APB 23: Accounting for Income Taxes—Special Areas

APB 23 STATUS

Issued: April 1972

Effective Date: For fiscal periods beginning after December 31, 1971

Affects: Deletes ARB 51, paragraph 16
Deletes APB 11, paragraphs 38, 39, and 41
Deletes APB 18, paragraph 19(j) and footnote 11

Affected by: Paragraph 2 amended by FAS 9, paragraph 16
Paragraph 4 deleted by FAS 71, paragraph 26(i)
Paragraph 9 and footnote 9 amended by FAS 96, paragraph 205(e), and FAS 109, paragraph 288(f)
Paragraph 10 amended by FAS 96, paragraph 205(e)
Paragraph 10 replaced by FAS 109, paragraph 288(f)
Paragraphs 11, 14, and 24 replaced by FAS 96, paragraph 205(e), and FAS 109, paragraph 288(f)
Paragraph 13 amended by FAS 96, paragraphs 204 and 205(e), and FAS 109, paragraphs 287 and 288(f)
Paragraphs 21 and 23 amended by FAS 109, paragraph 288(f)
Paragraphs 26 through 30 and footnote 11 deleted by FAS 60, paragraph 62
Footnote 3 deleted by FAS 109, paragraph 288(f)
Footnotes 4, 6, and 10 deleted by FAS 96, paragraph 205(e), and FAS 109, paragraph 288(f)
Footnote 7 amended by FAS 96, paragraph 204, and FAS 109, paragraph 287

Other Interpretive Pronouncements: AIN-APB 23, Interpretation No. 1
(Superseded by FAS 96 and FAS 109)
FIN 22 (Superseded by FAS 96 and FAS 109)
FIN 29 (Superseded by FAS 96 and FAS 109)
FTB 84-2 (Superseded by FAS 96 and FAS 109)

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: No EITF Issues

Interpreted by: Paragraph 12 interpreted by EITF Issue No. 93-16

Related Issues: EITF Issues No. 86-31 and 95-20

INTRODUCTION

1. In December 1967 the Accounting Principles Board issued APB Opinion No. 11, *Accounting for Income Taxes*, but deferred modifying the practices of accounting for income taxes in five special areas identified in paragraphs 38 through 41 of that Opinion as requiring further study:

a. Undistributed earnings of subsidiaries
b. Intangible development costs in the oil and gas industry
c. "General reserves" of stock savings and loan associations
d. Amounts designated as "policyholders' surplus" by stock life insurance companies

e. Deposits in statutory reserve funds by United States steamship companies.

2. The Board has examined the characteristics of the tax consequences of transactions in the three special areas designated (a), (c), and (d) above and sets forth in this Opinion its conclusions on appropriate accounting treatments. The Board also defers conclusions on deposits in capital construction funds or statutory reserve funds by United States steamship companies until regulations covering the provisions of the Merchant Marine Act of 1970 are available; experience under the 1970 Act, which substantially modified the Merchant Marine Act of 1936, is now limited. The Board also expresses in this Opinion its conclusions on accounting for taxes on income from investments in corporate joint ventures accounted for by the equity method in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. APB Opinion No. 24 covers accounting for taxes on income from investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures).

3. This Opinion supersedes paragraph 16 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, paragraphs 38, 39, and 41 of APB Opinion No. 11 and paragraph 19(j) of APB Opinion No. 18. Except as stated in the preceding sentence this Opinion does not modify APB Opinion No. 11.

4. [This paragraph has been deleted. See Status page.]

Discussion

5. In APB Opinion No. 11 the Board defined differences between taxable income and pretax accounting income as either timing differences or permanent differences and provided criteria for distinguishing between the differences. Timing differences are "Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods." Permanent differences are "Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods." The Board also recognized that the tax consequences of a number of other transactions are somewhat similar to those of timing differences; however, the initial differences between taxable income and pretax accounting income related to the transactions may not reverse until indefinite future periods or may never reverse.

6. A timing difference arises when the initial difference between taxable income and pretax accounting income originates in one period and predictably reverses or turns around in one or more subsequent periods. The reversal of a timing difference at some future date is definite and the period of reversal is generally predictable within reasonable limits. Sometimes, however, reversal of a difference cannot be predicted because the events that create the tax consequences are controlled by the taxpayer and frequently require that the taxpayer take specific action before the initial difference reverses.

UNDISTRIBUTED EARNINGS OF SUBSIDIARIES

Discussion

7. Paragraph 16 of ARB No. 51, *Consolidated Financial Statements*, which is superseded by this Opinion, provided guides for interperiod allocation of income taxes that will be incurred at the date that previously undistributed earnings of subsidiaries are remitted to the parent company. [i]**1** The concept of accruing income taxes for earnings included in consolidated income in accordance with APB Opinion No. 11 has been applied inconsistently. Some believe that the only appropriate method is to accrue related deferred taxes substantially in accordance with paragraphs 36 and 37 of APB Opinion No. 11 while others believe that under the criteria set forth in ARB No. 51 a parent company need accrue related deferred taxes only if the transfer of earnings to the parent company in a taxable distribution is imminent or relatively certain. Disclosure of the accounting for income taxes on undistributed earnings of subsidiaries has often been inadequate. Some believe that the contingent liability for taxes that would be payable if the

undistributed earnings of subsidiaries were remitted should be disclosed. In their view changing circumstances, often beyond the control of the parent company, may accelerate distribution of earnings of a subsidiary so that the parent company will incur a tax for which no provision has been made. They believe an inability to determine the exact amount of the tax that might be payable is in itself no justification for not accruing the best current estimate of the contingent liability. Others believe that instead the amount of undistributed earnings of subsidiaries for which a parent company has not accrued income taxes should be disclosed in notes to financial statements. In their view disclosure of a hypothetical tax which would be payable, assuming those earnings were distributed currently, implies a contradiction of the decision that it is not necessary to provide for income taxes on the earnings in the financial statements. They do not believe that such a hypothetical tax is normally a realistic quantification of the contingent taxes that would be incurred even if some portion of the undistributed earnings were remitted.

8. A domestic or foreign subsidiary remits earnings to a parent company after the parties consider numerous factors, including the following:

a. Financial requirements of the parent company
b. Financial requirements of the subsidiary
c. Operational and fiscal objectives of the parent company, both long-term and short-term
d. Remittance restrictions imposed by governments
e. Remittance restrictions imposed by lease or financing agreements of the subsidiary
f. Tax consequences of the remittance.

Remittance of earnings of a subsidiary may sometimes be indefinite because of the specific long-term investment plans and objectives of the parent company. Even in the absence of long-term investment plans, the flexibility inherent in the United States Internal Revenue Code may permit a parent company to postpone income taxes on the earnings of a subsidiary for an extended period or may permit the ultimate distribution to be taxed at special rates applicable to the nature of the distribution. Other circumstances may indicate that the earnings will probably be remitted in the foreseeable future. However, the parent company may control the events that create the tax consequences in either circumstance.

Opinion

9. The Board concludes that including undistributed earnings of a subsidiary [ii]**2** in the pretax accounting income of a parent company, either through consolidation or accounting for the investment by the equity method, results in a temporary difference.

10. *Temporary Difference.* The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free. However, for reasons described in FASB Statement No. 109, *Accounting for Income Taxes,* a deferred tax liability is not recognized for (a) an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 12 of this Opinion and (b) undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992 and that meet the criteria in paragraph 12 of this Opinion. The criteria in paragraph 12 of this Opinion do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference.

[3-4][These footnotes have been deleted. See Status page.]

11. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary in accordance with the requirements of paragraph 34 of Statement 109.

12. *Indefinite reversal criteria.* The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if

sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent company's representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item.

13. *Change in investment.* An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent company sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If the remaining investment in common stock should be accounted for by the equity method, the investor should recognize income taxes on its share of current earnings of the investee company in accordance with the provisions of FASB Statement No. 109, *Accounting for Income Taxes.* If a parent company did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 12 (and the company in which the investment is held ceases to be a subsidiary), it should accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent [iii]**5** that any of those undistributed earnings (prior to the change in status) will be remitted; the accrual of those income taxes should not be accounted for as an extraordinary item. If a parent company recognizes a deferred tax liability for the temporary difference arising from its equity in undistributed earnings of a subsidiary and subsequently reduces its investment in the subsidiary through a taxable sale or other transaction, the amount of the temporary difference and the related deferred tax liability will change. An investment in common stock of an investee (other than a subsidiary or corporate joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the investee acquires or retires common stock, or other transactions affect the investment. A temporary difference for the investor's share of the undistributed earnings of the investee prior to the date it becomes a subsidiary shall continue to be treated as a temporary difference for which a deferred tax liability shall continue to be recognized to the extent that dividends from the subsidiary do not exceed the parent company's share of the subsidiary's earnings subsequent to the date it became a subsidiary.

14. *Disclosure.* Statement 109 specifies the requirements for financial statement disclosures.

---

[6][This footnote has been deleted. See Status page.]

INVESTMENTS IN CORPORATE JOINT VENTURES

Discussion

15. Corporate joint ventures, as defined in APB Opinion No. 18 are of two kinds: (1) those essentially permanent in duration and (2) those that have a life limited by the nature of the venture or other business activity. In APB Opinion No. 18 the Board concluded that the equity method of accounting best enables an investor in a corporate joint venture to recognize the underlying nature of the investment regardless of duration.

16. Unless characteristics indicate a limited life, a corporate joint venture has many of the characteristics of a subsidiary. The investors usually participate in the management of the joint venture, consider the factors set forth in paragraph 8 above, and agree (frequently before forming the venture) as to plans for long-term investment, for utilizing the flexibility inherent in the United States Internal Revenue Code, and for planned remittances.

Opinion

17. The Board concludes that the principles applicable to undistributed earnings of subsidiaries (paragraphs 9, 10, 11, 12 and 13) also apply to tax effects of differences between taxable income and pretax accounting income attributable to earnings of corporate joint ventures that are essentially permanent in duration and are accounted for by the equity method. [iv]**7**

18. *Disclosure.* The disclosure requirements set forth in paragraph 14 also apply to earnings of corporate joint ventures.

"BAD DEBT RESERVES" OF SAVINGS AND LOAN ASSOCIATIONS

Discussion

19. Regulatory authorities require both stock and mutual savings and loan associations to appropriate a portion of earnings to general reserves [v]**8** and to retain the reserves as a protection for depositors. Provisions of the United States Internal Revenue Code permit a savings and loan association to deduct an annual addition to a reserve for bad debts [vi]**8** in determining taxable income, subject to certain limitations. This annual addition permitted by the Code generally differs significantly from the bad debt experience upon which determination of pretax accounting income is based. Thus, taxable income and pretax accounting income of an association usually differ.

20. Although a general reserve determined according to requirements of the regulatory authorities is not directly related to a reserve for bad debts computed according to provisions of the United States Internal Revenue Code, the purposes and restrictions of each reserve are similar. Amounts of bad debt deductions for income tax purposes are includable in taxable income of later years only if the bad debt reserves are used subsequently for purposes other than to absorb bad debt losses.

21. The term *pretax accounting income*, as used in this section, represents income or loss for a period, exclusive of related income tax expense, determined in conformity with generally accepted accounting principles. The term *taxable income*, as used in this section, represents pretax accounting income (a) adjusted for reversal of provisions for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property, and adjusted for events that do not have tax consequences, and (b) after giving effect to the bad debt deduction allowable by the United States Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

22. Some believe that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserve and undivided profits of a savings and loan association has attributes of a permanent or indefinite deferral of tax payments. In their view, a savings and loan association should not accrue income taxes on such differences. Others believe that this difference has the principal attributes of a timing difference as described in paragraphs 36 and 37 of APB Opinion No. 11. In effect, they believe that this difference is a Government sponsored deferral of tax, that the Government has an equity in the savings and loan association to the extent of the deferred tax, and that it is inappropriate to include earnings in stockholders' equity without accruing income taxes which the the association would incur if the earnings were distributed to stockholders or otherwise became subject to tax. In their view the savings and loan association should recognize deferred taxes on the difference.

Opinion

23. As described in Statement 109, a savings and loan association [vii]**9** should not provide deferred taxes on taxable temporary differences related to bad-debt reserves for tax purposes that arose in tax years beginning before December 31, 1987 (the base-year amount). However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax

expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

24. *Disclosure.* Statement 109 specifies the requirements for financial statement disclosures.

25. The disclosure requirements set forth in paragraph 24 also apply to a parent company of a savings and loan association accounting for that investment either through consolidation or by the equity method.

26-30. [The paragraphs have been deleted. See Status page.]

[10-11][These footnotes have been deleted. See Status page.]

EFFECTIVE DATE

31. This Opinion shall be effective for all fiscal periods beginning after December 31, 1971. However, the Board encourages earlier application of the provisions of this Opinion.

32. The conclusions of the Board on accounting for income taxes on undistributed earnings of subsidiaries and corporate joint ventures represent a clarification of current practice. Accordingly, this Opinion should be applied retroactively to undistributed earnings of subsidiaries included in consolidated financial statements and to undistributed earnings applicable to unconsolidated subsidiaries and investments in corporate joint ventures accounted for by the equity method in accordance with APB Opinion No. 18. An adjustment resulting from a change in accounting method to comply with this Opinion should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated.

33. The conclusions of the Board on "bad debt reserves" of savings and loan associations and amounts designated as "policyholders' surplus" by stock life insurance companies agree generally with current practice. If application of this Opinion should result in a change in accounting principle, the adjustment should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated.

The Opinion entitled "Accounting for Income Taxes—Special Areas" was adopted by the assenting votes of fourteen members of the Board, of whom four, Messrs. Halvorson, Hellerson, Norr, and Watt, assented with qualification. Messrs. Bevis, Bows, Broeker, and Burger dissented.

Mr. Halvorson assents to the publication of this Opinion but believes that a company should be permitted to accrue taxes on differences between taxable income and pretax accounting income in any circumstances where management judgment so dictates and that the prohibition thereof expressed by the "should not" injunction in paragraphs 12, 23, and 28 will stifle what could be a desirable development in accounting. He further believes that the disclosure of the cumulative amount of untaxed earnings required by paragraphs 14, 24, and 29 should be coupled with a requirement to disclose the amount of such earnings for each period currently under report.

Mr. Hellerson assents to the issuance of this Opinion as he believes it does clarify and standardize the accounting in the areas encompassed by it. However, he qualifies his assent because of disagreement with the last two sentences of paragraph 12. It is his view that if undistributed earnings of a subsidiary on which income taxes have not been recognized are, in fact, remitted this may be prima facie evidence that the company's plans have changed and a tax on the remainder of the undistributed earnings which have not, in fact, been reinvested should be provided. He also disagrees with the final sentence in paragraph 12 which sanctions the reversal of a tax previously accrued. It is his view that any plans for reinvestment of undistributed earnings should be applied prospectively and not retroactively, i.e., the tax expense for the current and future periods should be affected. Further, it is his understanding that the thrust of the portion of the Opinion pertaining to undistributed earnings of subsidiaries is that all such undistributed earnings give rise to a timing difference for which comprehensive interperiod income tax allocation is required in accordance with APB Opinion No. 11, *Accounting for Income Taxes.* However, after giving effect to available tax-planning alternatives and available tax credits and deductions, the resulting tax effect of the timing difference may be nil. He believes that paragraph 10, and particularly the second sentence thereof, does not clearly describe this thrust.

Mr. Norr assents to the publication of this Opinion but objects to the conclusions of paragraph 14(b). He believes that the most meaningful disclosure for the reader is the estimated amount of taxes that might be payable on undistributed earnings of the current period if such earnings were to be remitted currently taking into consideration all available tax-planning alternatives and available tax credits and deductions.

Mr. Watt assents to the issuance of this Opinion because it results in the accrual of only income taxes reasonably expected to be paid. However, he disagrees with the conclusions in paragraphs 12, 13, 23, and 28 that *in all cases* when circumstances change, income taxes not previously recognized or income taxes accrued but no longer required may never be accounted for as an extraordinary item. He believes that such adjustments should qualify as extraordinary in some cases based on a combination of extreme infrequency of occurrence and abnormal size. He further believes that this Opinion should not have an effective date prior to its issuance but instead should have been effective for fiscal periods beginning after December 31, 1972 to allow a reasonable time for preparation of information necessary to implement the Opinion.

Mr. Bevis dissents to this Opinion because he believes it contradicts the concepts of APB Opinion No. 11, *Accounting for Income Taxes.*

Messrs. Bows, Broeker, and Burger dissent to this Opinion because they believe the major conclusions relating to the omission of a requirement for providing deferred taxes are not supported in theory or logic by the provisions of the income tax laws. In their view, the Government sponsors a benefit by providing the use of tax funds during the deferment period (regardless of how long it may be), but it does not provide for the ultimate waiver of the taxes on those earnings. This Opinion validates a practice that they consider to be completely contrary to the underlying concepts of deferred tax accounting applicable to other businesses (APB Opinion No. 11) by sponsoring the idea that certain earnings may be accounted for on an accrual basis while the related income taxes are accounted for on the cash basis. They also believe that the accounting distinction provided in this Opinion for over 50% investors (no deferred income taxes) and in APB Opinion No. 24 for less than 50% investors (deferred taxes) is completely artificial.

APB 23 NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

[i]APB23, Footnote 1—Paragraph 16 of ARB No. 51 stated: "When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign-tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation."

[ii]APB23, Footnote 2—The conclusions of the Board on undistributed earnings of a subsidiary also apply to the portion of the earnings of a Domestic International Sales Corporation (DISC) that is eligible for tax deferral.

[iii]APB23, Footnote 5—The change in the status of an investment would not by itself mean that remittance of these undistributed earnings should be considered apparent.

[iv]Footnote 7—Certain corporate joint ventures have a life limited by the nature of the venture, project, or other business activity. Therefore, a reasonable assumption is that a part or all of the undistributed earnings of the venture will be transferred to the investor in a taxable distribution. Deferred taxes should be recorded, in accordance with the concepts of FASB Statement No. 109, *Accounting for Income Taxes*, at the time the earnings (or losses) are included in the investor's income.

[v]APB23, Footnote 8—The terms *general reserves* and *reserve for bad debts* are used in the context of the special meaning these terms have in regulatory pronouncements and in the United States Internal Revenue Code.

[vi]APB23, Footnote 8—The terms *general reserves* and *reserve for bad debts* are used in the context of the special meaning these terms have in regulatory pronouncements and in the United States Internal Revenue Code.

[vii]APB23, Footnote 9—The Board affirms that its conclusions in this Opinion apply to stock and mutual savings and loan associations and mutual savings banks.