FASB

Simplifications to Accounting for Income Taxes

PCC Meeting
June 25, 2019

FAF FINANCIAL ACCOUNTING FOUNDATION
FASB FINANCIAL ACCOUNTING STANDARDS BOARD
GASB GOVERNMENTAL ACCOUNTING STANDARDS BOARD

Background & Objective

Project Background

- Part of the Board's simplification initiative
- Accounting for income taxes has been a top area of restatements over the last several years
- Stakeholder feedback indicated income tax accounting is unnecessarily complex
- Stakeholders submitted an agenda request with certain simplification suggestions

Project Objective

Simplify the accounting for income taxes by removing certain exceptions to the general principles to Topic 740, Income Taxes, and by clarifying and amending guidance that already exists within generally accepted accounting principles (GAAP).

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Project Timeline

2017	December 2017	March 2019	May 2019	June 2019	2nd Half 2019
Letters received containing simplification suggestions for Topic 740	U.S. Government enacted the Tax Cuts and Jobs Act	Project added to the FASB technical agenda	Exposure Draft issued	Comment period ends	Final Update expected to be issued

Issue 1: Intraperiod Tax Allocation Exception to Incremental Approach

- Under current GAAP, tax expense (or benefit) generally allocated using an incremental approach
  - Step 1: Determine amount allocated to continuing operations
  - Step 2: Allocate remainder to items other than continuing operations
- Exception when there is a loss from continuing operations (and income/gain outside of continuing operations):
  - All components, including discontinued operations and items charged or credited directly to equity, are considered when determining the tax benefit from a loss from continuing operations
- Proposed Solution
  - Eliminate the exception
  - Basic intraperiod tax allocation principle would apply in all situations

Issue 1: Example—Current GAAP

Facts: This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

a. The entity's pretax financial income and taxable income are the same.

b. The entity's ordinary loss from continuing operations is $500.

c. The entity also has a gain on discontinued operations of $900 that is a capital gain for tax purposes.

d. The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $120 ($400 at 30%).

Total income tax expense ($400 at 30%)	$	120
Tax benefit allocated to the loss from continuing operations ($500 at 30%)		(150)
Incremental tax expense allocated to the gain on discontinued operations	$	270

Issue 1: Example—Proposed Solution

Facts: This Case illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

a. The entity's pretax financial income and taxable income are the same.

b. The entity's ordinary loss from continuing operations is $500.

c. The entity also has a gain on discontinued operations of $900 that is a capital gain for tax purposes.

d. The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $120 ($400 at 30%).

e. The entity has determined that the deferred tax asset that would have resulted if the gain on discontinued operations had not occurred would be expected to be realized (that is, a valuation allowance would not have been needed).

Total income tax expense ($400 at 30%)	$	120
Tax benefit allocated to the loss from continuing operations ($500 at 40%)		(200)
Incremental tax expense allocated to the gain on discontinued operations	$	320

Issue 2: Interim Period Accounting for Enacted Changes in Tax Law

- Topic 740 requires an entity to recognize deferred income tax effects of an enacted change in tax law on the date of enactment

- Interim period income tax model currently requires:
  - An entity to estimate the Annual Effective Tax Rate (AETR) at the end of each interim reporting period
  - The effect of a change in tax laws or rates on taxes currently payable or refundable to be recorded after the *effective date*

- Proposed Solution
  - Amend the interim guidance to require that the effects of an enacted change in tax law be reflected in the computation of the AETR in the first interim period that includes the enactment date of the new legislation

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Issue 2: Example—Facts

Facts: For the full fiscal year, an entity anticipates ordinary income of $100,000. All income is taxable in one jurisdiction at a 50% rate. Anticipated tax credits for the year total $10,000. No events that do not have tax consequences are anticipated.

Computation of Annual Effective Tax Rate (AETR):

Tax at statutory rate ($100,000 at 50%)	$50,000
Less anticipated tax credits	(10,000)
Net tax to be provided	$40,000
AETR ($40,000 / $100,000)	40%

Assume that new legislation creating additional tax credits was enacted during the second quarter of the entity's fiscal year. The new legislation is effective on the first day of the third quarter. As a result of the estimated effect of the new legislation, the entity revises its estimates of its AETR to the following.

AETR Adjusted for New Legislation:

Tax at statutory rate ($100,000 at 50%)	$50,000
Less anticipated tax credits	(12,000)
Net tax to be provided	$38,000
AETR ($38,000 / $100,000)	38%

Issue 2: Example—Current GAAP

	Ordinary Income			Tax		
Reporting Period	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Peviously Provided	Reporting Period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ -	$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	$\boxed{38\%}$	22,800	16,000	6,800
Fourth quarter	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$ 100,000					$ 38,000

Issue 2: Example—Proposed Solution

	Ordinary Income			Tax		
Reporting Period	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Year-to-Date	Less Peviously Provided	Reporting Period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ -	$ 8,000
Second quarter	20,000	40,000	$\boxed{38\%}$	15,200	8,000	7,200
Third quarter	20,000	60,000	38%	22,800	15,200	7,600
Fourth quarter	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$100,000					$ 38,000

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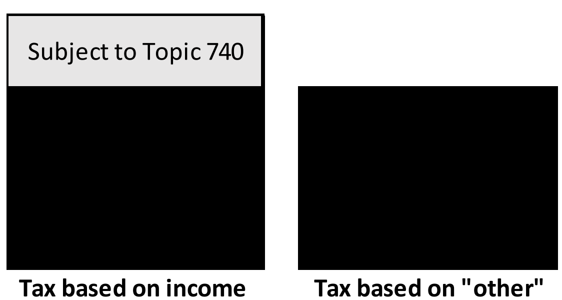
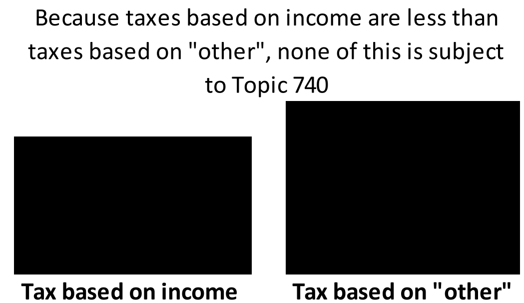
Issue 3: Franchise Taxes That Are Partially Based on Income

- Some tax jurisdictions impose the greater of two taxes:
  - One based on taxable income
  - One based on items other than income (e.g., capital)
- Topic 740 does not apply to franchise taxes based on capital when there is no additional tax based on income
- Currently, only the excess of income tax over the tax based on "other" (e.g., capital) is subject to guidance in Topic 740



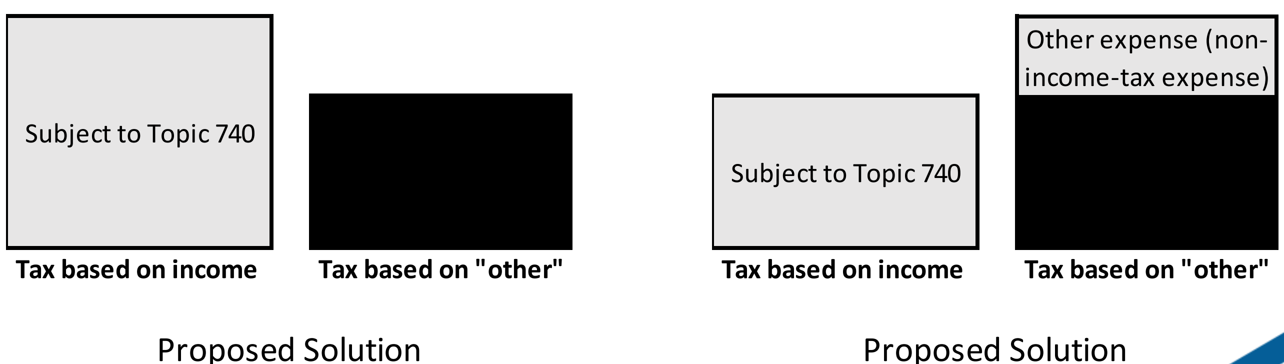
Current Guidance



Current Guidance

Issue 3: Franchise Taxes That Are Partially Based on Income (cont'd)

- Proposed solution is to amend guidance to state that if there is an amount based on income, it is in the scope of Topic 740, with any incremental amount recorded as a non-income-based tax.
  - Entity would only recognize non-income-tax expense if the tax based on other-than-income is greater than income tax
  - Effectively reverses the order of determining the type of tax from what is required in current guidance



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Issue 4: Year-to-Date Loss Limitation in Interim Period Tax Accounting

- Generally, an entity is required to make its best estimate of the AETR for the full fiscal year at the end of each interim reporting period
  - The AETR is used to calculate income taxes on a year-to-date basis
  - AETR should be applied to the year-to-date income or loss as long as no valuation allowance would be necessary
- Exception when loss on a year-to-date basis exceeds the anticipated ordinary loss for the year
  - The income tax benefit recognized for the year-to-date period is limited to the income tax benefit determined based on the year-to-date ordinary loss
- Proposed solution is to remove the exception
  - Apply the general guidance in Subtopic 740-270

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Issue 4: Example—Facts

Facts: For the full fiscal year, an entity anticipates an ordinary loss of $100,000. The entity operates entirely in one jurisdiction where the tax rate is 50%. Anticipated tax credits for the fiscal year total $10,000.

Computation of Annual Effective Tax Rate (AETR):

Tax benefit at statutory rate ($100,000 at 50%)	(50,000)
Tax credits	(10,000)
Net tax benefit	(60,000)
AETR ($60,000/$100,000)	60%

Issue 4: Example—Current GAAP

	Ordinary Income (Loss)			Tax (or Benefit)			
				Year-to-Date			
Reporting Period	Reporting Period	Year-to-Date	Estimated Annual Effective Tax Rate	Computed	Limited to	Less Previously Provided	Reporting Period
First quarter	$ 20,000	$ 20,000	60%	$ 12,000		$ -	$ 12,000
Second quarter	(80,000)	(60,000)	60%	(36,000)		12,000	(48,000)
Third quarter	(80,000)	(140,000)	60%	(84,000)	$(80,000) [(a)]	(36,000)	(44,000)
Fourth quarter	40,000	(100,000)	60%	(60,000)		(80,000)	20,000
Fiscal year	$(100,000)						$ (60,000)

(a) Because 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 amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the fiscal year. The limitation is computed as follows:

Year-to-date ordinary loss times the statutory rate ($140,000 at 50%)	$ (70,000)
Estimated tax credits for the year	(10,000)
Year-to-date benefit limited to	$ (80,000)

Issue 4: Example—Proposed Solution

	Ordinary Income (Loss)			Tax (or Benefit)		
Reporting Period	**Reporting Period**	**Year-to-Date**	**Estimated Annual Effective Tax Rate**	**Year-to-Date**	**Less Previously Provided**	**Reporting Period**
First quarter	$ 20,000	$ 20,000	60%	$ 12,000	$ -	$ 12,000
Second quarter	(80,000)	(60,000)	60%	(36,000)	12,000	(48,000)
Third quarter	(80,000)	(140,000)	60%	(84,000)	(36,000)	(48,000)
Fourth quarter	40,000	(100,000)	60%	(60,000)	(84,000)	24,000
Fiscal year	$ (100,000)					$ (60,000)

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Other Issues Included in the Exposure Draft

- Separate Financial Statements of Single Member LLCs (SMLLCs)
- Tax Basis Step-Up in Goodwill Obtained in a Transaction that is not a Business Combination
- Ownership Changes in Foreign Investments – Subsidiary to Equity Method Investment
- Ownership Changes in Foreign Investments – Equity Method Investment to Subsidiary
- Two Minor Codification Improvements

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