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Accounting for Income Taxes Considerations of Adopting ASU 2020-06

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Convertible debt instruments with cash or beneficial conversion features may be significantly affected by Accounting Standards Update (ASU) 2020-06. This article discusses specified accounting for income taxes considerations upon adoption of the ASU.

Introduction

In August 2020, the Financial Accounting Standards Board (FASB) issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, to simplify the accounting for certain convertible instruments and contracts potentially settled in an entity's own shares. The ASU changes the accounting for certain convertible instruments by eliminating two of the separation accounting models which will likely result in more convertible instruments being accounted for as a single unit.

ASU 2020-06 is expected to most significantly impact debt instruments with cash and beneficial conversion features. Cash conversion features allow an instrument's issuer to settle (or partially settle) a holder's exercise of the conversion option with cash instead of shares. Beneficial conversion features arise when the effective conversion price of a convertible instrument is below the per share fair value of the underlying shares at the commitment date. ASU 2020-06 may have a significant impact on the financial statements of an issuer of these types of instruments because it eliminates the existing accounting models for these instruments, which generally required separation of an equity component

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from the liability component. After adopting ASU 2020-06, a debt instrument will be separated into different components only if one of the following criteria are met.

- The conversion feature is an embedded derivative that requires separate accounting under ASC 815, *Derivatives and Hedging*, which results in the recognition of a debt component and a derivative liability component.
- The convertible debt is issued at a substantial premium which results in the recognition of a debt component and an equity component.

Absent an instrument incorporating a separable embedded derivative or a substantial premium, it is accounted for as a single unit with all proceeds received upon issuance being recorded as debt. The debt is subsequently measured at the amortized cost unless the fair value option is elected.

The ASU is effective for public business entities that are Securities and Exchange Commission (SEC) filers, excluding entities eligible to be smaller reporting companies as defined by the SEC, for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its annual fiscal year. The ASU is applied through either a full retrospective (cumulative effect adjustment to the opening balance of retained earnings as of the beginning of the first comparative period presented) or a modified retrospective (cumulative effect adjustment to the opening balance or retained earnings as of the date of adoption) method of transition.

In each interim period and the annual period that includes the adoption of ASU 2020-06, an entity shall disclose the nature of the change in accounting principle (including an explanation of the newly adopted accounting principle), the method of applying the change, the cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the change is initially applied, and for entities that present earnings per share information, the effect of the change on affected per share amounts for the period of adoption. Further, if an entity elects to apply the full retrospective transition method, the effect of the change on income from continuing operations, net income, any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted, shall also be disclosed.

Accounting for Income Taxes Considerations

Prior to the adoption of ASU 2020-06, a convertible instrument with a cash or beneficial conversion feature that is not accounted for separately under ASC 815 is accounted for under one of two equity separation models. These separation models require the issuer to allocate a portion of the debt proceeds to an equity component, resulting in the debt being carried for financial reporting purposes at an amount less than the total proceeds. For US federal income tax purposes, the tax basis of the debt is often the entire amount of the proceeds received and therefore a taxable temporary difference generally arises for which a deferred tax liability is recognized. The deferred tax liability is measured based upon the assumption that the liability will be settled at the financial statement carrying amount,

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which at the date of issuance would result in taxable cancellation of indebtedness income and therefore represents a taxable temporary difference. The deferred tax expense associated with this deferred tax liability is generally allocated as an adjustment to additional paid-in capital with the tax effect of subsequent changes recognized as a component of income tax expense (benefit).

Upon adoption of ASU 2020-06, as noted above, all proceeds other than those associated with separable embedded derivatives or substantial premiums are allocated to the convertible instrument as a single unit with no allocation to derivative liability or equity for cash or beneficial conversion features. Therefore, adjusting entries are reflected upon adoption as if the instrument were always accounted for as a single unit; in other words, the conversion feature and related deferred tax consequences originally recognized are reversed through a combination of adjusting entries to the liability, retained earnings and other equity components to adjust the financial statements to where they would have been if the entity had always followed ASU 2020-06. This article uses an example to illustrate the accounting for income taxes consequences of the adoption of ASU 2020-06 on these types of convertible instruments.

Example: Effects of ASU 2020-06 on Convertible Debt Instruments with Cash Conversion Features

On January 1, Year 1 ABC Corp. (ABC), a US corporation, issues a series of 1,000 fixed-rate bonds with a 20-year maturity. The bonds are issued for the aggregate par amount of $1,000,000, have a 4.0 percent stated coupon interest rate, and cash interest payments are made annually on December 31.

The holder has the option to convert each bond at any time to 20 of ABC's $1 par value common shares (representing a conversion price of $50 per share). On conversion, ABC may elect to settle by delivering a combination of cash and/or common shares with an aggregate value equal to the current market price of 20 of ABC's common shares (the conversion value). ABC has a stated policy and past practice of settling the bond principal in cash instead of common shares. The bonds do not contain embedded features other than the conversion option.

The tax basis of the bonds is $1,000,000 and ABC is entitled to US federal income tax deductions based on cash interest payments. ABC does not receive a tax deduction for the payment of consideration upon conversion in excess of the tax basis of the convertible notes, regardless of the form of that consideration (cash or shares). ABC's income tax rate is 21.0 percent. For all years considered, ABC has income from continuing operations and sufficient taxable income to realize the tax benefits arising from its interest deductions.

For simplicity, this example does not reflect debt issuance costs and presumes that ABC issues only annual financial statements.

Year 1: Recognition and Initial Measurement

Before the adoption of ASU 2020-06, the liability component under the cash conversion separation model would be recorded based on the fair value of a similar liability without the cash conversion option, with the remaining proceeds allocated to the equity component.

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ABC would therefore record the following pretax journal entry if, at issuance, the fair value of a similar liability that does not have the cash conversion option is $600,000.

Account	Debit (credit)	Notes
Cash	1,000,000	
Notes payable, net of discount	(600,000)	Fair value of debt without cash conversion option
Additional paid-in capital	(400,000)	Remaining proceeds in excess of fair value of debt without cash conversion option

The income taxes consequences of the issuance of the convertible instrument would be reflected by the following entry.

Account	Debit (credit)	Notes
Additional paid-in capital	84,000	
Deferred tax liability	(84,000)	21.0% of the $400,000 taxable temporary difference associated with the debt between the financial statement carrying amount of $600,000 and the tax basis of $1,000,000.

Before the adoption of ASU 2020-06, the discount on the liability component arising from allocating proceeds to equity for the cash conversion option is accreted using the effective interest method in ASC 835. At December 31, Year 1, ABC records the following pretax journal entry to reflect the interest on the convertible debt instrument.

Account	Debit (credit)	Notes
Interest expense	48,600	
Cash	(40,000)	$1,000,000 par value x 4.0% stated coupon interest rate.
Notes payable, net of discount	(8,600)	Represents discount accretion under the effective interest method (rounded).

The income taxes consequences of the interest on the convertible instrument would be reflected by the following entry.

Account	Debit (credit)	Notes
Income taxes payable	8,400	Represents the tax effect of deductions for interest payments: 40,000 x 21.0%
Deferred tax liability	1,800	Represents partial reversal of the deferred tax liability due to accretion of the debt discount which increases the financial statement carrying amount of the debt and reduces the related taxable temporary difference: $8,600 x 21.0% (rounded)
Current tax benefit	(8,400)	
Deferred tax benefit	(1,800)	

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Selected balance sheet accounts immediately prior to adoption of ASU 2020-06 as of December 31, Year 1 are as follows:

Account	Debit (credit)	Notes
Notes payable, net of discount	(608,600)	$600,000 initial fair value of debt without the cash conversion option, adjusted for the $8,600 Year 1 accretion
Deferred tax liability	(82,200)	Represents the difference between the financial statement carrying amount of $608,600 and tax basis of $1,000,000 of $391,400 x 21.0%

Year 2: Adoption of ASU 2020-06 and subsequent measurement

In Year 2, the Company adopts ASU 2020-06 using the modified retrospective method with a cumulative effect adjustment to the opening balance of retained earnings at January 1, Year 2. ABC records the following pretax journal entry upon adoption:

Account	Debit (credit)	Notes
Additional paid-in capital	400,000	Reversal of the proceeds on initial issuance allocated to equity
Retained earnings	(8,600)	Cumulative effect adjustment due to the accretion that was recognized in Year 1 as a component of pretax income from continuing operations that would not have been incurred if the instrument were treated as a single unit from inception
Notes payable, net of discount	(391,400)	Adjustment to reflect the financial statement carrying amount of the instrument as if it were accounted for as a single unit from inception

The income taxes consequences of the adoption of ASU 2020-06 would also be reflected by the following journal entry.

Account	Debit (credit)	Notes
Deferred tax liability	82,200	Reversal of the deferred tax liability as the financial statement carrying amount and tax basis subsequent to adoption are equal at $1,000,000 resulting in no remaining temporary difference
Retained earnings	1,800	Adjusts for deferred tax benefit from the reversal of the deferred tax liability in Year 1 for the tax effect of the accretion that was reflected in pretax income from continuing operations
Additional paid-in capital	(84,000)	Reversal of the deferred tax expense allocated to additional paid-in capital as if the transaction were originally accounted for as a single unit, no deferred tax liability would have been recognized and no amount of income tax expense would have been allocated to additional paid-in capital

Selected balance sheet balances immediately following adoption of ASU 2020-06 are as follows:

Account	Debit (credit)	Notes
Notes payable, net of discount	(1,000,000)	$1,000,000 financial statement carrying amount of the convertible debt instrument subsequent to adoption of ASU 2020-06
Deferred tax liability	-	Represents the difference between the financial statement carrying amount of $1,000,000 and tax basis of $1,000,000 of zero x 21.0%

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At December 31, Year 2, subsequent to the adoption of ASU 2020-06, ABC would record the following pretax journal entry to reflect the interest on the convertible debt instrument.

Account	Debit (credit)	Notes
Interest expense	40,000	$1,000,000 par value x 4.0% stated coupon interest rate.
Cash	(40,000)	

The income taxes consequences of the activity for the year ended December 31, Year 2 is reflected as part of the following journal entry:

Account	Debit (credit)	Notes
Income taxes payable	8,400	$40,000 of interest expense deductions x 21.0%
Current tax benefit	(8,400)	

In years following the adoption of ASU 2020-06, ABC subsequently measures the bonds at amortized cost. Because the convertible debt was issued at par, interest expense is recorded each period based on the debt's stated interest rate and a current tax benefit is recognized for the associated deduction related to the interest payments.

Conclusion

When adopting ASU 2020-06, entities should carefully consider the accounting for income taxes consequences of changing the accounting model for convertible debt instruments.

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