Accounting for Income Taxes

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I. Introduction

A. FASB Statement No. 109 establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes.

1. This Statement supersedes APB Opinion No. 11, FASB Statement No. 96 and most of other pronouncements which address various aspects of the financial accounting treatment of income taxes.

2. All enterprises must comply with FASB Statement No. 109 for fiscal years beginning after December 15, 1992. However, earlier application is encouraged.

B. In general

1. FASB Statement No. 109 retains the comprehensive allocation objective of its predecessors, APB Opinion No. 11 and FASB Statement No. 96 - recognition of the tax consequences of a transaction or event in the period the transaction or event is recognized in the financial statements. However, this objective is now achieved in a different manner. FASB Statement No. 109 makes fundamental changes in the conceptual basis and the methods of accounting for income taxes and, as a result, it impacts the way interperiod tax allocation is achieved.

2. FASB Statement No. 109 reaffirms the conclusion reached in FASB Statement No. 96 that deferred income taxes are assets and liabilities rather than residual deferred charges and credits. As in FASB Statement No. 96, the measurement of deferred tax assets and liabilities is largely determined by reference to the tax law and changes to it; however, unlike FASB Statement No. 96, FASB Statement No. 109 requires consideration of future events to assess the likelihood that tax benefits will be realized in future tax returns.

3. Briefly, under FASB Statement No. 109:

   a. Deferred tax liabilities are recognized for future taxable amounts.

   b. Deferred tax assets are recognized for future deductions and operating loss and tax credit carryforwards.

   c. Deferred tax assets and liabilities are measured using the applicable tax rate.

   d. A valuation allowance is recognized to reduce deferred tax assets to the amounts that are more likely than not to be realized.
e. The amount of the valuation allowance is based on available evidence about the future.

f. Deferred tax expense or benefit is computed as the difference between the beginning and ending balance of the net deferred tax asset or liability for the period.

g. In general, deferred tax assets and liabilities are classified as current or noncurrent in accordance with the classification of the related asset or liability for financial reporting purposes.

h. The effects of changes in rates or laws are recognized at the date of enactment.

II. Historical Perspective

A. APB Opinion No. 11 was issued in 1967. Over the years that followed, it was the frequent subject of numerous criticisms and concerns that focused both on the complexity of the accounting requirements and on the meaningfulness of the results of applying the requirements.

B. In January 1982, the Board added a project to its agenda to reconsider accounting for income taxes, and a task force was appointed to advise the Board during its deliberations on this project. An FASB Research Report, Accounting for Income Taxes: A Review of Alternatives, prepared by Ernst & Whinney, was published in July 1983. The report discussed the accounting and reporting alternatives advanced in the accounting literature on income taxes.

C. The Discussion Memorandum on accounting for income taxes was issued in August 1983, and more than 400 comment letters were received. The Board conducted a public hearing on the Discussion Memorandum in April 1984, and 43 organizations and individuals presented their views at the 3-day hearing. In May 1984, the FASB sponsored three regional meetings to obtain the views of preparers, users, and auditors associated with the financial statements of small companies.

D. Accounting for income taxes was addressed at 20 public Board meetings and at 2 public task force meetings and, in September 1986, the Board issued an Exposure Draft, Accounting for Income Taxes. It proposed an asset and liability approach to account for the effects of income taxes that result from an enterprise's activities during the current and preceding years. The Board received more than 400 comment letters in response to the Exposure Draft.

E. In January 1987, the Board conducted a public hearing on the Exposure Draft. Fifty-one organizations and individuals presented their views at the 3-day hearing. Based on the information received in the comment letters and at the public hearing, the Board reconsidered its proposals in the Exposure Draft at 21 public Board meetings during 1987.

F. FASB Statement No. 96, Accounting for Income Taxes, was issued in December 1987 and the FASB Special Report, A Guide to Implementation of Statement 96 on Accounting for Income Taxes, was issued in March 1989. As issued, Statement 96 was effective for financial statements for fiscal years beginning after December 15, 1988, but the effective date was deferred three times, the last of which was to fiscal years beginning after December 15, 1992.
G. After the issuance of Statement 96, the Board received (a) requests for about 20 different limited-scope amendments to that Statement, (b) requests to change the overly restrictive criteria for recognition and measurement of deferred tax assets to anticipate, in certain circumstances, the tax consequences of future income, and (c) requests to reduce the complexity of scheduling the future reversals of temporary differences and considering hypothetical tax-planning strategies. The Board considered the requests to amend Statement 96 at 41 public Board meetings and 3 Implementation Group meetings starting in March 1989.

H. In June 1991, the Board issued an Exposure Draft, Accounting for Income Taxes. The Exposure Draft retained the asset and liability approach for financial accounting and reporting for income taxes as in Statement 96, but reduced the complexity of the standard and changed the criteria for recognizing and measuring deferred tax assets. During the comment period for the Exposure Draft, a limited-scope field test of the proposals in the Exposure Draft was completed, and an FASB-prepared seminar that explained and analyzed the proposals was presented by Board and staff members at nine locations throughout the country.

I. The Board received more than 250 comment letters in response to the Exposure Draft. In October 1991, the Board held a 3-day public hearing on the Exposure Draft, and 25 organizations and individuals presented their views. Based on the information received in the comment letters and at the public hearing, the Board reconsidered its proposals in the Exposure Draft at 12 public Board meetings.

J. FASB Statement No. 109, Accounting for Income Taxes, is a reconciliation of the guidance in APB Opinion No. 11 and FASB Statement No. 96. The statement supersedes the guidance of those statements. The Boards believes that the requirements of FASB Statement No. 109 produce results that are understandable and relevant. The Board also believes that the requirements are less complex than those of either APB Opinion No. 11 or Statement 96.

III. Scope

A. FASB Statement No. 109 establishes standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:

1. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income;

2. Other events that create differences between the tax bases of assets and liabilities and the corresponding amounts for financial reporting;

3. Operating loss or tax credit carrybacks (for refunds of taxes paid in prior years) and carryforwards (to reduce taxes payable in future years).

B. The principles and requirements of FASB Statement No. 109 are applicable to:

1. Domestic federal (national) income taxes (U.S. federal income taxes for U.S. enterprises) and foreign, state, and local (including franchise) taxes which are based on income;

2. An enterprises's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method;
3. Foreign enterprises in preparing financial statements in accordance with U.S.
generally accepted accounting principles.

C. The principles and requirements of FASB Statement No. 109 are not applicable to:

1. Existing methods of accounting for the investment tax credits (See APB Opinions No.
   2 and 4);
2. The current proscription on discounting deferred taxes (See paragraph 6 of APB
   Opinion No. 10);
3. Accounting for income taxes in interim periods (other than the criteria for recognition
   of tax benefits and the effect of enacted changes in tax laws of rates and changes in
   valuation allowance) (See APB Opinion No. 28).

IV. Objectives and Basic Principle of Accounting for Income Taxes

A. Objectives

1. To recognize the amount of taxes payable or refundable for the current year.
2. To recognize deferred tax liabilities and assets for the future tax consequences of
   events that have been recognized in an enterprise's financial statements or its tax
   returns.

B. Basic Principles

FASB Statement No. 109 is based on the conclusion that deferred income taxes are assets
and liabilities, rather than deferred charges and credits. The following basic principles
underlie this approach to achieving the basic comprehensive allocation objective:

1. A current tax liability or asset is recognized for the estimated taxes payable or
   refundable on tax returns for the current year.
2. A deferred tax liability or asset is recognized for the estimated future tax effects
   attributable to "temporary differences" and carryforwards.
3. The measurement of current and deferred tax liabilities and assets is based on
   provisions of the enacted tax law; the effects of future changes in tax laws or rates
   are not anticipated.
4. The measurement of deferred tax assets is reduced, if necessary, by the amount of
   any tax benefits which, based on available evidence, are not expected to be realized.

C. Exceptions to the Basic Principles

FASB Statement No. 109 makes the following exceptions to the basic principles:

1. Continues some exceptions for recognition of deferred taxes addressed in APB
   Opinion No. 23, Accounting for Income Taxes -- Special Areas (See X.B.)
2. Provides special transitional procedures for temporary differences related to deposits
   in statutory reserve funds of U.S. steamship enterprises (See X.B.3.)
3. Does not amend accounting for leveraged leases as required by FASB Statement No. 13 and FASB Interpretation No. 21.

4. Prohibits recognition of a deferred tax liability or assets for goodwill that cannot be deducted for tax purposes.

5. Does not amend Accounting Research Bulletin No. 51, Consolidated Financial Statements, for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the basis of the assets in the buyer’s tax jurisdiction and their cost as reported in the consolidated financial statements.

6. Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, Foreign Currency Translation, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates of indexing for tax purposes.

V. "Temporary Differences" under FASB Statement No. 109

A. Background

1. While most of an enterprise’s transactions will receive identical tax and financial reporting treatment, there are several situations in which they are treated differently, and income and expense are reported in one period for tax purposes and in a different period for financial reporting purposes.

2. APB Opinion No. 11 used the term "timing difference" to describe differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax financial accounting income. Timing differences were described as differences that originate in one period and reverse or "turn around" in one or more subsequent periods.

3. FASB Statement No. 96 and FASB Statement No. 109 use the term "temporary difference," which comprehends more than the "timing difference" defined under APB Opinion No. 11.

B. Under FASB Statement No. 109, a temporary difference is:

"A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Some temporary differences cannot be identified with a particular asset or liability for financial reporting,..., but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amounts in future years based on provisions of the tax laws. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences."

C. Examples of Temporary Differences

1. Revenues or gains that are taxable after they are recognized in financial income. An asset (e.g., a receivable from an installment sale which qualifies under Sec. 453) may
be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

a. Such assets give rise to "deferred tax liabilities."

2. Expenses or losses that are deductible after they are recognized in financial income. A liability (e.g., a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

a. Such liabilities give rise to "deferred tax assets."

3. Revenues or gains that are taxable before they are recognized in financial income. A liability (e.g., certain subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

4. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (e.g., depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

5. A reduction in the tax basis of depreciable assets because of tax credits. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

6. ITC accounted for by the deferral method. Under APB Opinion No. 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred itc may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

7. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency.

Example: The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

8. Business combinations accounted for by the purchase method.

Example: There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under APB Opinion No. 16, Business Combinations. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and
liabilities are recovered and settled, respectively.

D. Certain Basis Differences that May Not Result in Taxable or Deductible Amounts

Certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized.

Example: The excess of cash surrender value of life insurance over premiums paid is a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy, but is not a temporary difference if the asset is expected to be recovered without tax consequence upon the death of the insured (there will be no taxable amount if the insurance policy is held until the death of the insured).

E. Temporary Differences that Have Balances Only on the Income Tax Balance Sheet

Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting.

Example 1: A long-term contract that is accounted for under the percentage-of-completion method for financial reporting, but under the completed-contract method for tax purposes. The temporary difference (income on the contract) is deferred income for tax purposes that becomes taxable when the contract is completed.

Example 2: Organizational costs are recognized as expenses when incurred for financial reporting and are deferred and deducted in a later year for tax purposes. In both instances, there is no related, identifiable asset or liability for financial reporting, but there is a temporary difference that results from an event that has been recognized in the financial statements and, based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future years.

VI. Recognition and Measurement

Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. Total income tax expense or benefit for the year is the sum of deferred tax expense of benefit and income taxes currently payable or refundable.

A. Deferred Tax Liabilities

A deferred tax liability is recognized for temporary differences that will result in taxable amounts in future years.

Example: A temporary difference is created between the reported amount and the tax basis of an installment sale receivable if, for tax purposes, some or all of the gain on the installment sale will be included in the determination of taxable income in future years. Because amounts received upon recovery of that receivable will be taxable, a deferred tax liability is recognized in the current year for the related taxes payable in future years.
B. Deferred Tax Assets

A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for loss and credit carryforwards.

Example: A temporary difference is created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years. A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.

C. Annual Computation of Deferred Tax Liabilities and Assets

Deferred taxes should be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

1. Identify (a) the types and amounts of existing temporary differences and (b) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period;

2. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (See VI.D.);

3. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate;

4. Measure deferred tax assets for each type of tax credit carryforward;

5. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. (See VI.F.)

D. Applicable Tax Rate

1. Single flat tax rate: Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate should be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor.

2. Average graduated tax rate: Enterprises for which graduated tax rates are a significant factor should measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized.

3. Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (e.g., different tax rates on ordinary income and capital gains).
4. Phased-in change in tax rate: If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

Illustration VI-1: Determination of the tax rate for measurement of a deferred tax liability for taxable temporary differences when there is a phased-in change in tax rates.

At the end of year 3 (the current year), an enterprise has $2,400 of taxable temporary differences, which are expected to result in taxable amounts of approximately $800 on the future tax returns for each of years 4-6. Enacted tax rates are 35 percent for years 1-3, 40 percent for years 4-6, and 45 percent for year 7 and thereafter.

The tax rate that is used to measure the deferred tax liability for the $2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of those temporary differences is on taxes payable for years 1-3, years 4-6, or year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in years 4-6. If tax losses are expected in years 4-6, however, the tax rate is:

* 35 percent if realization of a tax benefit for those tax losses in years 4-6 will be by loss carryback to years 1-3
* 45 percent if realization of a tax benefit for those tax losses in years 4-6 will be by loss carryforward to year 7 and thereafter.

Illustration VI-2: Determination of the tax rate for measurement of a deferred tax asset for deductible temporary differences when there is a change in tax rates.

The assumptions are as follows:

* Enacted tax rates are 30 percent for years 1-3 and 40 percent for year 4 and thereafter.
* At the end of year 3 (the current year), an enterprise has $900 of deductible temporary differences, which are expected to result in tax deductions of approximately $300 on the future tax returns for each of years 4-6.

The tax rate is 40 percent if the enterprise expects to realize a tax benefit for the deductible temporary differences by offsetting taxable income earned in future years. Alternatively, the tax rate is 30 percent if the enterprise expects to realize a tax benefit for the deductible temporary differences by loss carryback refund.

Assume that (a) the enterprise recognizes a $360 ($900 at 40 percent) deferred tax asset to be realized by offsetting taxable income in future years and (b) taxable income and taxes payable in each of years 1-3 were $300 and $90, respectively. Realization of the tax benefit of at least $270 ($900 at 30 percent) is assured because carryback refunds totalling $270 may be realized even if no taxable income is earned in future years. Recognition of a valuation allowance for the other $90 ($360 - $270) of the deferred tax asset depends on management's assessment of whether, based on the weight of available evidence, a portion or all of the tax benefit of the $900 of deductible temporary differences will not be realized at 40 percent tax rates in future years.

Alternatively, if enacted tax rates are 40 percent for years 1-3 and 30 percent for year 4 and thereafter, measurement of the deferred tax asset at a 40 percent tax rate could only occur if tax losses are expected in future years 4-6.
Illustration VI-3: Determination of the average graduated tax rate for measurement of deferred tax liabilities and assets by an enterprise for which graduated tax rates ordinarily are a significant factor.

At the end of year 3 (the current year), an enterprise has $1,500 of taxable temporary differences and $900 of deductible temporary differences, which are expected to result in net taxable amounts of approximately $200 on the future tax returns for each of years 4-6. Enacted tax rates are 15 percent for the first $500 of taxable income, 25 percent for the next $500, and 40 percent for taxable income over $1,000. This example assumes that there is no income (for example, capital gains) subject to special tax rates.

The deferred tax liability and asset for those reversing taxable and deductible temporary differences in years 4-6 are measured using the average graduated tax rate for the estimated amount of annual taxable income in future years. Thus, the average graduated tax rate will differ depending on the expected level of annual taxable income (including reversing temporary differences) in years 4-6. The average tax rate will be:

* 15 percent if the estimated annual level of taxable income in years 4-6 is $500 or less
* 20 percent if the estimated annual level of taxable income in years 4-6 is $1,000
* 30 percent if the estimated annual level of taxable income in years 4-6 is $2,000.

Temporary differences usually do not reverse in equal annual amounts as in the example above, and a different average graduated tax rate might apply to reversals in different years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate. For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero.

E. Changes in Tax Laws or Rates

1. Deferred tax liabilities and assets should be adjusted for the effect of the changes in tax laws or rates.
2. The changes in deferred tax should be included in income from continuing operations in the period during which the legislation was enacted.
3. If the change is enacted in an interim period, the entire effect of the change on existing deferred balances should be recognized in that interim period.
4. The effects of changes in tax laws on deferred income taxes that have been recognized directly in equity accounts should be allocated to income from continuing operations as a separate item in income tax expense or benefit.

F. Valuation Allowance

1. In general
a. All available evidence, both positive and negative, should be considered to
determine whether, based on the weight of that evidence, a valuation allowance
is needed.

b. Judgment must be used in considering the relative impact of negative and
positive evidence.

c. The weight given to the potential effect of negative and positive evidence should
be commensurate with the extent to which it can be objectively verified.

(1) The more negative evidence exists, the more positive evidence is necessary.

(2) The more negative evidence exists, the more difficult it is to support a
conclusion that a valuation allowance is not needed for some portion or all
of the deferred tax asset.

2. Sources of Future Taxable Income to Be Considered for Valuation Allowance

Future realization of the tax benefit of an existing deductible temporary difference or
carryforward ultimately depends on the existence of sufficient taxable income of the
appropriate character within the carryback, carryforward period available under the
tax law.

a. Possible sources of taxable income that may be available under the tax law to
realize a tax benefit for deductible temporary differences and carryforwards:

(1) Future reversals of existing taxable temporary differences;

(2) Future taxable income exclusive of reversing temporary differences and
carryforwards;

(3) Taxable income in prior carryback year(s) if carryback is permitted under
the tax law;

(4) Tax-planning strategies (see VI.G.1.) that would, if necessary, be
implemented.

b. To the extent evidence about one or more sources of taxable income is sufficient
to support a conclusion that a valuation allowance is not necessary, other
sources need not be considered.

c. Consideration of each source is required, however, to determine the amount of
the valuation allowance that is recognized for deferred tax assets.

3. Negative Evidence

The following are examples of negative evidence that would support a conclusion
that a valuation allowance is required:

a. Cumulative losses in recent years;

b. A history of operating loss or tax credit carryforwards expiring unused;

c. Losses expected in early future years (by a presently profitable entity);
d. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years;

e. A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (a) a significant deductible temporary difference is expected to reverse in a single year or (b) the enterprise operates in a traditionally cyclical business.

4. Positive Evidence

A conclusion that a valuation allowance is not required might be supported by the following types of positive evidence:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures;

b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset;

c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

5. Changes in the Valuation Allowance

a. The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily should be included in income from continuing operations.

b. The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations such as extraordinary items and shareholders' equity.

Illustration VI-4: Recognition of deferred tax assets and liabilities.

At the end of year 3 (the current year), an enterprise has $2,400 of deductible temporary differences and $1,500 of taxable temporary differences.

A deferred tax liability is recognized at the end of year 3 for the $1,500 of taxable temporary differences, and a deferred tax asset is recognized for the $2,400 of deductible temporary differences. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of the deferred tax asset. If evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not needed, other sources of taxable income need not be considered. For example, if the weight of available evidence indicates that taxable income will exceed $2,400 in each future year, a conclusion that no valuation allowance is needed can be reached without considering the pattern and timing of the reversal of the temporary differences, the existence of qualifying tax-planning strategies, and so forth.

Similarly, if the deductible temporary differences will reverse within the next 3 years and taxable income in the current year exceeds $2,400, nothing needs to be known about future taxable income exclusive of reversing temporary differences because the deferred tax asset could be realized by
carryback to the current year. A valuation allowance is needed, however, if the weight of available evidence indicates that some portion or all of the $2,400 of tax deductions from future reversals of the deductible temporary differences will not be realized by offsetting:

1. The $1,500 of taxable temporary differences and $900 of future taxable income exclusive of reversing temporary differences;
2. $2,400 of future taxable income exclusive of reversing temporary differences;
3. $2,400 of taxable income in the current or prior years by loss carryback to those years;
4. $2,400 of taxable income in one or more of the circumstances described above and as a result of a qualifying tax-planning strategy (See VI.G.1.).

To the extent that evidence about one or more sources of taxable income is sufficient to eliminate any need for a valuation allowance, other sources need not be considered. Detailed forecasts, projections, or other types of analyses are unnecessary if expected future taxable income is more than sufficient to realize a tax benefit. Detailed analyses are not necessary, for example, if the enterprise earned $500 of taxable income in each of years 1-3 and there is no evidence to suggest it will not continue to earn that level of taxable income in future years. That level of future taxable income is more than sufficient to realize the tax benefit of $2,400 of tax deductions over a period of at least 19 years (the year(s) of the deductions, 3 carryback years, and 15 carryforward years) in the U.S. federal tax jurisdiction.

Illustration VI-5: Recognition of a valuation allowance for a portion of a deferred tax asset in one year and a subsequent change in circumstances that requires adjustment of the valuation allowance at the end of the following year.

The assumptions are as follows:

* At the end of the current year (year 3), an enterprise’s only temporary differences are deductible temporary differences in the amount of $900.
* Pretax financial income, taxable income, and taxes paid for each of years 1-3 are all positive, but relatively negligible, amounts.
* The enacted tax rate is 40 percent for all years.

A deferred tax asset in the amount of $360 ($900 at 40 percent) is recognized at the end of year 3. If management concludes, based on an assessment of all available evidence, that it is more likely than not that future taxable income will not be sufficient to realize a tax benefit for $400 of the $900 of deductible temporary differences at the end of the current year, a $160 valuation allowance ($400 at 40 percent) is recognized at the end of year 3.

Assume that pretax financial income and taxable income for year 4 turn out to be as follows:

- Pretax financial loss $ (50)
- Reversing deductible temporary differences (300)
- Loss carryforward for tax purposes $ (350)
The $50 pretax loss in year 4 is additional negative evidence that must be weighed against available positive evidence to determine the amount of valuation allowance necessary at the end of year 4. Deductible temporary differences and carryforwards at the end of year 4 are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss carryforward from year 4 for tax purposes (see above)</td>
<td>$350</td>
</tr>
<tr>
<td>Unreversed deductible temporary differences ($900 - $300)</td>
<td>600</td>
</tr>
</tbody>
</table>

The $360 deferred tax asset recognized at the end of year 3 is increased to $380 ($950 at 40 percent) at the end of year 4. Based on an assessment of all evidence available at the end of year 4, management concludes that it is more likely than not that $240 of the deferred tax asset will not be realized and, therefore, that a $240 valuation allowance is necessary. The $160 valuation allowance recognized at the end of year 3 is increased to $240 at the end of year 4. The $60 net effect of those 2 adjustments (the $80 increase in the valuation allowance less the $20 increase in the deferred tax asset) results in $60 of deferred tax expense that is recognized in year 4.

G. Tax-Planning Strategies

1. Qualifying tax-planning strategies are actions that:
   a. Are prudent and feasible. Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years (e.g., management would not have to apply the strategy if income earned in a later year uses the entire amount of carryforwards from the current year).
   b. An enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and
   c. Would result in realization of deferred tax assets. The effect of qualifying tax-planning strategies must be recognized in the determination of the amount of a valuation allowance. Tax-planning strategies need not be considered, however, if positive evidence available from other sources is sufficient to support a conclusion that a valuation allowance is not necessary.

2. Tax-planning strategies may:
   a. Shift estimated future taxable income between future years.

   Example: Assume that an enterprise has a $1,500 operating loss carryforward that expires at the end of next year and that its estimate of taxable income exclusive of the future reversal of existing temporary differences and carryforwards is approximately $1,000 per year for each of the next several years. That estimate is based, in part, on the enterprise's present practice of making sales on the installment basis and on provisions in the tax law that result in temporary deferral of gains on installment sales. A tax-planning strategy to increase taxable income next year and realize the full tax benefit of that operating loss carryforward might be to structure next year's sales in a manner that does not meet the tax rules to qualify as installment sales.

   b. Shift the estimated pattern and timing of future reversals of temporary differences.

   Example: If an operating loss carryforward otherwise would expire unused at
the end of next year, a tax-planning strategy to sell the enterprise's installment sale receivables next year would accelerate the future reversal of taxable temporary differences for the gains on those installment sales.

c. Accelerate the future reversal of deductible temporary differences in time to offset taxable income that is expected in an early future year might be the only means to realize a tax benefit for those deductible temporary differences if they otherwise would reverse and provide no tax benefit in some later future year(s).

Example: Actions that would accelerate the future reversal of deductible temporary differences include:

(1) An annual payment that is larger than an enterprise's usual annual payment to reduce a long-term pension obligation (recognized as a liability in the financial statements) might accelerate a tax deduction for pension expense to an earlier year than would otherwise have occurred.

(2) Disposal of obsolete inventory that is reported at net realizable value in the financial statements would accelerate a tax deduction for the amount by which the tax basis exceeds the net realizable value of the inventory.

(3) Sale of loans at their reported amount (that is, net of an allowance for bad debts) would accelerate a tax deduction for the allowance for bad debts.

3. Consideration for Valuation Allowance

Enterprises should consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) should be included in the valuation allowance.

Illustration VI-6: Recognition of a deferred tax asset based on the expected effect of a qualifying tax-planning strategy when a significant expense would be incurred to implement the strategy.

The assumptions are as follows:

* A $900 operating loss carryforward expires at the end of next year.

* Based on historical results and the weight of other available evidence, the estimated level of taxable income exclusive of the future reversal of existing temporary differences and the operating loss carryforward next year is $100.

* Taxable temporary differences in the amount of $1,200 ordinarily would result in taxable amounts of approximately $400 in each of the next 3 years.

* There is a qualifying tax-planning strategy to accelerate the future reversal of all $1,200 of taxable temporary differences to next year.

* Estimated legal and other expenses to implement that tax-planning strategy are $150.

* The enacted tax rate is 40 percent for all years.
Without the tax-planning strategy, only $500 of the $900 operating loss carryforward could be realized next year by offsetting (a) $100 of taxable income exclusive of reversing temporary differences and (b) $400 of reversing taxable temporary differences. The other $400 of operating loss carryforward would expire unused at the end of next year. Therefore, the $360 deferred tax asset ($900 at 40 percent) would be offset by a $160 valuation allowance ($400 at 40 percent), and a $200 net deferred tax asset would be recognized for the operating loss carryforward.

With the tax-planning strategy, the $900 operating loss carryforward could be applied against $1,300 of taxable income next year ($100 of taxable income exclusive of reversing temporary differences and $1,200 of reversing taxable temporary differences). The $360 deferred tax asset is reduced by a $90 valuation allowance recognized for the net-of-tax expenses necessary to implement the tax-planning strategy. The amount of that valuation allowance is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal and other expenses to implement the tax-planning strategy</td>
<td>$150</td>
</tr>
<tr>
<td>Future tax benefit of those legal and other expenses ($150 at 40 percent)</td>
<td>(60)</td>
</tr>
<tr>
<td></td>
<td>$ 90</td>
</tr>
</tbody>
</table>

In summary, a $480 deferred tax liability is recognized for the $1,200 of taxable temporary differences, a $360 deferred tax asset is recognized for the $900 operating loss carryforward, and a $90 valuation allowance is recognized for the net-of-tax expenses of implementing the tax-planning strategy.

H. A Change in the Tax Status of an Enterprise

1. An enterprise’s tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa.

2. Date of Recognition
   a. A deferred tax liability or asset should be eliminated or recognized for temporary differences on the date that the change is made.
   b. The effect of an election for a voluntary change in tax status is recognized on the approval date, or on the filing date if approval is not necessary.
   c. The effect of a change in tax status that results from a change in tax law is recognized on the enactment date.

3. The effect of recognizing or eliminating the deferred tax liability or asset should be included in income from continuing operations.

VII. Recognition and Measurement of Purchase Business Combinations

A. Purchase Business Combinations

1. A deferred tax liability or asset should be recognized at the acquisition date for the income tax consequences of differences between the assigned values and tax bases of assets acquired and liabilities assumed in purchase business combination regardless of whether the transaction is taxable.
2. A deferred tax liability or asset is not recognized for a difference between the reported amount and the tax basis of goodwill or the portion thereof for which amortization is not deductible for tax purposes, unallocated "negative" goodwill, and leveraged leases.

B. Recognition and Measurement

1. Nontaxable Business Combinations

   a. The predecessor’s tax bases are carried forward.

   b. The amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes.

Illustration VII-1: Recognition and measurement of a deferred tax liability and asset in a nontaxable business combination.

The assumptions are as follows:

* The enacted tax rate is 40 percent for all future years, and amortization of goodwill is not deductible for tax purposes.

* An enterprise is acquired for $20,000, and the enterprise has no leveraged leases.

* The tax basis of the net assets acquired is $5,000, and the assigned value (other than goodwill) is $12,000. Future recovery of the assets and settlement of the liabilities at their assigned values will result in $20,000 of taxable amounts and $13,000 of deductible amounts that can be offset against each other. Therefore, no valuation allowance is necessary.

The amounts recorded to account for the purchase transaction are as follows:

- Assigned value of the net assets (other than goodwill) acquired $12,000
- Deferred tax liability for $20,000 of taxable temporary differences (8,000)
- Deferred tax asset for $13,000 of deductible temporary differences 5,200
- Goodwill 10,800
- Purchase price of the acquired enterprise 20,000

2. Taxable Business Combinations

   a. In a taxable business combination, unlike in a nontaxable business combination, the purchase price is assigned to the assets and liabilities assumed both for tax purposes and financial reporting purposes.

   b. The amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes.

   c. The example of recognition and measurement of a deferred tax liability and asset in a taxable business combination is as follows:
A portion of the amount of goodwill for financial reporting may be allocated to some other asset for tax purposes, and amortization of that other asset may be deductible for tax purposes. If a valuation allowance is recognized for that deferred tax asset at the acquisition date, recognized benefits for those tax deductions after the acquisition date should be applied (a) first to reduce to zero any goodwill related to that acquisition, (b) second to reduce to zero other noncurrent intangible assets related to that acquisition, and (c) third to reduce income tax expense.

C. Amortization of Goodwill

1. Amortization of goodwill is deductible for tax purposes in some tax jurisdictions.

2. The reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the combination date for purposes of deferred tax calculations as follows:

   a. The first component of each equals the lesser of (a) goodwill for financial reporting or (b) tax-deductible goodwill.

   b. The second component of each equals the remainder of each.

3. A deferred tax liability or asset is recognized for any temporary difference that arises between the book and tax basis of the first component of goodwill in future years.

4. No deferred taxes are recognized for the second component of goodwill.

5. If the second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is recognized when realized on the tax return, and that tax benefit is applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense.

Illustration VII-2: Accounting for the tax consequences of goodwill when amortization of goodwill is deductible for tax purposes.

The assumptions are as follows:

* At the combination date, the reported amount and tax basis of goodwill are $600 and $800, respectively.

* For tax purposes, amortization of goodwill will result in tax deductions of $400 in each of years 1 and 2. Those deductions result in a current tax benefit in years 1 and 2.

* For financial reporting, amortization of goodwill is straight-line over years 1-4.

* For purposes of simplification, the consequences of other temporary differences are ignored for years 1-4.

* Income before amortization of goodwill and income taxes in each of years 1-4 is $1,000.

* The tax rate is 40 percent for all years.
Income taxes payable for years 1-4 are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before amortization of goodwill</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(400)</td>
<td>(400)</td>
<td>0</td>
</tr>
<tr>
<td>Taxable income</td>
<td>600</td>
<td>600</td>
<td>1,000</td>
</tr>
<tr>
<td>Income taxes payable (40 percent)</td>
<td>240</td>
<td>240</td>
<td>400</td>
</tr>
</tbody>
</table>

At the combination date, goodwill is separated into two components as follows:

<table>
<thead>
<tr>
<th></th>
<th>Reported Amount</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>First component</td>
<td>$600</td>
<td>$600</td>
</tr>
<tr>
<td>Second component</td>
<td>0</td>
<td>200</td>
</tr>
<tr>
<td>Total goodwill</td>
<td>$600</td>
<td>$800</td>
</tr>
</tbody>
</table>

A deferred tax liability is recognized at the end of years 1-3 for the excess of the reported amount over the tax basis of the first component of goodwill. A deferred tax asset is not recognized for the second component of goodwill; the tax benefit is allocated to reduce goodwill when realized on the tax returns for years 1 and 2.

The second component of goodwill is deductible $100 per year in years 1 and 2. Those tax deductions provide $40 ($100 at 40 percent) of tax benefits that are realized in years 1 and 2. Allocation of those realized tax benefits to reduce the first component of goodwill produces a deferred tax benefit by reducing the taxable temporary difference related to that component of goodwill. Thus, the total tax benefit allocated to reduce the first component of goodwill in each of years 1 and 2 is the sum of (a) the $40 realized tax benefit allocated to reduce goodwill and (b) the deferred tax benefit from reducing the deferred tax liability related to goodwill. That total tax benefit (TTB) is determined as follows:

\[
TTB = \text{realized tax benefit plus (tax rate times TTB)}
\]
\[
TTB = $40 + (.40 \times TTB)
\]
\[
TTB = $67
\]

Goodwill for financial reporting for years 1-4 is:

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at beginning of year</td>
<td>$600</td>
<td>$383</td>
<td>$188</td>
</tr>
<tr>
<td>Amortization:</td>
<td>$600 / 4 years</td>
<td>$383 / 3 years</td>
<td>$188 / 2 years</td>
</tr>
<tr>
<td>Total tax benefit allocated to reduce goodwill</td>
<td>(67)</td>
<td>(67)</td>
<td>0</td>
</tr>
<tr>
<td>Balance at end of year</td>
<td>$383</td>
<td>$188</td>
<td>$94</td>
</tr>
</tbody>
</table>
The deferred tax liability for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 1-4 are:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported amount of goodwill at end of year</td>
<td>$383</td>
<td>$188</td>
<td>$94</td>
<td>$0</td>
</tr>
<tr>
<td>Tax basis of goodwill (first component)</td>
<td>(300)</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taxable temporary difference</td>
<td>83</td>
<td>188</td>
<td>94</td>
<td>0</td>
</tr>
<tr>
<td>Deferred tax liability: At end of year (40 percent)</td>
<td>$33</td>
<td>$75</td>
<td>$38</td>
<td>$0</td>
</tr>
<tr>
<td>At beginning of year</td>
<td>0</td>
<td>(33)</td>
<td>(75)</td>
<td>(38)</td>
</tr>
<tr>
<td>Deferred tax expense (benefit) for the year</td>
<td>33</td>
<td>42</td>
<td>(37)</td>
<td>(38)</td>
</tr>
</tbody>
</table>

Income for financial reporting for years 1-4 is:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before amortization of goodwill and income taxes</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(150)</td>
<td>(128)</td>
<td>(94)</td>
<td>(94)</td>
</tr>
<tr>
<td>Pretax income</td>
<td>850</td>
<td>872</td>
<td>906</td>
<td>906</td>
</tr>
<tr>
<td>Income tax expense (benefit): Current</td>
<td>240</td>
<td>240</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>Deferred</td>
<td>33</td>
<td>42</td>
<td>(37)</td>
<td>(38)</td>
</tr>
<tr>
<td>Benefit applied to reduce goodwill</td>
<td>67</td>
<td>67</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>340</td>
<td>349</td>
<td>363</td>
<td>362</td>
</tr>
<tr>
<td>Net income</td>
<td>$510</td>
<td>$523</td>
<td>$543</td>
<td>$544</td>
</tr>
</tbody>
</table>

D. NOL and Tax Credit Carryforwards at Acquisition

1. If a deferred tax asset is recognized in a purchase business combination, limitations under the tax law must be considered in determining the need for and amount of a valuation allowance.

2. If the tax law limits the use of the acquired enterprise's deductible temporary differences and carryforwards to subsequent taxable income of the acquired enterprise in a consolidated tax return for the combined enterprise, or if separate tax returns are expected to be filed in future years, the need for a valuation allowance for some portion or all of the acquired enterprise's deferred tax assets for deductible temporary differences and carryforwards is assessed based on the acquired enterprise's separate past and expected future results of operations.

3. If the tax law in some tax jurisdictions permits the future use of either of the combining enterprises' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination and a consolidated tax return is expected to be filed in future years, a deferred tax asset (net of a valuation allowance, if necessary) is recognized for deductible temporary differences or carryforwards of either combining enterprise based on an assessment of the combined enterprise's past and expected future results.
of operations as of the acquisition date. This either reduces goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creates or increases negative goodwill.

Illustration VII-3: Recognition of a deferred tax asset and the related valuation allowance for acquired deductible temporary differences at the date of a nontaxable business combination and in subsequent periods when the tax law limits the use of an acquired enterprise's deductible temporary differences and carryforwards to subsequent taxable income of the acquired enterprise in a consolidated tax return.

The assumptions are as follows:

* The enacted tax rate is 40 percent for all future years.
* The purchase price is $20,000, and the assigned value of the net assets acquired is also $20,000.
* The tax basis of the net assets acquired is $60,000. The $40,000 ($60,000 - $20,000) of deductible temporary differences at the combination date is primarily attributable to an allowance for loan losses. Provisions in the tax law limit the use of those future tax deductions to subsequent taxable income of the acquired enterprise.
* The acquired enterprise's actual pretax results for the two preceding years and the expected results for the year of the business combination are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Pretax Financial Income</th>
<th>Reversals of Acquired Deductible Temporary Differences</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$ (15,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 2</td>
<td>(10,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 3 to the combination date</td>
<td>(5,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected results for the remainder of year 3</td>
<td>(5,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Based on assessments of all evidence available at the date of the business combination in year 3 and at the end of year 3, management concludes that a valuation allowance is needed at both dates for the entire amount of the deferred tax asset related to the acquired deductible temporary differences.

The acquired enterprise's pretax financial income and taxable income for year 3 (after the business combination) and year 4 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Pretax Financial Income</th>
<th>Reversals of Acquired Deductible Temporary Differences</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 3</td>
<td>$15,000</td>
<td>(15,000)</td>
<td></td>
</tr>
<tr>
<td>Year 4</td>
<td>$10,000</td>
<td>(10,000)</td>
<td>$0</td>
</tr>
</tbody>
</table>

At the end of year 4, the remaining balance of acquired deductible temporary differences is $15,000 ($40,000 - $25,000). The deferred tax asset is $6,000 ($15,000 at 40 percent). Based on an assessment of all available evidence at the end of year 4, management concludes that no valuation allowance is needed for that $6,000 deductible tax asset. Elimination of the $6,000 valuation allowance results in a $6,000 deferred tax benefit that is reported as a reduction of deferred income tax expense because there is no goodwill or other noncurrent intangible assets related to the acquisition. For the same reason, tax benefits realized in years 3 and 4 attributable to reversals of acquired deductible temporary differences are reported as a zero current income tax expense. The consolidated statement of earnings would include the following amounts attributable to the acquired...
enterprise for year 3 (after the business combination) and year 4:

<table>
<thead>
<tr>
<th></th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income</td>
<td>$15,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Income tax (expense) benefit:</td>
<td>Current: 0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Deferred: 0</td>
<td>6,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$15,000</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

Illustration VII-4: Elimination of the need for a valuation allowance for the deferred tax asset for an acquired loss carryforward based on offset against taxable temporary differences of the acquiring enterprise in a nontaxable business combination when the tax law permits use of an acquired enterprise’s deductible temporary differences and carryforwards to reduce taxable income or taxes payable attributable to the acquiring enterprise in a consolidated tax return.

The assumptions are as follows:

* The enacted tax rate is 40 percent for all future years.

* The purchase price is $20,000. The tax basis of the identified net assets acquired is $5,000, and the assigned value is $12,000, that is, there are $7,000 of taxable temporary differences. The acquired enterprise also has a $16,000 operating loss carryforward, which, under the tax law, may be used by the acquiring enterprise in the consolidated tax return.

* The acquiring enterprise has temporary differences that will result in $30,000 of net taxable amounts in future years.

* All temporary differences of the acquired and acquiring enterprises will result in taxable amounts before the end of the acquired enterprise’s loss carryforward period.

In assessing the need for a valuation allowance, future taxable income exclusive of reversing temporary differences and carryforwards need not be considered because the $16,000 operating loss carryforward will offset (a) the acquired enterprise’s $7,000 of taxable temporary differences and (b) another $9,000 of the acquiring enterprise’s taxable temporary differences. The amounts recorded to account for the purchase transaction are as follows:

- Assigned value of the identified net assets acquired $12,000
- Deferred tax liability recognized for the acquired company’s taxable temporary differences ($7,000 at 40 percent) $2,800
- Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquired company’s taxable temporary differences ($7,000 at 40 percent) 2,800
- Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquiring company’s taxable temporary differences ($9,000 at 40 percent) 3,600
- Goodwill 4,400
- Purchase price of the acquired enterprise $20,000
E. NOL and Tax Credit Carryforwards after Acquisition

1. If a valuation allowance is recognized for an acquired enterprise's deferred tax asset for deductible temporary differences and NOL or tax credit carryforwards at the acquisition date, tax benefits for those items recognized in financial statements for a subsequent year(s) are:
   a. First applied to reduce to zero any goodwill related to the acquisition;
   b. Then applied to reduce to zero other noncurrent intangible assets related to the acquisition;
   c. And then applied to reduce income tax expense.

2. Additional amounts of deductible temporary differences and operating loss or tax credit carryforwards may arise after the acquisition date and before recognition of the tax benefit of amounts existing at the acquisition date. Tax benefits are recognized in later years as follows:
   a. The tax benefit of amounts existing at the acquisition date is first applied to reduce goodwill and other noncurrent intangible assets to zero. Any additional tax benefit reduces income tax expense.
   b. The tax benefit of amounts arising after the acquisition date is recognized as a reduction of income tax expense.

3. Whether a tax benefit recognized in later years is attributable to an amount (for example, an operating loss carryforward) existing at or arising after the acquisition date is determined for financial reporting by provisions in the tax law that identify the sequence in which those amounts are utilized for tax purposes. If not determinable by provisions in the tax law, a tax benefit recognized for financial reporting is prorated between a reduction of (a) goodwill and other noncurrent intangible assets and (b) income tax expense.

Illustration VII-5: Recognition of tax benefits subsequent to a business combination.

The assumptions are as follows:

* A nontaxable business combination occurs on the first day of year 1. Before considering any acquired deferred tax assets, the purchase transaction is summarized as follows:

<table>
<thead>
<tr>
<th>Assigned Value</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets acquired</td>
<td>$5,000</td>
</tr>
<tr>
<td>Excess of purchase price over the fair value of the net assets acquired **</td>
<td>1,500</td>
</tr>
<tr>
<td>Purchase price</td>
<td>6,500</td>
</tr>
</tbody>
</table>

** There are no other noncurrent intangible assets.

* The only difference between pretax financial income and taxable income (amortization of goodwill is disregarded for this example) for years 1-3 is a $1,000 loss for tax purposes in
year 1 from disposal of the acquired identified net assets at amounts equal to their $5,000 assigned value on the acquisition date.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income (loss)</td>
<td>$(3,000)</td>
<td>$2,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Disposal of acquired identified net assets</td>
<td>$(1,000)</td>
<td>_____</td>
<td>_____</td>
</tr>
<tr>
<td>Taxable income (loss) before loss carryforward</td>
<td>$(4,000)</td>
<td>2,500</td>
<td>1,500</td>
</tr>
<tr>
<td>Loss carryforward (loss carryback not permitted)</td>
<td>4,000</td>
<td>(2,500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Taxable income after loss carryforward</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

* The tax rate is 40 percent for all years.

* Based on an assessment of all available evidence, management reaches the following conclusions at the acquisition date and at the end of years 1 and 2:

a. At the acquisition date, the portion of the $1,000 of deductible temporary differences ($6,000 - $5,000) for which it is more likely than not that a tax benefit will not be realized is $500.

b. At the end of year 1, the portion of the $4,000 loss carryforward for which it is more likely than not that a tax benefit will not be realized is $1,750.

c. At the end of year 2, it is more likely than not that a tax benefit will be realized for all of the remaining $1,500 of loss carryforward.

At the acquisition date, a $400 ($1,000 at 40 percent) deferred tax asset and a $200 ($500 at 40 percent) valuation allowance are recognized. The $200 net tax benefit reduces the excess of purchase price over the fair value of the net assets acquired from $1,500 to $1,300. Thus, the amount of goodwill recognized at the acquisition date is $1,300.

During year 1, the $1,000 of net deductible temporary differences at the acquisition date reverse and are part of the $4,000 loss carryforward for tax purposes at the end of year 1. An analysis of the components of that $4,000 loss carryforward follows:

<table>
<thead>
<tr>
<th></th>
<th>Acquired Deductions</th>
<th>Loss in Year 1</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax loss carryforward</td>
<td>$1,000</td>
<td>$3,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Portion for which a tax benefit was recognized at the acquisition date</td>
<td>(500)</td>
<td>0</td>
<td>(500)</td>
</tr>
<tr>
<td>Remainder available for recognition of a tax benefit at the end of year 1</td>
<td>$500</td>
<td>$3,000</td>
<td>$3,500</td>
</tr>
</tbody>
</table>

Provisions in the tax law do not distinguish between those two components of the $3,500, and the component that is used first for tax purposes is indeterminable. However, the $500 of acquired deductions for which a tax benefit has not been recognized is one-seventh of the $3,500 total, and the $3,000 loss in year 1 is six-sevenths of the $3,500 total. The tax benefit of that $3,500 is prorated one-seventh to reduce goodwill and six-sevenths to reduce income tax expense when recognized in years 1 and 2.

At the end of year 1, a $1,600 ($4,000 at 40 percent) deferred tax asset and a $700 ($1,750 at 40 percent) valuation allowance are recognized. The tax benefit for the $700 increase in the net
deferred tax asset (from $200 at the acquisition date to $900 at the end of year 1) is prorated as follows:

* One-seventh or $100 to reduce goodwill, and six-sevenths or $600 to reduce tax expense.

During year 2, $1,000 ($2,500 at 40 percent) of the deferred tax asset recognized at the end of year 1 is realized. In addition, a tax benefit is recognized for the remaining $1,750 of future tax deductions by eliminating the $700 valuation allowance. That tax benefit is prorated $100 to reduce goodwill and $600 to reduce tax expense. The combined effect of the changes in the deferred tax asset and the related valuation allowance during year 2 is illustrated below:

<table>
<thead>
<tr>
<th>Deferred Tax Asset</th>
<th>Tax Expense or (Benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$1,600</td>
</tr>
<tr>
<td>Valuation allowance</td>
<td>(700)</td>
</tr>
<tr>
<td></td>
<td>900</td>
</tr>
<tr>
<td>Portion of $700 tax benefit allocated to reduce goodwill</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense for year 2</td>
<td></td>
</tr>
</tbody>
</table>

The $600 deferred tax asset at the end of year 2 is realized in year 3, resulting in $600 of deferred tax expense for year 3. The consolidated statement of earnings would include the following amounts attributable to the acquired enterprise:

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income (loss)</td>
<td>$(3,000)</td>
<td>$2,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Net deferred tax (expense) benefit</td>
<td>600</td>
<td>(400)</td>
<td>(600)</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$(2,400)</td>
<td>2,100</td>
<td>900</td>
</tr>
</tbody>
</table>

VIII. Recognition and Measurement of Pooling-of-Interests Business Combination

A. Restatement of Separate Financial Statements

1. The separate financial statements of combining enterprises for prior periods are restated on a combined basis when a business combination is accounted for by the pooling-of-interests method.

2. For restatement of periods prior to the combination date, a combining enterprise’s NOL carryforward does not offset the other enterprise’s taxable income because consolidated tax returns cannot be filed for those periods.

3. However, provisions in the tax law may permit an NOL carryforward of either of the combining enterprises to offset combined taxable income subsequent to the combination date.

B. Filing of Consolidated Tax Returns

1. If the combined enterprise expects to file consolidated tax returns, a deferred tax asset is recognized for either combining enterprise’s NOL carryforward in a prior period.
2. Valuation Allowance
   
a. A valuation allowance is necessary to the extent it is more likely than not that a tax benefit will not be realized for that loss carryforward through offset of either (a) the other enterprise's deferred tax liability for taxable temporary differences that will reverse subsequent to the combination date or (b) combined taxable income subsequent to the combination date.

b. The valuation allowance may be less than the sum of the valuation allowances in the separate financial statements of the combining enterprises prior to the combination date. That tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods.

3. The same requirements apply to deductible temporary differences and tax credit carryforwards.

C. Taxable Business Combinations
   
1. A taxable business combination may sometimes be accounted for by the pooling-of-interests method.

2. The increase in the tax basis of the net assets acquired results in temporary differences. The deferred tax consequences of those temporary differences are recognized and measured the same as for other temporary differences.

3. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital.

4. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date (that is, by elimination of a valuation allowance) are reported as a reduction of income tax expense.

IX. Intraperiod Tax Allocation

FASB Statement No. 109 requires allocation of tax expense or benefit for a year among continuing operations, discontinued operations, extraordinary items, and shareholders' equity.

A. Continuing Operations

The tax effects of the following should be allocated to continuing operations:

1. Pretax income or loss from continuing operations for the year.

2. Changes in circumstances that cause a change in judgement about the realization of deferred tax assets in future years.

3. Changes in tax laws or rates.


5. Tax-deductible dividends paid to shareholders, except for dividends paid on unallocated shares held by an ESOP or other stock compensation arrangements.
B. Shareholders' Equity

The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders' equity:

1. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error.

2. Gains and losses included in comprehensive income but excluded from net income (e.g., translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities).

3. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock).

4. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination.

5. Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, Accounting for Stock Issued to Employees).

6. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings.

7. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization.

C. Method of Allocation

1. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item.

2. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations should be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year.

3. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations.

4. The procedures to allocate the remaining amount to items other than continuing operations are as follows:
   a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items;
   b. Apportion the tax benefit determined in a. above ratably to each net loss item;
c. Determine the amount that remains, that is, the difference between (a) the amount to be allocated to all items other than continuing operations and (b) the amount allocated to all net loss items;

d. Apportion the tax expense determined in c. above ratably to each net gain item.

Illustration IX-1: Allocation of income tax expense if there is only one item other than income from continuing operations.

The assumptions are as follows:

* The enterprise’s pretax financial income and taxable income are the same.
* The enterprise’s ordinary loss from continuing operations is $ 500.
* The enterprise also has an extraordinary gain of $ 900 that is a capital gain for tax purposes.
* The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $ 120 ($ 400 at 30 percent).

Income tax expense is allocated between the pretax loss from operations and the extraordinary gain as follows:

<table>
<thead>
<tr>
<th>Total income tax expense</th>
<th>$ 120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax benefit allocated to the loss from operations</td>
<td>150</td>
</tr>
<tr>
<td>Incremental tax expense allocated to the extraordinary gain</td>
<td>$ 270</td>
</tr>
</tbody>
</table>

The effect of the $ 500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, $ 150 ($ 500 at 30 percent) of tax benefit is allocated to continuing operations. The $ 270 incremental effect of the extraordinary gain is the difference between $ 120 of total tax expense and the $ 150 tax benefit from continuing operations.

Illustration IX-2: Allocation of the tax benefit of a tax credit carryforward that is recognized as a deferred tax asset in the current year.

The assumptions are as follows:

* The enterprise’s pretax financial income and taxable income are the same.
* Pretax financial income for the year comprises $ 300 from continuing operations and $ 400 from an extraordinary gain.
* The tax rate is 40 percent. Taxes payable for the year are zero because $ 330 of tax credits that arose in the current year more than offset the $ 280 of tax otherwise payable on $ 700 of taxable income.
* A $ 50 deferred tax asset is recognized for the $ 50 ($ 330 - $ 280) tax credit carryforward. Based on the weight of available evidence, management concludes that no valuation allowance is necessary.

Income tax expense or benefit is allocated between pretax income from continuing operations and the extraordinary gain as follows:
Total income tax benefit $ 50

Tax (expense) benefit allocated to income from continuing operations:

Tax (before tax credits) on $300 of taxable income at 40 percent $(120)
Tax credits 330 210

Tax expense allocated to the extraordinary gain $ 160

Absent the extraordinary gain and assuming it was not the deciding factor in reaching a conclusion that a valuation allowance is not needed, the entire tax benefit of the $330 of tax credits would be allocated to continuing operations. The presence of the extraordinary gain does not change that allocation.

Illustration IX-3: Allocation of income taxes for translation adjustments under Statement 52 directly to shareholders’ equity.

* A foreign subsidiary has earnings of FC600 for year 2. Its net assets (and unremitted earnings) are FC1,000 and FC1,600 at the end of years 1 and 2, respectively.

* The foreign currency is the functional currency. For year 2, translated amounts are as follows:

<table>
<thead>
<tr>
<th>Foreign Currency</th>
<th>Exchange Rate</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unremitted earnings, beginning of year</td>
<td>FC1 = $1.20</td>
<td>1,200</td>
</tr>
<tr>
<td>Earnings for the year</td>
<td>FC1 = $1.10</td>
<td>660</td>
</tr>
<tr>
<td>Unremitted earnings, end of year</td>
<td>FC1 = $1.00</td>
<td>1,600</td>
</tr>
</tbody>
</table>

* A $260 translation adjustment ($1,200 + $660 - $1,600) is charged to the cumulative translation adjustment account in shareholders’ equity for year 2.

* The U.S. parent expects that all of the foreign subsidiary’s unremitted earnings will be remitted in the foreseeable future, and under APB Opinion No. 23, a deferred U.S. tax liability is recognized for those unremitted earnings.

* The U.S. parent accrues the deferred tax liability at a 20 percent tax rate (that is, net of foreign tax credits, foreign tax credit carryforwards, and so forth). An analysis of the net investment in the foreign subsidiary and the related deferred tax liability for year 2 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Net Investment</th>
<th>Deferred Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, beginning of year</td>
<td>$1,200</td>
<td>$240</td>
</tr>
<tr>
<td>Earnings and related taxes</td>
<td>660</td>
<td>132</td>
</tr>
<tr>
<td>Translation adjustment and related taxes</td>
<td>(260)</td>
<td>(52)</td>
</tr>
<tr>
<td>Balances, end of year</td>
<td>$1,600</td>
<td>$320</td>
</tr>
</tbody>
</table>

* For year 2, $132 of deferred taxes are charged against earnings, and $52 of deferred taxes are credited directly to the cumulative translation adjustment account in shareholders’ equity.
D. Carryforwards and Carrybacks

A net operating loss, certain deductible items that are subject to limitations, and some tax credits arising but not utilized in the current year may be carried back for refund of taxes paid in prior years or carried forward to reduce taxes payable in future years.

1. Recognition of Tax Benefit for Carrybacks

A receivable is recognized for the amount of taxes paid in prior years that is refundable by carryback of an NOL or unused tax credits of the current year.

2. Recognition of a Tax Benefit for Carryforwards

a. A deferred tax asset is recognized for an NOL or tax credit carryforward.

b. In assessing the need for a valuation allowance, provisions in the tax law that limit utilization of an NOL or tax credit carryforward are applied in determining whether it is more likely than not that some portion or all of the deferred tax asset will not be realized by reduction of taxes payable on taxable income during the carryforward period.

Illustration IX-4: Recognition of the tax benefit of an operating loss when a valuation allowance is necessary in the loss year.

The assumptions are as follows:

(a) The enacted tax rate is 40 percent for all years.

(b) An operating loss occurs in year 5.

(c) The only difference between financial and taxable income results from use of accelerated depreciation for tax purposes. Differences that arise between the reported amount and the tax basis of depreciable assets in years 1-7 will result in taxable amounts before the end of the loss carryforward period from year 5.

(d) Financial income, taxable income, and taxes currently payable or refundable are as follows:

\[
\begin{array}{cccccc}
\text{Year} & \text{Year 1} & \text{Years 2-4} & \text{Year 5} & \text{Year 6} & \text{Year 7} \\
\text{Pretax financial income (loss)} & $2,000 & $5,000 & ($8,000) & $2,200 & $7,000 \\
\text{Depreciation differences} & (800) & (2,200) & (800) & (700) & (600) \\
\text{Loss carryback} & 0 & 0 & 2,800 & 0 & 0 \\
\text{Loss carryforward} & 0 & 0 & 0 & (6,000) & (4,500) \\
\text{Taxable income (loss)} & 1,200 & 2,800 & (6,000) & (4,500) & 1,900 \\
\text{Taxes payable (refundable)} & $480 & $1,120 & ($1,120) & $0 & $760 \\
\end{array}
\]

(e) At the end of year 5, profits are not expected in years 6 and 7 and later years, and it is concluded that a valuation allowance is necessary to the extent realization of the deferred tax asset for the operating loss carryforward depends on taxable income (exclusive of reversing temporary differences) in future years.
The deferred tax liability for the taxable temporary differences is calculated at the end of each year as follows:

Unreversed differences:

<table>
<thead>
<tr>
<th>Year</th>
<th>Years 2-4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning amount</td>
<td>$0</td>
<td>$800</td>
<td>$3,000</td>
<td>$3,800</td>
</tr>
<tr>
<td>Additional amount</td>
<td>800</td>
<td>2,200</td>
<td>800</td>
<td>700</td>
</tr>
<tr>
<td>Total</td>
<td>$800</td>
<td>3,000</td>
<td>$3,800</td>
<td>$4,500</td>
</tr>
</tbody>
</table>

Deferred tax liability (40 percent) | $320 | $1,200 | $1,520 | $1,800 | $2,040 |

The deferred tax asset and related valuation allowance for the loss carryforward are calculated at the end of each year as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Years 2-4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss carryforward for tax purposes</td>
<td>$0</td>
<td>$0</td>
<td>$6,000</td>
<td>$4,500</td>
</tr>
<tr>
<td>Deferred tax asset (40 percent)</td>
<td>$0</td>
<td>$0</td>
<td>$2,400</td>
<td>$1,800</td>
</tr>
<tr>
<td>Valuation allowance equal to the amount by which the deferred tax asset exceeds the deferred tax liability</td>
<td>0</td>
<td>0</td>
<td>(880)</td>
<td>0</td>
</tr>
<tr>
<td>Net deferred tax asset</td>
<td>$0</td>
<td>$0</td>
<td>$1,520</td>
<td>$1,800</td>
</tr>
</tbody>
</table>

Total tax expense for each period is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Years 2-4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in deferred tax liability (Increase) decrease in net deferred tax asset</td>
<td>$320</td>
<td>$880</td>
<td>$320</td>
<td>$280</td>
</tr>
<tr>
<td>Currently payable (refundable)</td>
<td>0</td>
<td>0</td>
<td>(1,520)</td>
<td>(280)</td>
</tr>
<tr>
<td>Total tax expense (benefit)</td>
<td>$320</td>
<td>$880</td>
<td>(1,200)</td>
<td>0</td>
</tr>
</tbody>
</table>

In year 5, $2,800 of the loss is carried back to reduce taxable income in years 2-4, and $1,120 of taxes paid for those years is refunded. In addition, a $1,520 deferred tax liability is recognized for $3,800 of taxable temporary differences, and a $2,400 deferred tax asset is recognized for the $6,000 loss carryforward. However, based on the conclusion described in assumption (e), a valuation allowance is recognized for the amount by which that deferred tax asset exceeds the deferred tax liability.

In year 6, a portion of the deferred tax asset for the loss carryforward is realized because taxable income is earned in that year. The remaining balance of the deferred tax asset for the loss carryforward at the end of year 6 equals the deferred tax liability for the taxable temporary differences. A valuation allowance is not needed.

In year 7, the remaining balance of the loss carryforward is realized, and $760 of taxes are payable on net taxable income of $1,900. A $2,040 deferred tax liability is recognized for the $5,100 of taxable temporary differences.
E. Reporting the Tax Benefit of NOL Carryforwards or Carrybacks

1. The manner of reporting the tax benefit of an operating loss carryforward or carryback is determined by:
   a. The source of the income, or
   b. Loss in the current year.

2. The manner of reporting the tax benefit of an operating loss carryforward or carryback is not determined by:
   a. The source of the operating loss carryforward or taxes paid in a prior year, or
   b. The source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year.

3. Deferred tax expense or benefit that results because a change in circumstances causes a change in judgment about the future realization of the tax benefit of an operating loss carryforward is allocated to continuing operations.

Examples:

   a. The tax benefit of an NOL carryforward that resulted from an extraordinary loss in a prior year and that is first recognized in the financial statements for the current year:
      (1) Is allocated to continuing operations if it offsets the current or deferred tax consequences of income from continuing operations;
      (2) Is allocated to an extraordinary gain if it offsets the current or deferred tax consequences of that extraordinary gain;
      (3) Is allocated to continuing operations if it results from a change in circumstances that causes a change in judgment about future realization of a tax benefit.

   b. The current or deferred tax benefit of a loss from continuing operations in the current year is allocated to continuing operations regardless of whether that loss offsets the current or deferred tax consequences of an extraordinary gain that:
      (1) Occurred in the current year;
      (2) Occurred in a prior year (that is, if realization of the tax benefit will be by carryback refund);
      (3) Is expected to occur in a future year.

X. Other Matters

A. Regulated Enterprises

1. Regulated enterprises that meet the criteria for application of FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation, are not exempt from the
requirements of FASB Statement No. 109. The criteria for application of FASB Statement No. 71 are as follows:

a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

2. Net-of-tax accounting and reporting are prohibited.

3. Recognition of a deferred tax liability is required (a) for tax benefits that are flowed through to customers when temporary differences originate and (b) for the equity component of the allowance for funds used during construction.

4. Adjustment of a deferred tax liability or asset is required for an enacted change in tax laws or rates.

Illustration X-1: Recognition of an asset for the probable future revenue to recover future income taxes related to the deferred tax liability for the equity component of the allowance for funds used during construction (AFUDC).

The assumptions are as follows:

* During year 1, the first year of operations, total construction costs for financial reporting and tax purposes are $400,000 (exclusive of AFUDC).

* The enacted tax rate is 34 percent for all future years.

* AFUDC (consisting entirely of the equity component) is $26,000. The asset for probable future revenue to recover the related income taxes is calculated as follows:

34 percent of ($26,000 + A) = A (where A equals the asset for probable future revenue)

A = $13,394

At the end of year 1, the related accounts are as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction in progress</td>
<td>$426,000</td>
</tr>
<tr>
<td>Probable future revenue</td>
<td>$13,394</td>
</tr>
<tr>
<td>Deferred tax liability [34 percent of ($26,000 + $13,394)]</td>
<td>$13,394</td>
</tr>
</tbody>
</table>

** In this example, if AFUDC had consisted entirely of a net-of-tax debt component in the amount of $26,000, the related accounts and their balances at the end of year 1 would be construction in progress in the amount of $439,394 and a deferred tax liability in the amount of $13,394.

B. APB Opinion No. 23 and U.S. Steamship Enterprise Exceptions

1. Nonrecognition of A Deferred Tax Liability

A deferred tax liability is not recognized for the following types of temporary
differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, that is essentially permanent in duration;

b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992;

c. "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount);

d. "Policyholders' surplus" of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

The indefinite reversal criterion in APB Opinion No. 23 must not be applied to analogous types of temporary differences.

2. Recognition of A Deferred Tax Liability

A deferred tax liability must be recognized for the following types of taxable temporary differences:

a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992;

b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in X.B.1.a. and X.B.1.b. above for a corporate joint venture that is essentially permanent in duration;

c. "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

3. Recognition of Tax Effects of Temporary Differences

The tax effects of temporary differences that (a) are related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992, and (b) were not previously recognized should be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which FASB Statement No. 109 is first applied.

4. Situations Where a Taxable Temporary Difference May Not Be Addressed

a. Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed.
b. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example:

(1) An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary’s net assets rather than by reference to the parent company’s tax basis for the stock of that subsidiary.

(2) An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary’s stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

5. Recognition of Deferred Tax Assets for an Excess of the Tax Basis over the Financial Reporting Amount

a. A deferred tax asset should be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future.

b. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to APB Opinion No. 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association’s bad-debt reserve for financial reporting) should be assessed.

c. Sources of taxable income to be considered in determining the need for and amount of a valuation allowance:

(1) Future reversals of temporary differences;

(2) Future taxable income exclusive of reversing temporary differences and carryforwards. (Exception: Future distributions of future earnings of a subsidiary or corporate joint venture should not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.)

C. Separate Financial Statements of a Subsidiary

1. FASB Statement No. 109 requires that members of a group filing a consolidated tax return allocate the consolidated amount of deferred tax expense when issuing separate financial statements.

2. The method should be systematic, rational, and consistent with the broad principles established by FASB Statement No. 109 (e.g., a method that allocates current and deferred taxes to members of the group by applying FASB Statement No. 109 to each member as if it were a separate taxpayer meets those criteria).

3. Methods that are not consistent with the broad principles established by FASB Statement No. 109 include:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences;
b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method discussed in FASB Statement No. 109;

c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

D. Certain Quasi Reorganizations

1. The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization should be reported as a direct addition to contributed capital if the tax benefits are subsequently recognized.

2. The following exception exists for entities that adopted FASB Statement No. 96 and effected a quasi reorganization involving only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting FASB Statement No. 109:

   a. Subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported and then reclassified from retained earnings to contributed capital.

   b. Disclosure requirements are:

      (1) The date of the quasi reorganization;

      (2) The manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises;

      (3) The effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

E. Financial Statement Presentation

1. In a classified statement of financial position, an enterprise should separate deferred tax liabilities and assets into a current amount and a noncurrent amount.

2. Deferred tax liabilities and assets should be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting.

3. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to carryforwards, should be classified according to the expected reversal date of the temporary difference.

4. The valuation allowance for a particular tax jurisdiction should be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

5. Presentation of a particular tax-paying component within a particular tax jurisdiction

   a. All current deferred tax liabilities and assets should be offset and presented as a single amount.
b. All noncurrent deferred tax liabilities and assets should be offset and presented as a single amount.

6. An enterprise should not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

XI. Financial Statement Disclosure

A. Balance Sheet

1. The components of the net deferred tax liability or asset recognized in an enterprise's statement of financial position should be disclosed as follows:
   a. Total deferred tax liabilities;
   b. Total deferred tax assets;
   c. Total valuation allowance;
   d. The net change in the total valuation allowance during the year;
   e. For a public enterprise, the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances);
   f. For a nonpublic enterprise, the types of significant temporary differences and carryforwards but not the tax effects of each type;
   g. For a public enterprise that is not subject to income taxes because its income is taxed directly to its owners, fact and the net difference between the tax bases and the reported amounts of the enterprise’s assets and liabilities.

2. Entities not recognizing deferred tax liabilities based on permitted exceptions from comprehensive recognition of deferred taxes should disclose the following:
   a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable;
   b. The cumulative amount of each type of temporary difference;
   c. The amount of the unrecognized deferred tax liability for investments in foreign subsidiaries or a statement that its determination is impracticable;
   d. The amount of the deferred tax liability for other temporary differences that arose prior to the period for which application of FASB Statement No. 109 is first required for each of those particular differences.

B. Income Statement

1. The significant components of income tax expense attributable to continuing operations for each year presented should be disclosed in the financial statements or notes thereto.
2. Those components would include, for example:
   a. Current tax expense or benefit;
   b. Deferred tax expense or benefit (exclusive of the effects of other components listed below);
   c. Investment tax credits;
   d. Government grants (to the extent recognized as a reduction of income tax expense);
   e. The benefits of operating loss carryforwards;
   f. Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity;
   g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise;
   h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

C. Other Disclosures

1. Income Tax Expense or Benefit

The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items, such as discontinued operations or extraordinary items, should be disclosed for each year for which those items are presented.

2. Reconciling Items

a. A public enterprise should disclose a reconciliation using percentages or dollar amounts of

   (1) The reported amount of income tax expense attributable to continuing operations for the year;

   (2) The amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations (the "statutory" tax rates should be the regular tax rates if there are alternative tax systems);

   (3) The estimated amount and the nature of each significant reconciling item.

b. A nonpublic enterprise should disclose the nature of significant reconciling items but may omit a numerical reconciliation.

3. NOL and Tax Credit Carryforwards

An enterprise should disclose
a. The amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes, and

b. Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital.

D. Separate Financial Statements of a Subsidiary

An entity that is a member of a group that files a consolidated tax return should disclose in its separately issued financial statements:

1. 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;

2. 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 disclosures in 1. above are presented.

E. Quasi Reorganizations

Entities that have undergone quasi-reorganizations covered under FASB Statement No. 109 should disclose the following:

1. The date of the quasi reorganization;

2. The manner of reporting the tax benefits and that it differs from present accounting requirements for other entities;

3. The effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and related per share amount).

XII. Effective Date and Transition

A. General Requirements

1. FASB Statement No. 109 should be effective for fiscal years beginning after December 15, 1992. However, earlier application is encouraged.

2. Retroactive Application

a. Financial statements for any number of consecutive fiscal years before the effective date may be restated to conform to the provisions of FASB Statement No. 109.

b. Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period should be based on the facts and circumstances as they existed at that prior date without the benefit of hindsight.
3. Prospective Application
   a. Initial application should be as of the beginning of an enterprise’s fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year should be restated).
   b. Entities applying FASB Statement No. 109 prospectively are required to report the effect of initial application as a cumulative effect of a change in accounting principle.

   Exception: Initially recognized tax effects of following items are required by FASB Statement No. 109 to be excluded from net income.

   (1) Certain tax benefits recognized subsequent to a business combination;

   (2) Tax effects of changes in contributed capital;

   (3) An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests if the acquired tax benefit would have been recognized at the date of the combination if FASB Statement No. 109 were applied in that year;

   (4) Deductible temporary differences and carryforwards that existed at the date of quasi reorganization.

   c. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings and, if necessary, any other components of shareholders’ equity for the earliest year presented should be adjusted for the effect of the restatement as of that date.

   d. Pro forma effects of retroactive application are not required if statements of earnings presented for prior years are not restated.

4. Financial Statement Disclosure Requirements in the Year of Adoption of FASB Statement No. 109
   a. If FASB Statement No. 109 is applied retroactively to a year that is prior to the earliest year presented, the beginning balance of retained earnings and, if necessary, any other components of stockholders’ equity for the earliest year presented must be adjusted for the cumulative effect at that date. For all subsequent years restated, the enterprise must disclose the nature of the restatement and the effect on income from continuing operations, income before extraordinary items, net income, and related per share amounts.

   b. If FASB Statement No. 109 is applied retroactively to the earliest year or any subsequent year presented, the cumulative effect adjustment is included in determining net income of the year of earliest application. In addition, as above, for all years restated the enterprise must disclose the effects of the restatement on pretax income from continuing operations, income before extraordinary items, net income, and related per share amounts. Pro forma effects of retroactive application are not required if statements of earnings for prior years presented are not restated.
c. If FASB Statement No. 109 is not applied retroactively, the enterprise must disclose the effects of adopting the Statement on pretax income from continuing operations (i.e., the effect of gross-ups for prior business combinations and for regulated enterprises) for the year of adoption, income before extraordinary items, net income, and per share amounts for that year. Pro forma disclosures for prior years presented are not required.

B. Prior Business Combinations

There are specific transition provisions in FASB Statement No. 109 for business combinations consummated before adoption of the Statement.

1. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years should be remeasured in accordance with FASB Statement No. 109.

   a. At the end of initial application (regardless of whether the change in accounting is effected prospectively or by retroactive restatement), the remaining balances of assets and liabilities acquired in prior business combinations must be adjusted from their net-of-tax amounts to their pretax amounts and any differences between those adjusted remaining balances and their tax bases are temporary differences.

   b. The net effect of these adjustments is included in the cumulative adjustment for the effect of applying the Statement.

   c. Any adjustment to goodwill or negative goodwill should not be adjusted.

2. If adoption is effected by retroactive restatement and the earliest year restated is not presented, the net effect of these adjustments is recognized as an adjustment to the beginning balance of retained earnings for the earliest year presented.

3. If it is impracticable to determine the necessary adjustments, because the information is no longer available or because the cost to develop the information is excessive, the differences between the unadjusted carrying amounts of the assets and liabilities and their respective tax bases are accounted for as temporary differences.
APPENDIX 1

Summary of Issues Arising in Connection
with the Transaction From
APB Opinion No. 11
To
FASB Statement No. 109

I. Practices Under APB Opinion No. 11 That Are Unchanged by FASB Statement No. 109

The following are several aspects of present practice under APB Opinion No. 11 which remain the same or are modified only slightly by the Statement.

A. Deferred tax liabilities

In general, enterprises must recognize a deferred tax liability for the tax consequences of future taxable amounts.

Example: A deferred tax liability must be established as a result of accelerated tax depreciation in excess of financial reporting depreciation, irrespective of whether the enterprise expects to incur future tax losses that will offset the reversing future tax amounts from those differences in future periods.

B. Discounting

Discounting deferred tax assets and liabilities to amounts representing the present value of future receipts or payments is prohibited.

C. Comprehensive income

1. The tax consequences of items recorded directly in stockholders' equity (i.e., foreign currency translation adjustments, valuation allowances on noncurrent securities portfolios, and minimum pension liabilities) are also recorded in equity.

2. However, enterprises must record in income from continuing operations the effects of changes in tax laws or rates (See II.C.1.b. below).

3. This rule applies to all deferred tax assets and liabilities regardless of whether they relate to items recorded in stockholders' equity.

D. Interim tax provisions

The annual effective rate used to measure the tax on income or losses in interim periods of a fiscal year is based on an estimate of the rate expected to be applicable for the full fiscal year.

E. Balance sheet classification

1. Deferred assets and liabilities are classified as current and noncurrent based on the classification of the related asset or liability for financial reporting.

2. If an item is not directly related to an asset or liability (i.e., an NOL carryforward), classification is based on the expected reversal or utilization period.
II. Practices Under APB Opinion No. 11 That Are Changed by FASB Statement No. 109

Under FASB Statement No. 109, the tax consequences of temporary differences and operating loss and tax credit carryforwards represent either tax liabilities to be settled in the future or tax assets that will be realized as a reduction of future taxes. Thus, deferred tax assets and liabilities represent the future tax consequences of temporary differences and carryforwards measured at the balance sheet date, and the deferred portion of the tax provision or benefit is the result of changes in the net deferred tax asset or liability for the period.

The recognition and measurement of deferred tax assets and liabilities under FASB Statement No. 109 is significantly different from the recognition and measurement under APB Opinion No. 11. Some of the important changes are as follows:

A. Temporary differences

1. "Timing differences" under APB Opinion No. 11

   Interperiod tax allocation was required for the tax consequences of differences between the periods in which transactions affect taxable income and the periods in which those transactions enter into pretax accounting income. These differences were referred to as "timing differences."

2. "Temporary differences" under FASB Statement No. 109

   Tax allocation required on "temporary differences" includes all timing differences addressed under APB Opinion No. 11 along with most other transactions and events that result in differences between the reported amount of assets and liabilities and their tax bases.

B. Deferred tax assets

1. Under FASB Statement No. 109:

   Enterprises must recognize a deferred tax asset, reduced by a valuation allowance, if necessary, for deductible temporary differences and operating loss and tax credit carryforwards.

2. Under APB Opinion No. 11:

   a. Recognition of tax benefits for tax credit carryforwards was precluded.

   b. Recognition of tax benefits was restricted for operating loss carryforwards to amounts whose realization in future tax returns was assured beyond a reasonable doubt.

C. Tax law changes

1. Under FASB Statement No. 109:

   a. The deferred tax consequences of changes in tax laws or rates must be computed on the amounts of temporary differences and carryforwards existing at the date a new law is enacted.

   b. Recording the effects of the change involves adjusting deferred tax expense or benefit from continuing operations.
2. Under APB Opinion No. 11:

Deferred tax credits and charges established in the balance sheet were not remeasured to consider the effects of enacted tax law changes.

D. Measurement

1. Under FASB Statement No. 109:

Measurement of deferred tax assets and liabilities is based on the applicable tax rate. The objective is to measure a deferred tax liability or asset using the enacted tax rates expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

2. Under APB Opinion No. 11:

Deferred tax consequences were measured at the rate in effect during the period in which timing differences originated.

F. Tax status changes

1. Under FASB Statement No. 109:

The tax consequences attributable to a change either from a taxable to nontaxable status or from nontaxable to taxable status are recorded as a credit or charge to income tax expense from continuing operations at the date the change in tax status occurs.

2. Under APB Opinion No. 11:

The practice followed for recording tax status changes was mixed, with some enterprises recording the change in income, others recording it in equity, and others restating all years presented to apply the effects of the changed status retroactively, as if the enterprise had always been a taxable or nontaxable entity.

G. Business combinations - Purchase

1. Under FASB Statement No. 109:

Deferred tax assets and liabilities are recognized for the tax effect of differences between assigned values and tax bases of assets and liabilities.

2. Under APB Opinion No. 11:

Deferred tax assets and liabilities were not recorded in purchase business combinations; however, the amounts that would otherwise be assigned to the individual assets acquired and liabilities assumed were often adjusted to reflect consideration of the tax consequences of basis differences, that is, they were recorded net of tax.

H. Business combinations - Pooling

1. Under FASB Statement No. 109:

The financial statements of the combining enterprises in a business combination
accounted for as a pooling of interests must be restated on a combined basis for all periods presented. The tax consequences of deductible temporary differences and NOL or tax credit carryforwards that were not recognized in financial statements for periods prior to the date of combination must be recognized, subject to the more likely than not realization test, in the restated combined financial statements.

2. Under APB Opinion No. 11:

Restated combined financial statements for periods prior to the combination were not adjusted for unrecognized tax benefits.

I. Intercorporate tax allocation

1. Under FASB Statement No. 109:

Enterprises that are members of a group that files a consolidate tax returns and issues separate financial statements must use a tax allocation method that is consistent with the broad principles established by FASB Statement No. 109.

2. Under APB Opinion No. 11:

There was no restriction on the method of allocating income tax expense or benefit to group members.

J. Employee stock ownership plans (ESOPs)

1. Under FASB Statement No. 109:

a. The tax benefits of deductible dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings must be credited to retained earnings.

b. Tax benefits on allocated ESOP shares must be recognized as a reduction of income tax expense from continuing operations.

2. Under APB Opinion No. 11:

Tax benefits from allocated and unallocated shares were recognized in equity.

K. Exceptions to interperiod tax allocation

FASB Statement No. 109 eliminates, on a prospective basis, most of the exceptions from the requirement to record deferred taxes for those items addressed in APB Opinion No. 23, Accounting for Income Taxes - Special Areas.

1. This may have a minimal effect on enterprises other than savings and loan associations and enterprises with domestic corporate joint ventures because there is an exception for the excess of the amount for financial reporting over the tax basis of foreign subsidiaries and foreign corporate joint ventures.

2. Recognition of deferred taxes on the excess of the financial reporting over the tax basis of domestic subsidiaries may be unnecessary if the investment is expected, ultimately, to be recovered tax-free.
3. For savings and loan associations, the tax "bad debt" reserve that arose prior to the fiscal year that begins after December 31, 1987, (that is, the base year amount) is frozen and the book reserve at that date and all subsequent changes are tax-effected.

4. "Policyholders' Surplus" of stock life insurance companies that arose prior to the fiscal year that begins after December 15, 1992, is grandfathered, but all changes after that date are temporary differences and treated in accordance with the Statement.
APPENDIX 2

Summary of Issues Arising in Connection
With the Transaction From
FASB Statement No. 96
To
FASB Statement No. 109

I. Practices Under FASB Statement No. 96 That Are Unchanged by FASB Statement No. 109

The following are several aspects of present practice under FASB Statement No. 96 which remain the same or are modified only slightly by the Statement.

A. Temporary differences

Interperiod tax allocation is required for the tax consequences of a temporary difference - broadly defined as the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability may not require a determination of the particular future year(s) in which existing temporary differences will reverse and enter into the determination of taxable income (referred to in FASB Statement No. 96 as "scheduling") for those enterprises that conclude a valuation allowance is not necessary. For those enterprises that conclude that a valuation allowance is necessary, detailed scheduling is also not required; however, a general understanding of the timing of reversals is necessary.

B. Deferred tax liabilities

In general, enterprises must recognize a deferred tax liability for the tax consequences of future taxable amounts.

Example: A deferred tax liability must be established as a result of accelerated tax depreciation in excess of financial reporting depreciation irrespective of whether the enterprise expects to incur future tax losses that will offset the future taxable amounts from those differences in future periods.

C. Tax law changes

1. The deferred tax consequences of changes in tax laws or rates is computed on the amount of temporary differences and carryforwards existing at the date a new law is enacted.

2. Deferred tax balances are adjusted for the effects of the change, with the corresponding charge or credit recognized in income tax expense or benefit from continuing operations.

3. The approach used under FASB Statement No. 96 is identical; however, that Statement precludes recognition of tax assets for deductible temporary differences and tax loss or credit carryforwards.

D. Discounting

Discounting deferred tax assets and liabilities to amounts representing the present value of future receipts or payments is prohibited.
E. **Tax status changes**

The tax consequences attributable to a change either from a taxable to nontaxable status or from nontaxable to taxable status are recorded as a credit or charge to income tax expense from continuing operations at the date the change in tax status occurs.

F. **Comprehensive income**

1. The tax consequences of items recorded directly in stockholders’ equity (i.e., foreign currency translation adjustments, valuation allowances on noncurrent securities portfolios, and minimum pension liabilities) must also be recorded in equity.

2. However, enterprises must record in income from continuing operations the effects of changes in tax laws or rates (See I.C.2. above).

3. This rule applies to all deferred tax assets and liabilities regardless of whether they relate to items recorded in stockholders’ equity.

G. **Interim tax provisions**

The annual effective rate used to measure the tax on income or losses in interim periods of a fiscal year is based on an estimate of the rate expected to be applicable for the full fiscal year.

H. **Business combinations - Purchase**

The deferred tax consequences of a business combination accounted for as a purchase are recorded at their gross amounts at the combination date.

I. **Business combination - Pooling**

1. The financial statements of the combining enterprises in a business combination accounted for as a pooling of interests, for periods prior to the combination, must be restated on a combined basis.

2. The tax consequences of deductible temporary differences and operating loss or tax credit carryforwards that were not recognized in financial statements for periods prior to the combination must be recognized, subject to the more likely than not realization test, in the restated combined financial statements.

II. **Practices Under FASB Statement No. 96 That Are Changed by FASB Statement No. 109**

Under FASB Statement No. 109, the tax consequences of temporary differences and operating loss and tax credit carryforwards represent either tax liabilities to be settled in the future or tax assets that will be realized as a reduction of future taxes. Thus, deferred tax assets and liabilities represent the future tax consequences of temporary differences and carryforwards measured at the balance sheet date, and the deferred portion of the tax provision or benefit is the result of changes in the net deferred tax asset or liability for the period.

In contrast, under FASB Statement No. 96, the tax consequences of temporary differences were either tax liabilities to be paid in the future or tax benefits to be refunded by tax jurisdictions. As under FASB Statement No. 109, measurement of deferred tax assets and liabilities was determined by reference to enacted tax law; however, unlike FASB Statement No. 109, FASB Statement No. 96 precluded consideration of assumptions about future economic events.
The recognition and measurement of deferred tax assets and liabilities under FASB Statement No. 109 is significantly different from the recognition and measurement under FASB Statement No. 96. Some of the important changes are discussed as follows:

A. Deferred tax assets

1. Under FASB Statement No. 109:
   a. Enterprises must recognize a deferred tax asset, reduced by a valuation allowance if required, for deductible temporary differences and operating loss and tax credit carryforwards.
   b. Determining whether a valuation allowance is required depends on whether available evidence about the future supports a conclusion that realization of existing tax benefits in future tax returns is more likely than not.

2. Under FASB Statement No. 96:

   Consideration of evidence about the future was not permitted, and thus recognition of a deferred tax asset was limited to the tax benefits for deductible temporary differences that would result in carryback refunds and a deferred tax asset was not recognized for carryforward benefits.

B. Measurement

1. Under FASB Statement No. 109:

   Measurement of deferred tax assets and liabilities is based on the applicable tax rate. The objective is to measure a deferred tax liability or asset using the enacted tax rates expected to apply to taxable income in the periods the deferred tax liability or asset is estimated to be settled or realized.

2. Under FASB Statement No. 96:

   Measurement was based on the statutory rate that would apply assuming the only taxable or deductible amounts to be included in future years' tax returns would result from the reversal of existing temporary differences.

C. Balance sheet classification

1. Under FASB Statement No. 109:
   a. For those enterprises that present a classified statement of financial position, deferred tax assets and liabilities are classified as current and noncurrent on the basis of the classification of the related asset or liability for financial reporting.
   b. If an item is not directly related to an asset or liability (i.e., an NOL carryforward), classification is based on the expected reversal or utilization period.

2. Under FASB Statement No. 96:

   The classification method was based on the periods in which net temporary differences were expected to reverse.
D. Intercorporate tax allocation

1. Under FASB Statement No. 109:

Enterprises that are members of a group that files a consolidated tax return and issues separate financial statements must use a tax allocation method that is consistent with the broad principles established by FASB Statement No. 109.

2. Under FASB Statement No. 96:

There was no restriction on the method an enterprise used to allocate income tax expense or benefit to group members.

E. Employee stock ownership plans (ESOPs)

1. Under FASB Statement No. 109:

The tax benefits of deductible dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings must be credited to retained earnings. Tax benefits on allocated ESOP shares must be recognized as a reduction of income tax expense from continuing operations.

2. Under FASB Statement No. 96:

Tax benefits from allocated and unallocated shares were recognized in income.

F. Exceptions to interperiod tax allocation

FASB Statement No. 109 eliminates, on a prospective basis, most of the exceptions from the requirement to record deferred taxes for those items addressed in APB Opinion No. 23, Accounting for Income Taxes - Special Areas.

1. This may have a minimal effect on enterprises other than savings and loan associations and enterprises with domestic corporate joint ventures because there is an exception for the excess of the amount for financial reporting over the tax basis of foreign subsidiaries and foreign corporate joint ventures.

2. Further, recognition of deferred taxes on the excess of the financial reporting over the tax basis of domestic subsidiaries may be unnecessary if the investment is expected, ultimately, to be recovered tax-free.

3. For savings and loan associations, the tax "bad debt" reserve that arose prior to the fiscal year that begins after December 31, 1987, (that is the base year amount) is frozen and the book reserve at that date and all subsequent changes are tax-effected.

4. "Policyholders' Surplus" of stock life insurance companies that arose prior to the fiscal year that begins after December 15, 1992, is grandfathered, but all changes after that date are temporary differences and treated in accordance with the Statement.