



FASB to Propose Changes to Accounting for Income Taxes for Intercompany Transfers and the Presentation of Deferred Taxes

The FASB recently decided to propose changes to accounting for income taxes to require recognition of the income tax consequences of intercompany asset transfers and to classify all deferred tax assets and liabilities as noncurrent in a classified statement of financial position.¹ The Board expects to issue a proposed Accounting Standards Update (ASU) in early 2015.

Key Facts

- The proposals are part of the Board’s simplification initiative.
- The change in accounting for intercompany transfers would be applied at the beginning of the period of adoption with a cumulative effect adjustment to beginning retained earnings.
- The change in classification of deferred tax balances on the balance sheet would be applied prospectively.
- The guidance would be effective for public companies for annual and interim periods in fiscal years beginning after December 15, 2016. For private companies, the guidance would be effective for annual periods beginning after December 15, 2017 and interim periods in fiscal years beginning after December 15, 2018. Early adoption would be allowed for private companies, but only if both changes are adopted at the same time.

Key Impacts

- The elimination of the exception for recognition of intercompany transfers could result in significant impacts on effective tax rates, and more volatility in those rates, reflected in financial statements, particularly for companies that transfer intangible assets.
- Approval of the proposals would result in convergence with International Financial Reporting Standards on these topics.²

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¹ FASB meeting on October 22, 2014.

² IAS No. 12, Income Taxes, and IAS No. 1, Presentation of Financial Statements.

Intercompany Asset Transfers

An intercompany sale or purchase of assets, such as the sale of inventory or depreciable assets between tax jurisdictions, generally is a taxable event for the seller and establishes a new tax basis for the assets in the buyer's tax jurisdiction. Generally the result will be a taxable gain in the seller's jurisdiction and a difference in the buyer's tax jurisdiction between the new tax basis and the carrying amount of the assets as reported in the consolidated financial statements. In consolidation, intercompany balances, transactions, and intercompany profit or loss on assets remaining within the group should be eliminated.³ Accordingly, no immediate gain or loss is recognized on transactions among companies within a consolidated group.

Currently GAAP prohibits recognition of the income tax consequences of intercompany asset transfers.⁴ The seller defers recognizing, for financial statement purposes, any net tax effect associated with the transfer of the assets and the buyer is prohibited from recognizing a deferred tax asset for the tax effect of the difference between the tax basis of the assets in the buyer's tax jurisdiction and their financial statement carrying amounts (as reported in the consolidated financial statements). This is consistent with the consolidation guidance. The proposal would require recognition of these tax consequences.

The proposed guidance is similar to the income tax treatment of intercompany transfers under FASB Statement 96, the predecessor to Statement 109.⁵ Under Statement 96, the income tax consequences of intercompany asset transfers were recognized upon transfer. When the Statement 109 model was adopted, the Board's rationale for the exception was that recognizing the income tax consequences of intercompany asset transfers resulted in recognizing income taxes related to intercompany gains that were not recognized for financial reporting purposes.

The consolidation guidance stipulates that consolidated financial statements should not include gains or losses on transactions among the companies in a consolidated group and that income taxes that have been paid on intercompany profits on assets remaining within the group should be deferred. Although removing the exception would result in more consistent tax treatment for all transactions including intercompany transfers, it would create an exception to the current consolidation guidance.

The Board questioned whether the proposed change would actually result in simplification for financial statement preparers because of additional tracking of deferred taxes that may be required. Despite the varied opinions on potential incremental cost and effort, the Board generally held that the revised accounting should in most cases more accurately reflect the underlying economics of the transactions. Further, the change in accounting would result in convergence between U.S. GAAP and IFRS in this area.

The proposed guidance could result in significant impacts on the effective tax rates, and more volatility in those rates, reflected in financial statements, particularly for companies that transfer intangible assets.

³ FASB ASC Topic 810, Consolidation, available at www.fasb.org.

⁴ FASB ASC paragraphs 810-10-45-8 and 740-10-25-3(e), available at www.fasb.org.

⁵ FASB Statement No. 96, Accounting for Income Taxes, replaced by FASB Statement No. 109, Accounting for Income Taxes, both available at www.fasb.org.

Presentation of Deferred Taxes

Currently, entities that present a classified statement of financial position classify deferred tax assets and liabilities as current and noncurrent. Classification as current or noncurrent is generally based on the underlying asset or liability for financial reporting. Deferred tax assets and liabilities not related to assets or liabilities for financial reporting are classified according to the expected reversal date of the temporary difference. Valuation allowances are allocated by jurisdiction between current and noncurrent deferred tax assets on a pro-rata basis.

Financial statement preparers have indicated to the FASB that complying with this requirement is costly and provides little to no benefit to users because the classification of deferred taxes may not be consistent with when the deferred tax amounts are expected to be recovered or settled. The proposal would require that all deferred tax assets and liabilities be classified as noncurrent.

The Board discussed the possibility of an alternative solution in which deferred tax assets and liabilities would be presented as current or noncurrent based on when the deferred tax amounts are expected to be recovered or settled. This alternative would be consistent with the Statement 96 model. The Board generally agreed that this alternative would likely increase cost and complexity because of the detailed analysis required to determine the amount of temporary differences that would reverse in the next year and would not be consistent with the objectives of the simplification initiative.

During deliberations prior to the issuance of the Statement 109 guidance in current U.S. GAAP, the Board at the time also contemplated classifying all deferred taxes as noncurrent. That Board did not adopt this alternative then because it believed the results would be confusing for financial statement users and that an inappropriate current ratio would result from noncurrent classification of the deferred tax consequences of temporary differences related to current assets and liabilities. The current Board acknowledged the same concerns with the current proposal, but believes that the benefits from simplification outweigh those issues.

Proposed Transition and Effective Dates

The change in accounting for intercompany transfers would be applied at the beginning of the period of adoption with a cumulative effect adjustment to beginning retained earnings. The change in classification of deferred tax balances on the balance sheet would be applied prospectively.

The guidance would be effective for public companies for annual and interim periods in fiscal years beginning after December 15, 2016. For private companies, the guidance would be effective for annual periods beginning after December 15, 2017 and interim periods in fiscal years beginning after December 15, 2018. Early adoption would be allowed for private companies, but only if both changes are adopted at the same time.

Next Steps

The Board expects to issue a proposed ASU in early 2015 with an expected comment period of 120 days.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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