this Update should not be an exception. Private entities have less resources to learn, prepare, and adopt accounting changes and granting additional time is appropriate.

If you have any questions, please do not hesitate to contact me via email: ybarbut@gmail.com

Sincerely,

Yosef Barbut

Independent Consultant