The Financial Accounting Standards Board (FASB or Board) has embarked on a simplification initiative to identify, evaluate and improve areas of GAAP for which the cost and complexity can be reduced while maintaining or improving the usefulness of financial information reported by an entity for its users. A noble and commendable endeavor indeed.

The FASB issued an exposure draft at the behest of stakeholders for an accounting standard update on January 22, 2015, proposing to eliminate a historically complex GAAP requirement for a buyer and seller within the same consolidated reporting group to defer recognition of the current and deferred income tax consequences resulting from an intra-entity asset transfer until such time that the asset leaves the consolidated group, such as being sold to an outside party. In theory, the existing rule to defer all income tax consequences for transfers between related entities is simpler than its real-world application has proven to be. The current rule for intra-entity asset transfers is an exception to the principle of comprehensive recognition of current and deferred income taxes in ASC 740. Many in the accounting community feel the exception doesn’t provide useful information to financial statement users because the income tax consequences of the transaction, such as taxes payable or paid as a result of the transfer, are not reported until the asset ultimately leaves the group. However, others feel the current exception is more appropriately consistent with the consolidation principles of ASC 810, under which intercompany balances and transactions are eliminated such that the consolidated financial statements represent the financial position and operating results of a single business enterprise.

Comments on the FASB’s exposure draft were requested by May 29, 2015, and more than 30 comment letters were submitted and published on the FASB’s website. The commentators ranged from public accounting firms, state accounting professional societies and financial advisors to current and former in-house accounting personnel. All commentators support the FASB’s overall simplification initiative, many agreed with this proposed accounting standard update, and many had proposed changes of their own to add, but most respondents were not convinced the proposal delivers on its stated goal to simplify GAAP or provide better information to financial statement users. Many of those opposed to the updated standard, and some who were agreeable to the proposed standard, were in favor of issuing additional guidance clarifying the existing rules or maintaining the current exception for frequently recurring inventory transfers.

Current Rules

Under the consolidation rules of ASC 810, intercompany transactions and balances are eliminated within a consolidated group’s financial statements. Even though the intra-entity transfer of an asset between two entities in different tax jurisdictions can have a cash tax consequence to the selling entity, typically from the recognition of a taxable gain in the seller’s tax jurisdiction, ASC 810—10—45–8 defers the income taxes paid by the seller on its transfer of assets remaining within the group until such time that the asset leaves the consolidated group. This generally creates a prepaid tax asset on the seller’s books, which is reversed into income when the asset either is sold outside the group or otherwise leaves the group through amortization or impairment. The difference between the tax basis in the asset purchased in the buyer’s tax jurisdiction and the consolidated group’s financial statement basis in that asset is not recorded pursuant to the current rules of ASC 740—10–25–3(e), which prohibits the recognition of a deferred tax asset for the difference between the tax basis of the asset in the buyer’s tax jurisdiction and the cost as reported in the consolidated financial statements. This difference in the tax basis from the book basis of the asset is tracked off balance sheet instead of creating a deferred tax asset or liability on the buyer’s books.

The focus of the original exception was to address the intercompany transfer of inventory and similar tangible assets that would
generally have relatively short-lived reporting consequences and could recur regularly within a business. However, the prevalence, complexity and magnitude of cross-border intercompany transfers of assets such as intellectual property has muddied the waters, and the lack of robust guidance on these types of transfers has led to diversity in the practical application of the exception. Areas that have been subject to interpretation have revolved around the intra-entity transfer of intangible assets that may or may not have an associated book basis, assets with an indefinite life, transfers of subsidiaries, licensing agreements and the treatment of a valuation allowance release in connection with an intra-entity transfer.

Proposed Rule

The proposed accounting standard would require an entity to recognize the current and deferred income tax consequences of intra-entity transfers of assets such as inventory, fixed assets and intangible assets at the time of the transfer. The seller in an intra-entity transfer would recognize tax expense immediately related to the taxable gain in the seller’s tax jurisdiction, while the buyer would recognize a deferred tax asset for the difference between the tax basis of the asset in the buyer’s tax jurisdiction and the cost of the asset reported in the consolidated group’s financial statements, not the buyer’s stand-alone book basis. Along with the recognition of a deferred tax asset, the company would also be required to remeasure the asset with any changes in the buyer’s tax rate and evaluate the realizability of the asset in assessing its need for a valuation allowance.

Potential Consequences

The FASB’s proposal aims to simplify accounting for income taxes, reduce complexity and diversity in financial statement reporting, provide more useful, consistent information, and eliminate the need for additional guidance on the existing exception that would be needed to gain clarity and comparability within financial statements but could easily add more complexity. The proposed update would align GAAP with International Financial Reporting Standards (IFRS), specifically IAS 12, Income Taxes, which requires recognition of current and deferred income taxes resulting from an intra-entity asset transfer when the transfer occurs. A company’s current need to track the prepaid tax asset recorded by the seller at the time of the transfer, to track the basis difference in the asset between book and tax off balance sheet and ultimately to recognize the tax consequences for both entities in the appropriate period without error would be eliminated. This change could reduce the time, effort and resources incurred by some entities in the past to identify, analyze, interpret and document an entity’s accounting for intra-entity transfers.

However, in many instances, considerable time and resources have been spent by companies establishing accounting policies, sophisticated systems, processes and controls to comply with the current GAAP treatment of intra-entity transfers. FASB’s proposed change will require entities to re-evaluate and implement new, and possibly just as complex, procedures to recognize and track the buyer’s deferred taxes for the difference between the tax basis and the consolidated book carrying basis, remeasure the deferred tax asset for changes in the buyer’s tax rate and determine the realizability of the asset as part of the company’s valuation allowance assessment.

The FASB also believes the proposed update is a better representation of the real economic consequences of the transaction than the current exception requiring the deferral of the income tax consequences. Since intra-entity transfers between two entities in the same consolidated group in different tax jurisdictions often create a taxable event, there are income tax consequences that affect the seller’s taxing authority and the buyer’s taxing authority. The Board felt this effect outside the consolidated group made recognizing the tax consequences immediately appropriate. The FASB noted that recognition of current income tax paid or payable would assist users in comparing current tax expense and the effective tax rate to cash paid for income taxes. However, there is a concern among some practitioners that the elimination of the current exception merely creates a new exception to the consolidated principles of ASC 810 under which the pre-tax gain or loss related to the intra-entity transfer will continue to be eliminated but the tax effect of the transfer will impact the company’s earnings.

With this proposed update, the ability of a company to defer reporting the tax consequences of these transactions will be eliminated, and it could create greater volatility in tax expense and earnings, increase a company’s effective tax rate, lead to real or perceived manipulation of earnings and create more difficulty in estimating the annual effective tax rate if forecasting of intra-entity transfers must be performed at interim periods. The current proposal does not specifically address whether the income tax consequences of an intra-entity transfer would be included in the estimated annual effective tax rate calculation at interim periods or recognized discretely in the period in which the transfer occurs. Varying degrees of complexity will be encountered by entities having to forecast intra-entity transfers within a complex global supply chain to facilitate forecasting the entity’s effective tax rate for the year.
Proposed Effective Date

The proposed update includes an effective date for public companies in annual periods, including the interim periods within those annual periods, beginning after December 15, 2016. Early adoption for public companies would not be allowed under the currently proposed change. However, several commentators suggested the Board should consider allowing early adoption for all entities or same—time adoption for public and non—public entities.

The proposed effective date for non—public entities is annual periods beginning after December 15, 2017 and interim periods in annual periods beginning after December 15, 2018. Early adoption is permitted, but not before the effective date for public entities under the currently proposed change.

Disclosures

Transition reporting under the proposed update requires recording a cumulative adjustment to retained earnings as of the beginning of the period of adoption for the recognition of the income tax consequences of any intra—entity asset transfers occurring before the effective date. Companies are required to disclose the nature of and reason for the change in accounting principle, as well as quantitative information about the effects of the accounting change.

The FASB did not propose changes to other existing disclosure requirements with this exposure draft because it felt the current requirements provide users with information on significant intra—entity transfers and it is evaluating all income tax disclosures as part of a broader initiative. The income tax effects will be visible to a financial statement user to the extent the tax effects are material enough to require disclosure in the effective tax rate reconciliation. Also, if an intra—entity transfer gives rise to a significant portion of the company’s deferred income taxes, an entity will be required to disclose it under the existing disclosure framework.

Alvarez & Marsal Taxand Says:

Only time will tell if the FASB achieves its admirable goal of overall simplification of tax accounting. It will be interesting to see what the Board does with this proposed update with the majority of respondents opposed to it, given that the update was initiated by stakeholders’ contention that the current guidance does not provide useful information to financial statement users. The proposed update would affect companies in a wide range of industries, to varying degrees, with potential impact on their tax tracking, accounting procedures, internal controls and information systems. If the standard is adopted as drafted, the proposed change would take effect for calendar year—end public entities in 2017; therefore, companies should be aware of how these changes could affect their specific organization and preliminarily assess the potential changes to the organization’s current processes, systems and controls.

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