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FASB Decisions on Intra-Entity Asset Transfers

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The Financial Accounting Standards Board ("FASB") recently held a meeting during which its project on intra-entity asset transfers was discussed. The project started as a way to simplify the accounting for intra-entity asset transfers as part of a simplification initiative. This article is intended to summarize the forthcoming accounting for income taxes implications of the FASB's changes to the accounting for intra-entity asset transfers under U.S. generally accepted accounting principles ("U.S. GAAP").

Background

Generally, an intercompany sale or purchase of assets between entities in separate tax-paying components is a taxable event for the seller and establishes a new tax basis for the assets in the buyer's jurisdiction. Existing guidance under ASC 810, *Consolidation*, provides that intra-entity balances, transactions, and profit or loss on assets remaining within the group should be eliminated. ASC 810-10-45-8 states:

> If income taxes have been paid on intra-entity profits on assets remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced.

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Additionally, ASC 740-10-25-3(e) provides an exception to the recognition of deferred taxes in the buyer's jurisdiction noting:

> A prohibition on recognition of a deferred tax asset for the intra-entity difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements.

The net tax effect to the seller of an intra-entity asset transfer deferred in consolidation (including taxes currently payable, unrecognized tax benefits and deferred tax effects, net of any related valuation allowance) is generally referred to as a deferred charge (credit) and reflected as an other asset (liability) on an entity's consolidated balance sheet. The deferred tax effects should be recognized as a component of income tax expense (benefit) when the asset is sold outside of the consolidated group if associated with inventory or land. Deferred tax effects of assets subject to depreciation or amortization generally should be amortized over an appropriate period. Similarly, any adjustment to tax basis in the buyer's tax jurisdiction is recognized as a component of income tax expense (benefit) as it becomes deductible.

FASB Decisions

The FASB met on June 15, 2016, and decided to require an entity to recognize the income tax consequences of an intra-entity asset transfer, other than an intra-entity asset transfer of inventory, when the transfer occurs. For intra-entity asset transfers of inventory, the FASB decided to retain current U.S. GAAP guidance that requires an entity to recognize the income tax consequences of the transaction when the inventory has been sold to a party outside the consolidated group, as noted above.

The FASB decided that entities should apply the amendments on a modified retrospective basis with a cumulative effect adjustment directly to retained earnings as of the beginning of the period of adoption.

The amendments are expected to be effective for public business entities in annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. All other entities should apply the amendments in annual reporting periods beginning after December 15, 2018, and interim periods in annual periods beginning after December 15, 2019.

The FASB decided to permit entities to early adopt the amendments as of the beginning of an annual reporting period that begins after the issuance date of the Accounting Standards Update ("ASU").

Finally, the FASB directed its staff to draft a final ASU for vote by written ballot. It is anticipated that the final ASU will be issued prior to September 30, 2016.

KPMG Observations

As a result of the changes discussed above, greater volatility in reported earnings may occur because all tax effects associated with intra-entity asset transfers other than inventory will be recognized as a component of income tax expense (benefit) in the period of the transfer. Additionally, the recognition of income tax consequences as they occur is expected to be more representationally faithful of an entity's economic operations.

Further, some entities may face difficult judgments about whether to record a valuation allowance when deferred tax assets on deductible temporary differences in the buyer's tax jurisdiction are recognized.

It is noted that the decisions by the FASB do not impact the pretax book accounting for intra-entity asset transfers and the impacts of such transfers, outside of income taxes, will continue to be eliminated.

Financial Statement Disclosures Prior to Adoption

For periods subsequent to issuance but prior to adoption of the forthcoming ASU, the U.S. Securities and Exchange Commission ("SEC") requires disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. These disclosures include the following:

- A brief description of the new standard, the date adoption is required, and the date the registrant plans to adopt, if earlier
- Discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined
- Discussion of the impact of adoption or a statement that it is not known or reasonably estimable
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard

As noted above, the issuance of the final ASU is anticipated by September 30, 2016.

Financial Statement Disclosures upon Adoption

It is anticipated that the ASU will require a public business entity to disclose in the first annual period after adoption, and interim periods within that first annual period, the nature of and reason for the change in accounting principle, the effect of the change on affected financial statement line items and affected per-share amounts and the cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.

Illustration

Alpha Corporation and Beta Corporation are wholly owned subsidiaries of Delta Corporation, a calendar year-end U.S. corporation. Alpha and Beta enter into an intra-entity asset transfer on December 31, 2017, for which Alpha sells intellectual property with a financial statement carrying amount and tax basis of $100 to Beta for $150.

Alpha and Beta file separate tax returns in different tax jurisdictions. Alpha and Beta have statutory tax rates of 40 percent and 10 percent, respectively. Beta is very profitable and does not need a valuation allowance. At the time the transaction was executed, Delta Corporation had not yet adopted the proposed guidance on accounting for intra-entity asset transfers.

The transaction resulted in Alpha incurring income tax expense in the amount of $20 [($150 carrying amount less $100 of tax basis) at a 40 percent tax rate]. The $20 was included as a deferred charge in the Delta consolidated financial statements. No deferred tax asset was recognized for the excess of Beta's $150 tax basis over the $100 carrying amount in Delta's consolidated financial statements.

Effective January 1, 2018, Delta adopted the expected new guidance on accounting for intra-entity asset transfers. As a result of adoption, Delta would debit a net adjustment to retained earnings of $15 comprised of a $20 debit associated with the reversal of the deferred charge, partially offset by a $5 credit on establishing a deferred tax asset for Beta's excess of its tax basis of $150 over its financial statement carrying amount of $100 (based on a 10 percent tax rate).

Had the expected new guidance been adopted on January 1, 2017, Delta would have recognized a $20 current tax expense and a $5 deferred tax benefit in the consolidated financial statements at the time of the transfer.

In Conclusion

The forthcoming ASU on intra-entity asset transfers may have a significant impact on an entity's financial statements upon and subsequent to adoption. Companies may want to consider the potential impact of the forthcoming ASU to ensure the consequences upon issuance are appropriately considered.