KPMG

What's News in Tax

Analysis that matters from Washington National Tax

SEC Comments on Accounting for Income Taxes

January 18, 2023

by Jack Coman, Jenna Summer, and Ashby Corum, Washington National Tax

Representatives of the U.S. Securities and Exchange Commission ("SEC") made comments about accounting for income taxes during the 2022 AICPA Conference on Current SEC and PCAOB Developments. This article summarizes certain comments made at the conference and provides examples of comments related to income taxes recently issued by the SEC to registrants.

2022 AICPA Conference on Current SEC and PCAOB Developments

The 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments (the "Conference") was held December 12-14, 2022, in Washington, D.C. The speakers and panellists included representatives of the SEC, the Financial Accounting Standards Board ("FASB"), the International Accounting Standards Board ("IASB"), and the Public Company Accounting Oversight Board ("PCAOB"), who shared views on various accounting, financial reporting, auditing, and regulatory issues. SEC representatives reiterated recent themes and concerns, in particular the need for registrants to focus on quality in the current economic environment. Additionally, remarks by FASB officials pointed to an increased focus on the needs of investors, which suggests they may play a more prominent role in its technical agenda going forward.

SEC Acting Chief Accountant Paul Munter stressed the importance to investors of financial statements containing greater disaggregation of certain information during his remarks. FASB Chair Richard Jones further reiterated this point by noting three current disaggregation projects on the FASB's technical agenda, including the Improvements to Income Tax Disclosures project. The FASB refocused the scope of its income tax disclosures project to meet the information needs of financial statement users when making capital allocation decisions. In line with this new focus, in December 2022, the FASB decided to issue an exposure draft that would require disclosure of:

— Income taxes paid year to date, disaggregated by federal, state, and foreign taxes (on an interim and annual basis), and further disaggregated for each individual jurisdiction that exceeds five percent of total income taxes paid on an annual basis; and

— Rate reconciliation information by specific categories, including (but not limited to) state and local income tax, foreign tax effects, tax credits, and valuation allowances.

An exposure draft is expected to be released early in 2023 with a 75-day comment period. During his remarks, Munter also noted that effective communication could include voluntarily providing the type of information investors have been asking for, and a company may provide disaggregated disclosures now.[1]

Examples of Recent SEC Comment Letters

The following selection of SEC comment letters specific to income taxes is provided to illustrate areas in which the SEC staff ("Staff") questioned whether the disclosures provided adequate insight for investors to understand a company's income taxes environment or when the Staff wanted a better understanding of the basis for management's judgements. The comments below highlight common findings that are representative of the Staff's areas of recent focus associated with income taxes.

Example 1: Effective tax rate reconciliation

The Staff may request additional detail on whether fluctuations in the effective tax rate reconciliation are expected to have a continuing effect:

> Please expand your disclosures of income tax expense to discuss the changes in the effective tax rate from period to period and correspondingly the significant factors that impacted the rate from period to period. Please quantify the material factors disclosed as well as whether the material factors impacting the effective tax rate are expected to have a continuing impact. Please specifically disclose whether you are aware of any reasons why the effective tax rate in the historical financial statements may not be indicative of your expected effective tax rate in future periods.

Example 2: Effective tax rate reconciliation

The Staff may request additional detail on significant fluctuations in the effective tax rate reconciliation:

> Your effective tax rate reconciliation shows a significant fluctuation in the line item "stock-based compensation (benefit) expense" and "non-deductible executive compensation" for the year ended December 31, 2019 compared to the year ended December 31, 2020. Please explain to

[1] ASC 740-10-S99-1(5), Question 2 notes that where there are significant reconciling items that relate in significant part to foreign operations as well as domestic operations, in many cases, disclosure of the separate amounts by geographical area would seem appropriate.

> us the reasons for the fluctuation in these line items and your consideration of disclosing the nature of these reconciling items in your financial statements. Refer to the guidance in ASC 740-10-50-12.

Example 3: Effective tax rate reconciliation

The Staff may request additional detail on the components included within the other category in the effective tax rate reconciliation:

> Please tell us what consideration you gave to providing a further quantitative breakdown of the "Other" category in the income tax rate reconciliation schedule pursuant to Rule 4- 08(h)(2) of Regulation S-X and FASB ASC 740-10-50-12.

Example 4: Valuation allowances

The Staff may request additional detail on the source of income and evidence to support the realizability of deferred tax assets:

> We note your disclosure that you have recorded certain deferred tax assets you believe will be realized in future periods based on your analysis of both positive and negative evidence about the future realization of the tax benefit of each existing deductible temporary difference or carryforward and that future realization is based on the existence of sufficient taxable income of the appropriate character, within the appropriate taxing jurisdiction, and within the carryback and carryforward periods available under the applicable tax laws. We also note that the realizability of deferred tax assets is a Critical Audit Matter identified by your auditor in their report. Given the significant balance of deferred tax assets and the material losses from continuing operations during each of the three years ended December 31, 2021, please tell us and more fully disclose and discuss how you determined it is more likely than not that you will realize net deferred tax assets as of December 31, 2021. Please provide us and disclose a detailed description of the positive and negative factors you considered in assessing the realizability of deferred tax assets. Please also tell us and disclose and discuss your reliance on each source of taxable income identified in ASC 740-10-30-18 and specifically address the following:
>
> — Explain how you determined the tax valuation allowance you recorded;
>
> — If you are relying on the recognition of future pre-tax income, tell us and disclose the amount of pre-tax income you will need to generate to fully realize deferred tax assets and the taxing jurisdiction and time period in which such pre-tax income will be required to be generated. Provide and disclose and discuss the significant assumptions underlying any future earnings projections; and
>
> — If you are relying on tax planning strategies, tell us and disclose the nature of the tax planning strategies, how each strategy supports the realization of deferred tax assets, the amount each strategy covers, and any uncertainties, risks, or assumptions related to the tax-planning strategies. Please refer to ASC 740-10-30-16 through 25 and Section 501.14 of the Financial Reporting Codification.

Example 5: Unrecognized tax benefits

The Staff may request additional detail on an entity's judgment on a tax position with uncertainty:

> We note that Company X is currently involved in a tax dispute with the Australian Taxation Office and that you are not recognizing any tax expense related to the matter since you believe it is more likely than not that Company X's tax position will be sustained. Please tell us if you believe this matter falls within the scope of ASC 740 or other literature, such as ASC 450, and how you arrived at your determination. If applicable, tell us how you applied ASC 740-10-30-7 in determining that no additional tax expense was required.

Example :6 Unrecognized tax benefits

The Staff may question whether and adjustment is a correction of an error:

> Here and at page 67, you disclose that you recorded a $X million liability as of December 31, 2021, related to an uncertain tax position regarding your allocation of revenue between Belgium and the U.S. Also as disclosed on pages 14 and 23 of the Form 10-Q for the fiscal quarter ended March 31, 2022, you recorded an additional $X million liability as of March 31, 2022. Please tell us and disclose in more detail in future filings the reason for the significant increase in the liability, the uncertainties, as well as its potential impact, if recognized, to your effective tax rate. Refer to ASC 740-10-50-15. Please also ensure your response specifically addresses whether the change is the result of correcting an error under ASC 250, Accounting Changes and Error Corrections.

Example 7: Investments in subsidiaries

The Staff may request additional detail on an entity's access to worldwide cash and the potential tax consequences if distributed:

> Please revise your disclosure to provide a clear description of how cash is transferred through your organization, addressing the following:
>
> — Disclose your intentions to distribute earnings.
>
> — Quantify any cash flows and transfers of other assets by type that have occurred between the holding company and its Chinese subsidiaries, and the direction of transfer.
>
> — Quantify any dividends or distributions that a Chinese subsidiary has made to the holding company and which entity made such transfer, and their tax consequences. Similarly, please quantify dividends or distributions made to U.S. investors, the source, and their tax consequences. Your disclosure should make clear if no transfers, dividends, or distributions have been made to date.
>
> — Describe any restrictions on foreign exchange and your ability to transfer cash between entities, across borders, and to U.S. investors.
>
> — Describe any restrictions and limitations on your ability to distribute earnings from the company, including your Chinese subsidiaries to the parent company and U.S. investors.

Example 8: Investments in partnerships

The Staff may request additional detail on deferred taxes related to an investment in partnership:

> Please explain to us what the line item "Partnership basis" in the table of deferred tax assets and liabilities on page 67 represents. Consider disclosing what it represents as well for full understanding by readers.

Example 9: Change in ownership and potential limitations

The Staff may request additional detail on whether a transaction will impose limitations on the utilization of attributes:

> We note your statement that it is likely that the Business Combination would result in an ownership change and if an ownership change is deemed to have occurred, Company X's carryforwards may be limited. Please revise to explain how the limitation on the use of carryforwards is determined if there is an ownership change. Please revise to quantify the carryforwards you plan to realize into tax savings.
>
> Please estimate the applicable long-term, tax-exempt rate.

Example 10: Tax receivable agreements

The Staff may request additional detail on the operational aspect and benefits associated with a tax receivable agreement:

> We note your disclosure that the Up-C structure will provide potential future tax benefits for Company X. Please revise to add a separate question and answer discussing the Tax Receivable Agreement and who exactly receives the future tax benefits to include quantification of the allocation of future tax benefits and the potential size of any payments under the agreement.
>
> Please revise to quantify the carryforwards you plan to realize into tax savings.
>
> Please revise to quantify the potential size of any payments under the Tax Receivable Agreement.
>
> We note that on April 28, 2021 [Advisor] sent a revised term sheet which revised the terms of the Tax Receivable Agreement. To the extent applicable, please revise to discuss any negotiations regarding the allocation of future tax benefits between the respective parties.

Example 11: Non-GAAP measures

The Staff may question whether an adjustment is an appropriate non-GAAP measure:

> Your adjustments (a) and (b) on pages 17 and 18 related to tax law change and to reverse the tax valuation allowance appear to result in an individually tailored income tax recognition method. Please revise your presentation to omit these adjustments or tell us why you believe they are appropriate. Refer to Questions 100.04 and 102.11 of the Staff's Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

Example 12: Non-GAAP measures

The Staff may question how the tax effects of non-GAAP measures are calculated and for the tax effects to be presented separately:

> In your non-GAAP reconciliations of adjusted net income, you present adjustments net of tax. Please revise to present the tax effects of non-GAAP adjustments as a separate adjustment and provide an explanation of how the tax impacts are calculated. Refer to Question 102.11 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

Example 13: Non-GAAP measures

The Staff may request additional detail on the tax rate applied to non-GAAP measures:

> We note your response to prior comment 2 and it remains unclear how your non-GAAP tax rate is consistent with the guidance in Question 102.11 of the Non-GAAP C&DIs. As previously noted, the tax adjustment should include tax expense commensurate with your non-GAAP measure of profitability. You appear to have reported cumulative non- GAAP net income before taxes in recent years, which suggests that from a non-GAAP perspective, loss carryforwards may not be available nor would a valuation allowance be warranted and therefore should not be considered in determining your non-GAAP income tax adjustment. Please further explain how your non-GAAP tax rate is consistent with Question 102.11 or revise.

Example 14: Non-GAAP measures

The Staff may request additional detail on why an adjustment is appropriately reflected as a non-GAAP measure:

> We note from your response to prior comment 2 that management separately analyzes the realizability of deferred tax assets on a non-GAAP basis and has determined that no valuation allowance is needed to reflect the Company's non-GAAP deferred tax assets. Please address the following:
>
> — Provide us with your analysis of the realizability on your deferred tax assets on a non-GAAP basis.
>
> — Explain the differences between your non-GAAP analysis and the analysis management performs under GAAP.
>
> — Explain why you believe this does not constitute an individually tailored recognition and measurement method under Non-GAAP Financial Measures C&DI 100.04.

Example 15: Pro forma adjustments

The Staff may request additional detail on the adjustments related to income taxes within pro forma financial statements:

> In regards to your provision for income tax, we note that you have not included a pro forma adjustment for income taxes. Please disclose how you determined the provision for income

> taxes and benefit from income taxes used in your pro forma statements of operations for the period ended September 30, 2021 and December 31, 2020. In addition, specifically expand your disclosure to discuss the income tax rate used, as applicable.

Conclusion

In summary, as demonstrated in recent Staff comment letters, accounting for income taxes continues to be an area of focus for the SEC. Consequently, financial statement preparers may decide to consider the recent comments from regulators and standard setters to identify areas for improvements in existing income taxes disclosures.

□ □ □ □

