FASB Emerging Issues Task Force

Issue No. 13-C

Title: Presentation of a Liability for an Unrecognized Tax Benefit When a Net Operating Loss or Tax Credit Carryforward Exists

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FASB Staff: Walsh (ext. 354)/Irwin (ext. 468)

EITF Liaison: Mark Bielstein

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Background

1. In certain circumstances, the settlement of a liability for an unrecognized tax benefit does not result in a cash payment because it is settled by reducing a net operating loss (NOL) or tax credit carryforward. For example, U.S. tax law requires that an entity's taxable income be reduced by available NOL carryforwards and carrybacks. The IRS cannot require a taxpayer to settle a disallowed uncertain tax position in cash if sufficient NOL carryforwards are available to eliminate the additional taxable income. In addition, the IRS does not permit a taxpayer to choose when to use its NOL carryforwards; the taxpayer is required to use NOL carryforwards in the first year taxable income arises.

2. Topic 740, Income Taxes, does not include explicit guidance on whether and when an entity should present an unrecognized tax benefit as a liability or as a reduction of NOL carryforwards

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* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

or other tax credits related to the same jurisdiction. The FASB staff previously received technical inquiries about the presentation of unrecognized tax benefits. The FASB staff's response, which is not authoritative U.S. GAAP, was that the presentation of the liability for an unrecognized tax benefit depends on the relationship between the unrecognized tax benefit and the NOL carryforwards. If the liability for an unrecognized tax benefit is directly associated with a tax position taken in a tax year that results in or that resulted in the recognition of an NOL carryforward for that year (and the NOL carryforward has not yet been utilized), the unrecognized tax benefit should be presented as a reduction to the NOL; otherwise, it should be presented as a liability.

3. Although a majority of entities appear to present unrecognized tax benefits consistent with the FASB staff's responses to the aforementioned technical inquiries, there appears to be some diversity in practice attributable to the absence of explicit guidance within U.S. GAAP. However, the FASB staff believes that this diversity in practice may not be important to users of financial statements.

Accounting Issue and Alternatives

How an entity should present a liability for an unrecognized tax benefit in the statement of financial position when nonrecognition of the tax benefit would otherwise reduce a deferred tax asset related to an NOL or tax credit carryforward under the provisions of the tax law.

View A: An unrecognized tax benefit should be presented as a reduction of a deferred tax asset for an NOL or tax credit carryforward (rather than as a liability) when the uncertain tax position would, or is available to, reduce the NOL or tax credit carryforward under the provisions of the tax law.

4. Proponents of View A believe that the tax provision should be prepared as if the uncertain tax position was not claimed in the tax return. In the absence of any uncertain tax positions, an entity that generates taxable income, but has NOL carryforwards available to offset any taxes payable, would not recognize a payable under the general provisions of Topic 740. Instead, it

would reduce deferred tax assets as tax expense is incurred. Proponents believe that this same principle should be applied when liabilities related to tax uncertainties are recognized. That is, if uncertain tax positions were settled with the taxing authority on the basis recognized and measured, the position's resolution effectively amounts to additional taxable income. The NOL carryforward would be applied to the liability if the uncertain tax position is not sustained and the liability related to the uncertain tax position will not result in a payment of taxes but instead will reduce the NOL carryforward. Proponents believe that View A is consistent with the guidance in paragraph 740-10-25-16, which states the following:

> The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created (**or the amount of a net operating loss carryforward or amount refundable is reduced**) for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of this Subtopic. [Emphasis added.]

5. Proponents of View A believe that presenting an unrecognized tax benefit as a liability even when the uncertain tax position would reduce the NOL or tax credit carryforward under the provisions of the tax law creates two inconsistent assertions within the financial statements. First, under U.S. tax law, accrual of interest expense is not required for unpaid tax obligations as long as the taxpayer is able to offset the exposures with NOL carryforwards within the same jurisdiction and no cash payment will be remitted to the taxing authority. Therefore, entities with NOL carryforwards are not required to accrue interest on their uncertain tax positions under Topic 740. Proponents of View A believe that the non-accrual of interest is contradictory to presenting the unrecognized tax benefit as a liability. Second, in assessing the realizability of deferred tax assets under Topic 740, entities may consider the unrecognized tax benefit liability as a source of taxable income, which proponents of View A believe is contradictory to presenting the unrecognized tax benefit as a liability.

6. Subtopic 210-20, Balance Sheet—Offsetting (formerly FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*), addresses whether and in what circumstances it is appropriate to setoff assets and liabilities in the statement of financial

position. Paragraph 210-20-45-1 provides the following four conditions that must be met for a right of setoff to exist:

a. Each of two parties owes the other determinable amounts.
b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
c. The reporting party intends to set off.
d. The right of setoff is enforceable at law.

7. Proponents of View A believe that in many jurisdictions, liabilities related to unrecognized tax benefits and NOL carryforwards satisfy the conditions of paragraph 210-20-45-1 (particularly criteria (b), (c), and (d)) because the liability would be offset under the provisions of the tax law. For example, the IRS cannot require a taxpayer to settle, and the taxpayer may not elect to settle, a disallowed uncertain tax position in cash if sufficient NOL carryforwards or other tax credit carryforwards are available to eliminate the additional taxable income; therefore, the right, the intention, and the enforceability of the entity to setoff exists.

8. Proponents of View A note the feedback the FASB received from users of financial statements in its recent project on balance sheet offsetting (FASB Accounting Standards Update No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*). Users of financial statements did not have a universal view on whether gross or net presentation in the statement of financial position was preferable, but they agreed that both gross and net information are useful and necessary to analyze the financial statements. They also welcomed quantitative disclosures in a tabular format. Because paragraph 740-10-50-15A (excerpt included below) requires a public entity to disclose a rollforward of its unrecognized tax benefits, proponents of View A believe that the net presentation in the statement of financial position accompanied by the existing gross disclosure requirements would be consistent with views that users of financial statements recently expressed to the FASB.

9. Opponents of View A believe that the accounting policies of a majority of entities are consistent with View B, and they do not believe that the costs to change financial reporting for a majority of entities is worthwhile when users of financial statements may not have a clear preference.

View B: An entity should present an unrecognized tax benefit as a liability in the statement of financial position unless the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results in or that resulted in the recognition of an NOL carryforward for that year (and such an NOL carryforward has not yet been utilized).

10. Proponents of View B believe that a majority of entities present unrecognized tax benefits in accordance with View B because it is consistent with the FASB staff's response to the aforementioned technical inquiries. Proponents believe that the presentation may not be significant to users of financial statements in many circumstances, especially considering the aforementioned disclosure requirements for unrecognized tax benefits for public entities. They also believe that any change to current practice would not result in significant improvement to the financial reporting of an entity's unrecognized tax benefits. Consequently, they do not believe that the cost to change financial reporting for a majority of entities is worthwhile.

11. Proponents of View B believe that their approach is preferable to View A because an NOL that exists at the date of the statement of financial position may not be available at the date the uncertain tax position is disallowed by the taxing authority.

12. Proponents of View B believe that their approach is consistent with the guidance in paragraph 740-10-45-11, which states the following:

> An entity that presents a classified statement of financial position shall classify a liability associated with an unrecognized tax benefit as a current liability (or the amount of a net operating loss carryforward or amount refundable is reduced) to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, if longer. **The liability for unrecognized tax benefits (or reduction in amounts refundable) shall not be combined with deferred tax liabilities or assets.** [Emphasis added.]

13. Opponents of View B believe that the approach is inconsistent with the provisions of tax law in certain jurisdictions (including the U.S.) whereby an unrecognized tax benefit would reduce a deferred tax asset related to an NOL or tax credit carryforward.

View C: An entity shall make an accounting policy election to apply either View A or View B.

14. Proponents of View C believe that the presentation of unrecognized tax benefits may not be important to users of financial statements. Because there is some diversity in practice in the presentation of these liabilities, some entities would incur costs to change their accounting approach if the Task Force were to select View A or View B. Proponents of View C do not believe that those costs are warranted because they do not believe that the costs would outweigh the benefits.

15. Proponents of View C believe that there are merits to both View A and View B, as summarized above.

16. Proponents of View C believe that their approach is consistent with Subtopic 210-20, which does not *require* an entity to offset assets and liabilities. Subtopic 210-20 permits an entity to offset assets and liabilities when certain criteria are met, but it does not require an entity to offset when those criteria are met. Opponents of View C observe that, although Subtopic 210-20 does not require offsetting, other guidance either requires or precludes an offsetting presentation in specific circumstances. That guidance includes paragraph 740-10-45-6, which requires offsetting of deferred tax assets and liabilities arising from the same tax jurisdiction.

17. Opponents of View C believe that accounting policy elections add complexity to financial reporting; therefore, they believe that the Task Force should select either View A or View B. They also believe that allowing an entity to elect an accounting policy will result in inconsistent presentation, which may not be beneficial to the users of the financial statements. Finally, opponents of View C believe that an SEC registrant may be required to obtain a preferability letter from their auditor if they were to change their accounting policy (for example, the entity's existing accounting policy is View B and it decides to change its policy to View A). It is not clear whether an auditor would be able to conclude that one policy is preferable to another; therefore, an SEC registrant may not be able to change its accounting policy under View C.

Recurring Disclosures

18. Paragraph 740-10-50-15A requires a public entity to disclose the following about unrecognized tax benefits:

> Public entities shall disclose both of the following at the end of each annual reporting period presented:
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> a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:
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> 1. The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
> 2. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
> 3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
> 4. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.
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> b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

19. The FASB staff does not believe that these disclosure requirements should be modified as a result of the proposed guidance for presentation of unrecognized tax benefits, and the FASB staff does not believe that additional recurring disclosure requirements are necessary.

Transition

20. The FASB staff believes that the transition approach should be prospective application of the proposed guidance with early adoption permitted. Some entities have unrecognized tax benefits for many (potentially hundreds of federal, international, state, and local) taxing jurisdictions. The FASB staff does not believe that the costs associated with retrospective application are warranted because the presentation of unrecognized tax benefits in the statement of financial position may not be important to users of financial statements. However, the Task Force could select a retrospective approach. Some of the aforementioned cost versus benefit concerns for a retrospective approach may be alleviated if the Task Force were to select View C because View C would not require an entity to change its current accounting policy.

Transition Disclosures

21. The guidance on other presentation matters in Subtopic 250-10, Accounting Changes and Error Corrections—Overall, is applicable for any voluntary change in accounting principle, including a change in the method of applying an accounting principle. The FASB staff believes that entities should be required to apply the disclosure requirements in Section 250-10-50 for an accounting change required by this proposed guidance. In addition, the FASB staff believes that no additional transition disclosures should be required.