What's News in Tax

Analysis that matters from Washington National Tax

SEC Comments on Accounting for Income Taxes

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Examples of comments about accounting for income taxes recently issued by the U.S. Securities and Exchange Commission ("SEC") to registrants are provided in this article. 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 is provided to illustrate areas in which the SEC staff (the "Staff") questioned whether the disclosures provided adequate insight for investors to understand a company's income taxes environment or when 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 those related to effective tax rate reconciliations, valuation allowances, unrecognized tax benefits, investments in subsidiaries, intra-entity transfers of assets other than inventory, intraperiod tax allocations, accounting for income taxes in interim periods, and corrections of errors and assessment of materiality.

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Example 1: Effective Tax Rate Reconciliation

The Staff may request additional detail on the components of the other line in the effective tax rate reconciliation:

> *Please tell us each of the individual components of the 18.1% and 32.0% benefits in your "other, net" reconciling item in your rate reconciliations for 2018 and 2017, respectively*. In addition, tell us your consideration for disclosing those items that account for more than 1.05 percentage points of your effective tax rate in 2018 and 1.75 percentage points in 2017 as stipulated in Rule 4-08(h)(2) of Regulation S-X.

Example 2: Effective Tax Rate Reconciliation

The Staff may request additional information on which 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, *please revise to disclose these amounts separately*.

Example 3: Valuation Allowances

The Staff may request to understand why additional disclosure was excluded regarding the assumptions used as part of the valuation allowance judgment:

> We note that you have not recorded a valuation allowance against your significant U.S. jurisdiction deferred tax assets, other than the U.S. interest limitation. In light of the objective and verifiable negative evidence in the form of cumulative losses over the three years ended December 31, 2019, *please tell us your consideration of providing more robust critical accounting policy disclosures regarding the various judgments and assumptions made in determining the deferred tax assets are realizable, including a discussion of the degree of uncertainty associated with key assumptions*. Such discussion would desirably provide specifics (e.g., projected future taxable income assumes revenue and margin growth rates of X% and positive net income by what year) as well as a description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions. Please refer to Item 303(a)(3)(ii) of Regulation S-K and SEC Release No. 34-48960.

Example 4: Valuation Allowances

The Staff may request detail, including an understanding of the evidence assessed, that supports why a valuation allowance is not recognized:

> We note that you have net deferred tax assets of $X million as of September 30, 2018, and that you are in a three-year cumulative loss position on a consolidated basis for your US jurisdiction. *Finally, we did not note any analysis in your Critical Accounting Policies and Estimates section*

> *of MD&A that details the positive evidence and why the positive evidence outweighs the significant negative evidence of 3-year cumulative loss for your US jurisdiction. Please provide us with your comprehensive analysis of the specific positive and negative evidence management evaluated in arriving at the conclusion that a full valuation allowance is not needed as of September 30, 2018*. Your analysis should include the weighting of the evidence that is commensurate with the extent to which it is objectively verified. For any tax-planning strategies that you are relying on in your analysis, please ensure that your discussion provides us with a detailed explanation of the nature and any uncertainties, risk, and assumptions for those strategies. Please refer to ASC 740-10-30-16 – 740-10-30-25, ASC 740-10-55-39 – 740-10-55-48, and ASC 740-10-55-120 – 740-10-55-123 for guidance.

Example 5: Valuation Allowances

The Staff may request that a valuation allowance be recognized or request detail that supports why a valuation allowance is not recognized:

> As noted in your revised forecast in Exhibit X, due to the increasingly stricter regulations of the industry by the local government you now forecast losses in all future periods. Based on your historical losses and your revised forecast of projected losses, *please recognize a valuation allowance on your deferred tax asset* or tell us further how and why you have determined that a valuation allowance is not appropriate.

Example 6: Unrecognized Tax Benefits

The Staff may request additional detail as to why a potentially significant tax position with uncertainty is excluded from the disclosure of positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:

> *We note that you are currently litigating a tax matter with the Italian tax authority. Considering the potential significance, please tell us why you have not included a discussion of this matter in your financial statement footnotes disclosures or revise accordingly*. We refer you to ASC 740-10-50-15(d).

Example 7: Unrecognized Tax Benefits

The Staff may request additional detail as to changes from the measurement of an unrecognized tax benefit when compared to the final settlement:

> We note the reversal of $X million of your tax reserves primarily due to the settlement of an audit of your fiscal year 2009 through 2011 federal corporate income tax returns. We also note your disclosure in prior filings that in May 2018, a preliminary understanding was reached with the IRS regarding the contested issues for the audit and post-audit years. *Please tell us and disclose in more detail the reason for the significant change in amounts from the preliminary understanding to the final settlement*.

Example 8: Investments in Subsidiaries

The Staff may request to understand the consequences associated with a change in the indefinite reversal assertion:

> *Please provide us an accounting analysis supporting the reversal of the deferred tax liability and related $X million tax benefit in 2019 related to the change in indefinite reinvestment tax assertion for unremitted earnings from Canada*. Specifically tell us how you considered the mandatory deemed repatriation of post-1986 undistributed Non-U.S. earnings and profits from the 2017 Tax Cuts and Jobs Act.

Example 9: Intra-entity Transfers of Assets other than Inventory

The Staff may request additional detail on an intra-entity transaction and the related impact if the valuation allowance were released:

> Please describe the nature of the foreign tax restructuring in 2018 that gave rise to the $X million in deferred tax assets and *revise your disclosures to describe the restructuring*. Also, confirm whether these are the same deferred tax assets of your Irish subsidiary referred to in the March 31, 2019 Form 10-Q that would give rise to an income tax benefit in excess of $X million if the valuation allowance were released. If they are the same, revise your disclosures to clarify.

Example 10: Intraperiod Tax Allocations

The Staff may request additional detail as to why an income tax benefit is recognized by an entity that has a full valuation allowance:

> Please describe to us in greater detail the accounting and underlying facts and circumstances that led to the recognition of the $X million income tax benefit under ASC 740-20.

Example 11: Accounting for Income Taxes in Interim Periods

The Staff may request entities to disclose the estimated annual effective tax rate in interim periods:

> *Revise your discussions of income taxes in this note and in MD&A in future filings to disclose the estimated annual effective tax rate used in computing your year-to-date provision for income taxes*. Refer to ASC 740-270-25 and ASC 740-270-50.

Example 12: Correction of an Error and Assessment of Materiality

The Staff may request additional detail as to why a correction of an error is immaterial:

> We note that in the first quarter of 2019, you recorded a $X million tax expense that related to the fourth quarter of 2018. We further note that you believe this correction was not material. Given that the adjustment recognized during 2019 of $X million represented 16% of your fourth quarter 2018 net income as well as resulted in a net loss in your first quarter 2019, *please tell us how you considered materiality in the context of SAB Topic 1M and provide us with your detailed analysis in determining the out-of-period adjustment was not material to your results of operations for the quarters ended December 31, 2018 and March 31, 2019*.

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. Consequently, financial statement preparers may decide to consider the recent comments from regulators and standard setters to identify areas for improvements in existing income taxes disclosures.