What's News in Tax

Analysis that matters from Washington National Tax

SEC Comments on Accounting for Income Taxes

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This article provides examples of comments about accounting for income taxes recently issued by the U.S. Securities and Exchange Commission ("SEC") to registrants. Recent comments from regulators and standard setters may help issuers identify areas for improvements in existing income taxes disclosures in order to provide more robust and relevant information to investors.

Examples of Recent SEC Comment Letters

The following selection of SEC comment letters specific to income taxes are provided to illustrate areas in which the SEC staff questioned whether the disclosures provided adequate insight for investors to understand a company's income taxes environment or when the SEC staff (the "Staff") wanted a better understanding of the basis for management's judgments. The comments below (emphasis added) highlight common findings that are representative of the Staff's areas of recent focus associated with income taxes. The examples involve the effective tax rate reconciliation, valuation allowances, investments in subsidiaries, unrecognized tax benefits, changes in tax law, tax credits, and the adoption of new accounting standards.

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Example 1: Effective Tax Rate Reconciliation

The Staff may request additional information on what items are included within the foreign operations line of the effective tax rate reconciliation and whether such matters should be separately disclosed:

> We note that the line item “other impact of foreign operations” in your effective tax rate reconciliation has grown significantly. To the extent any of the items in this amount exceed the 5% disclosure threshold in Rule 4-08(h)(2) of Regulation S-X, <u>please revise to disclose these amounts separately</u>.

Example 2: Effective Tax Rate Reconciliation

The Staff may request additional information on variances within the effective tax rate*:*

> Based on your effective tax rate reconciliation within Note 11, <u>it appears there are other material factors impacting your income tax benefit (expense) that should be included in your MD&A discussion so that readers can fully understand the variances and assess the continuing impact</u>. For example, it appears that the differences in your “foreign tax rate” caption in your rate reconciliation changed from additional benefit of $X million or a X% decrease to your effective tax rate in 2017 to an income tax benefit of $X million or X% decrease to the effective tax rate in 2018. We further note your disclosures on page F-34 indicate that the US Tax Cuts and Job Act favorably impacted your tax rate by X%. As such, it appears that there are other material factors that are negatively impacting your foreign tax rate line that offset the X% benefit from the US Tax Cuts and Job Act. <u>Given the impact to your effective income tax rate, it appears a more robust a*nalysis around the other factors impacting this line item should be included in your disclosures*</u>*. In considering your disclosures please note that <u>material items that are not expected to recur should be highlighted</u>. In addition, please note that Article 4-08(h)(2) of Regulation S-X requires that reconciling items exceeding 5% be separately presented. The disclosures should fully explain why your effective tax rate changed from X% in 2017 to X% in 2018. Please refer to Item 303(a)(3) of Regulation S-K and Section 501.12 of the Financing Reporting Codification for guidance.*

Example 3: Effective Tax Rate Reconciliation

The Staff may request additional information on items included within the other line of the effective tax rate reconciliation and inquire as to the fluctuations year over year and whether such matters are recurring:

> We note your discussion and analysis of income taxes on page 33. Referring to the "other" caption in your effective tax rate reconciliation in Note 8, please explain the specific facts and circumstances that resulted in an $X million benefit to the provision in 2018 and a $X million expense in the prior year. Given these amounts had a material impact to your income tax provision for the year, <u>your discussion should describe the material factors within this line item that drove the change between the periods presented, whether they are recurring, and the</u>

potential impact on future operations. Please refer to Item 303(a)(3) of Regulation S-K and Section 501.12 of the Financial Reporting Codification for guidance.

Example 4: Valuation Allowances

The Staff may request additional information on the evidence assessed and weight given to such evidence as part of the overall valuation allowance judgment:

> We note that during the year ended December 31, 2017 you recorded a valuation allowance of $X million against your net U.S. deferred tax assets and maintained a valuation allowance on $X million of foreign NOLs. Please expand your disclosure to explain your basis for concluding that a valuation allowance is needed. Specifically, tell us and disclose the positive and negative evidence you considered in your determination, how that evidence was weighted, and how that evidence led you to determine it was necessary to record a valuation allowance.

Example 5: Valuation Allowances

The Staff may request additional disclosures related to the realizability of deferred tax assets and the expiration of carryforwards:

> We note your loss carryforward disclosures on page F-33. In future filings please disclose the amount of pre-tax income you need to generate to realize your deferred tax assets. Also, please provide a more meaningful breakdown of the timing of the expiration of NOL carryforwards. In this regard, we note that 96% of the NOL carryforwards expire after 2021.

Example 6: Investments in Subsidiaries

The Staff may request additional information on why the company excluded certain items from disclosures associated with investments in subsidiaries:

> Please tell us your consideration for disclosing the cumulative amount of undistributed foreign earnings that are considered indefinitely reinvested in accordance with ASC 740-30-50-2 in light of your disclosure that you intend to indefinitely reinvest your undistributed foreign earnings.

Example 7: Unrecognized Tax Benefits

The Staff may request additional information on whether unrecognized tax benefits have been recorded for proposed adjustments:

> You disclose that the IRS has proposed significant adjustments to your taxable income for the years 2012 through 2015 with respect to the deferral of tax on certain premium income related to your self-insurance programs. Please explain to us the nature of the premium income and how this is reflected in your financial statements. Also, tell us whether your unrecognized tax benefits include any amounts for the proposed adjustments. We note the significant increase in your unrecognized tax benefits on page 100 of your Form 10-K for the year ended December 31, 2018. Refer to ASC 740-10-50.

Example 8: Changes in Tax Law

The Staff may request additional information to reconcile the effects of changes in tax laws separately disclosed to the amounts reflected within the income taxes footnote disclosures:

> We note your disclosure that as a result of the Tax Reform Act, you recognized a tax benefit of $X million in the consolidated statement of operations for the year ended December 31, 2017 which is comprised of $X million of deferred tax expense associated with the revaluation of the Company's net deferred tax assets, as reflected in the rate reconciliation, and $X million of deferred tax benefit associated with the partial release of your valuation allowance as a result of the Tax Reform Act. However, this disclosure does not appear consistent with the tax rate reconciliation on page 126 which reflects an $X million tax expense related to the change in legislation as well as a $X million tax expense related to the valuation allowance and does not appear to reflect a significant tax benefit related to the Tax Reform Act. Please advise or revise accordingly.

Example 9: Tax Credits

The Staff may request additional information to ensure tax credits are appropriately reflected within the financial statements:

> Please address the following comments regarding the income tax benefit reflected in your financial statements:
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> - Tell us why it is appropriate to reflect the benefits recorded and how they are realizable given your historical losses.
> - Revise your disclosure to describe the basis for the Research and development claim provided in your reconciliation of your tax credit to the statutory rate. In addition, separately tell us how this claim is based on taxable profits to be recorded as an income tax benefit as stipulated in paragraph 2 of IAS 12 and why it is not reflected as a reduction of research and development expenses as indicated in the second paragraph on page 57.
> - Revise your disclosure to describe the nature of the Adjustments due to prior periods included in your reconciliation of the tax credit to the statutory rate for 2017. Separately tell us why these adjustments are not the correction of errors that should be reflected in earlier periods under IAS 8.
> - Revise your disclosure to include a discussion of the tax impact for the year in the Management's Discussion and Analysis of Financial Condition and Results of Operations narrative on page 59.

Example 10: Adoption of New Accounting Standards

The Staff may request additional information arising from the adoption of new accounting standards:

> We note your disclosure in footnote 6 to the table on page 18 that you recognized an income tax benefit of $X million resulting from the adoption of ASC 606. Please explain what intercompany activities were impacted by the adoption of ASC 606 and how that resulted in an income tax benefit during the six months ended June 30, 2018.

Conclusion

In summary, as demonstrated in recent SEC staff comment letters, accounting for income taxes continues to be an area of focus for the SEC.

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