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ASU 2019-12
Income Tax Accounting Changes for Private Companies

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Accounting Standards Update (ASU) 2019-12 is effective for private companies with the calendar year end 2022 financial statements (effective for fiscal years beginning after December 15, 2021). The ASU makes narrow simplifications to income tax accounting which are mostly applicable to C-Corporations with specific circumstances (such as foreign subsidiaries, interim reporting, and other comprehensive income). However, ASU 2019-12 does have a few provisions which will impact some private companies that are largely pass-through entities. In this report, we discuss the provisions which may impact private companies in detail and summarize with relevant context the more narrow provisions which pertain to C-Corporations with specific circumstances.

Does FASB ASC 740 Apply to Certain Types of Franchise Taxes Partially Based on Income?

While FASB *Accounting Standards Codification* (FASB ASC) 740, *Income Taxes,* does not broadly define "income tax," it has historically noted at FASB ASC 740-10-15-4(a) that franchise taxes "based on capital" with no additional tax based on income are not within the scope of FASB ASC 740. Some taxing jurisdictions impose a tax that is in part franchise tax and income tax such as a tax based on the greater of a franchise tax based on capital or income tax based on taxable net income (hereinafter we will refer to these type of taxes as "hybrid income/franchise tax"). Based on the aforementioned guidance in FASB ASC 740-10-15-4(a), these hybrid income/franchise taxes were only considered in the scope of FASB ASC 740 for incremental amounts owed on income tax, if any, in excess of the franchise tax computation. Essentially, in the past, for these hybrid income/franchise tax regimes FASB ASC 740 dictated the "order of operations" which deemed the tax to first be a franchise tax and then income tax for any amounts due in excess of the franchise tax formula.

In ASU 2019-12, the FASB decided to reverse the ordering in the previous guidance to require, in cases where a tax is a hybrid income/franchise tax, that an entity first compute the amount owed as an income tax for which FASB ASC 740 will apply (including deferred tax assets and liabilities). If additional amounts are owed under the tax regime, the incremental amount is treated as a franchise tax for which FASB ASC 740 would not apply.

In making this decision, the FASB noted in Basis for Conclusion (BC), p. 9 that the previous guidance was costly and complex "particularly when the amount related to the non-income-based tax is not significant, and that the guidance does not result in increased usefulness to users of financial statements." The FASB further noted that, "[i]n many cases, the tax amount based on amounts other than income (for example, capital) generally is only significant if that amount is greater than the income tax amount. That is because an entity is likely operating at a loss or near the breakeven point in those situations. Stakeholders also indicated that this guidance introduces complexity in determining which rate to use when recording deferred taxes on temporary differences."

The amendments also note that an entity shall not consider the effect of potentially paying a non-income-based tax in future years when evaluating the realizability of its deferred tax assets. ASU 2019-12 applies to all entities subject to income taxes, this includes entities which are not subject to income taxes at the federal level but are subject to income taxes at the state and/or local level. The FASB specifically rejected a scope exception for pass-through entities in BC 19, noting that these entities are considered a taxable entity in some jurisdictions.

Practice Note: We typically do not see deferred income tax accounting for any taxing jurisdiction on the financial statements of pass-through entities**.** FASB ASC 740-10-55-25 does require a separate deferred tax computation if state or local deferred tax assets or liabilities are significant. Many pass-through entities may not record state/local deferred tax assets and liabilities that are technically required under FASB ASC 740 for entity-based income taxes assessed on pass-through entities at the state and local level due to materiality considerations. While ASU 2019-12 does broaden the scope of taxes inside FASB ASC 740, it did not appear based on public filings to have a material impact on public companies. At present, we noted only a limited number of state tax regimes which would appear to be hybrid income/franchise taxes such as New York and Connecticut. Entities with operations in these jurisdictions may wish to reevaluate materiality assessments previously made.

Example 17 in FASB ASC 740-10-55-140 through 55-143 was revised (copied below) to illustrate the new guidance on evaluating whether a tax is an income tax in ASU 2019-12:

> A state's franchise tax on each corporation is set at the greater of 0.25 percent of the corporation's net taxable capital and 4.5 percent of the corporation's net taxable earned surplus. Net taxable earned surplus is a term defined by the tax statute for federal taxable income.
>
> In this Example, the amount of franchise tax equal to the tax on the corporation's net taxable earned surplus is an income tax.
>
> Deferred tax assets and liabilities are required to be recognized under this Subtopic for the temporary differences that exist as of the date of the statement of financial position using the tax rate to be applied to the corporation's net taxable earned surplus (4.5 percent).
>
> The portion of the total computed franchise tax that exceeds the amount equal to the tax on the corporation's net taxable earned surplus should not be presented as a component of income tax expense during any period in which the total computed franchise tax exceeds the amount equal to the tax on the corporation's net taxable earned surplus.
>
> While the tax statutes of states or other jurisdictions differ, the accounting described FASB ASC 740-10-55-140 through 55-143 would be appropriate if the tax structure of another state or jurisdiction was essentially the same as in this Example.

For these provisions of ASU 2019-12 related to franchise taxes that are partially based on income, an entity may transition to the new guidance on a retrospective basis for all prior periods presented or through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption (January 1, 2022 for a calendar year private company).

<u>Allocation of Tax on Consolidated Tax Returns to Separate Financial Statements of Legal Entities not Subject To Tax</u>

FASB ASC 740-10-30-27 indicates that the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. BC 21 of ASU 2019-12 noted diversity in practice in allocating income tax to single-member limited liability companies that are disregarded for tax purposes and generally are not severally liable for the taxes of its taxable owner. ASU 2019-12 addressed this diversity in practice by providing guidance that an entity is not required to allocate consolidated current and deferred tax expense to legal entities not subject to tax. However, an entity may elect to allocate the consolidated amount of current and deferred tax expense to legal entities that are both subject to tax and disregarded by the tax authority. (FASB ASC

740-10-30-27A) This election can be made on an entity-by-entity basis for their respective separate financial statements. However, an entity cannot elect to allocate consolidated current and deferred tax expense for legal entities that are partnerships or are other pass-through entities that are not wholly owned.

An entity that is both not subject to tax and disregarded by the taxing authority that elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements shall disclose that fact. These entities also should make the disclosures required by FASB ASC 740-10-50-17 which are:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented

Entities making the election also should do so by retrospectively presenting all prior periods presented. The retrospective application is only required for entities making the election in separate financial statements. If the retrospective application requirement is burdensome for private companies, the private company may wish to consider eliminating prior period financial statements. Generally, private companies are not under statutory requirements to provide prior period financial statements.

CPEA Observation: FASB ASC 740-10-50-16 continues to require that an entity disclose that it is not subject to income tax. Accordingly, if an applicable entity does not make the election described above in FASB ASC 740-10-30-27A, such an entity would continue to be required to disclose that it is not subject to income tax.

<u>What Are the Other Provisions of ASU 2019-12?</u>

The remaining provisions of ASU 2019-12 are not broadly applicable to private companies as they pertain to C-Corporations and foreign investments held by C-Corporations. We summarize below the provisions and the relevant context for the changes.

1. FASB ASC 740-20 has detailed guidance on allocation of income tax expense between continuing operations, discontinued operations, and other comprehensive income. Generally, income tax is first computed based on income from continuing operations with the remainder allocated to items other than continuing operations which is known as the "incremental approach." An exception to the incremental approach for intraperiod tax allocation is when there is a loss

from continuing operations and income or a gain from other items (for example, discontinued operations or other comprehensive income). ASU 2019-12 removes that exception to the incremental approach.

2. Deferred tax balances generally are recorded on temporary timing differences. One exception to this requirement relates to indefinitely reinvested earnings in a subsidiary, typically a foreign subsidiary. If criteria are met, deferred tax liabilities are not recognized for indefinitely reinvested earnings in a subsidiary. This exception does not apply to equity method investments. However, in the past if a subsidiary became an equity method investment, no deferred tax liability was recognized for the temporary timing difference related to indefinitely reinvested earnings for the time that the investment was a subsidiary. This exception was removed by ASU 2019-12. Accordingly, when a subsidiary becomes an equity method investment a deferred tax liability needs to be recognized related to indefinitely reinvested earnings when the investment was a subsidiary.

3. In the converse of #2, when an equity method investment becomes a subsidiary, in the past, deferred tax liabilities were maintained related to the period the investment was an equity method investment even if the subsidiary is able to assert that the deferred tax liabilities related to indefinitely reinvested earnings. ASU 2019-12 changes this guidance and now a deferred tax liability is not maintained for a subsidiary with indefinitely reinvested earnings (assuming criteria are met) related to the period the investment was an equity method investment.

4. In situations where Generally Accepted Accounting Principles (U.S. GAAP) compliant interim financial statements are issued and a loss exists for the interim period which exceeds the anticipated loss for the year, extant guidance in FASB ASC 740-270-30-28 limited the tax benefit recognized. This was an exception to the general methodology for calculating income taxes in an interim period when a year-to-date loss exceeds the anticipated loss for the year. ASU 2019-12 removes this exception.

5. In some foreign taxing jurisdictions, an entity may enter into a transaction with a government in its capacity as a taxing authority that results in an increase in the tax basis of assets of the entity. In these cases, guidance in ASU 2019-12 now requires that an entity evaluate when a step up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized and when it should be considered a separate transaction. FASB ASC 740-10-25-54 now indicates how deferred tax accounting should be handled in situations that are part of a business combination or a separate transaction.

6. ASU 2019-12 now requires that an entity reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the interim period that includes the enactment date.

7. ASU 2019-12 also makes minor Codification improvements for income taxes related to employee stock ownership plans and investments in qualified affordable housing projects accounted for using the equity method.

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