31st ANNUAL

PAUL J. HARTMAN

STATE AND LOCAL TAX FORUM

Getting SALTy with ASC 740 / 450

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Agenda

- ASC 740 and ASC 450 Overview
- Decoupling considerations
- Tax attributes and valuation allowances
- Uncertain tax positions
- ASU 2023-09

ASC 740 Overview

ASC 740 Tax Types

- ASC 740-10-15-3: "The guidance in the Income Taxes Topic applies to...state and local (including franchise) taxes based on income“
- ASC 740-10-15-4: "The guidance in this Topic does not apply to...a franchise tax to the extent it is based on capital and there is no additional tax based on income“
- "Net income": income less allowable expenses (e.g., Texas franchise tax, Oregon CAT are considered taxes based on net income)

ASC 740 Overview

- Primary objectives:
  - Recognize amount of taxes payable or receivable for current year
  - Recognize deferred tax liabilities or assets for future tax consequences of events recognized in financial statements versus tax returns
- Balance sheet focus—the liability method
  - A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year
  - A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards

ASC 740 Overview

- Measurement of current and deferred tax liabilities and assets is based on provisions of enacted tax law
- Effects of potential or proposed changes in tax laws or rates are not incorporated
- Measurement of deferred tax assets is reduced by the amount of any tax benefits that are not expected (more-likely-than-not) to be realized

ASC 450 Overview

ASC 450 Tax Types

- Applicable to taxes *other than taxes based on income*, such as:
  - Sales/Use Taxes
  - Gross Receipts Taxes
  - Property Taxes
  - Franchise Taxes (not based on income)

ASC 450 Overview

- Accounting Standards Codification Topic 450, Contingencies (ASC 450—f/k/a FAS 5)
  - Addresses contingencies
- Contingency is an:
  - Existing condition, situation, or set of circumstances
  - Involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur
- Loss contingencies may include litigation, product warranties, environmental liabilities, as well as losses related to indirect taxes
- Gain contingencies may include favorable monetary outcomes from litigation, and insurance recovery in excess of the costs or losses recognized in the financial statements

ASC 450: Accounting for Loss Contingencies

- Uncertainties associated with non-income taxes should be accounted for under ASC 450
- First determine the likelihood of a material loss
  - Remote – chance for future event is slight
  - Reasonably possible – chance more than remote but less than likely
  - Probable – chance is likely to occur
- An estimated loss from a loss contingency is required to be accrued by a charge to income if both of the following conditions are met:
  - Information available prior to issuance of the financial statements indicates that it is **"probable"** that an asset had been impaired or a liability incurred at the date of the financial statements.
  - The amount of loss can be **"reasonably estimated"**

ASC 450: Accounting for Loss Contingencies

- A loss contingency and a liability are recorded if the loss is both probable and estimable.
- If the loss is either probable or estimable but not both and it is at the very least reasonably possible that a liability may have been incurred, a disclosure note is required.
- The disclosure must include:
  - The nature of the contingency
  - An estimate of the possible loss or range of loss or a statement that an estimate cannot be made

Decoupling Considerations

State Conformity to the IRC

- State generally conform to the IRC on a "fixed" or "rolling" basis, or will specifically adopt or decouple from specific provisions of the IRC
- When states do not conform to sections of the IRC that create timing differences, it results in the gross deferred tax asset/liabilities bases to be used for calculating the federal deferred tax asset/liability and the state deferred tax asset/liability
  - Common areas for non-conforming treatment resulting in potentially material considerations for provisions include:
    - IRC § 163(j) – Interest expense limitations
    - IRC §§ 168 and 168(k) – Depreciation/Bonus Depreciation
    - IRC § 174 – Research and Experimentation Costs

Section 163(j)

- IRC §163(j) is calculated at the federal consolidated level, separate calculations may be required at each entity level for separate company state return purposes
- Decoupling methods:
  - Full decouple
    - Interest is deductible in current year, added back in year deducted on federal return
  - Partial decouple/state specific
    - Separate company 163(j) limit is only applied if there was federal consolidated amount disallowed
  - Does not conform to CARES 50% increase
  - Changes to conformity since implementation

Section 168(k)

- Non-conformity leads to differing state and federal asset bases
- These differences result in a different gain/loss calculation when property is disposed
- State depreciation should be tracked at an asset level to ensure proper calculation of the gain/loss upon disposal
- Decoupling from Bonus Depreciation is a timing difference of the deduction. If depreciation and basis is not tracked at the asset level, the additional state deduction in the year of disposal may be missed resulting in a permanent increase to state taxable income
- State inconsistent treatment year over year (examples, PA, IL)

Section 174

- The Tax Cuts and Jobs Act (TCJA) resulted in significant changes to the treatment of R&E expenditures under IRC § 174
  - For tax years beginning after December 31, 2021, taxpayers are required to capitalize and amortize all R&E expenditures regardless of how they were treated previously
  - IRC § 174 costs specifically include items previously immediately expensed under Rev. Proc. 2000-50
  - IRC § 174 expenditures required to be capitalized and amortized (midpoint of tax year incurred):
    - Over 5 years for R&E performed in the US
    - Over 15 years for R&E performed outside of the US
- State conformity to IRC § 174 is currently evolving as this became effective for the 2022 tax year

Impact to the State Provision

- First question always - materiality
- Provisions using blended rates:
  - DTA/DTL created using blended rate
  - Contra (DTA/DTL) should be created to offset non-conforming rates for decoupling states
- State DTA rate applied
  - The rate applied should be the enacted rate expected when the deferred item will reverse
  - If material, consideration should be given to scheduling deferred reversals
  - Considerations should be given to states with known rate reductions over longer periods if material

State Attributes and Valuation Allowances

NOLs and ASC 740

- State net operating losses (NOLs) create deferred tax assets (DTAs)
  - State NOLs are recorded net of federal benefit as they reduce current and future state income taxes and, thus, increase future federal income
- Measurement of DTAs is reduced by the amount of any tax benefits that are not expected to be realized based on a MLTN standard, i.e., a valuation allowance (VA)
  - A VA is a financial accounting principle that reduces a DTA to its net realizable value
  - A VA is based on management and advisor views of what is MLTN to be realized after considering all quantitative and qualitative information available

State NOL Considerations

- Enacted future tax rate changes
  - Trend of decreasing state CIT rates
  - Estimating future taxable income
- Impact of state NOL limitations and siloing rules
- Uncertain Tax Positions (ASU 2013-11)
  - UTPs cannot increase an NOL
  - NOL carryforwards should be reduced for UTPs if the entity expects to use the NOL against the liability (scheduling)

Valuation Allowances

- Taxpayers must establish a VA for deferred tax assets when it is more-likely-than-not (a probability level of more than 50%) that they will not be realized. Reporting entities with gross deferred tax assets are required to undertake a VA assessment.
- Being in a net deferred tax liability position does not exempt a reporting entity from this VA assessment because of the possibility that deferred tax liabilities may not reverse in a manner that provides a source of taxable income
- VAs do not deal with the existence of the asset. Instead, they address the realizability of an asset. Will there be an actual reduction in future tax liability?
- In theory applies to any deferred tax asset. In practice, the focus is on NOLs and credits.

Valuation Allowances

- Consider all evidence (both positive and negative) and use judgement
- Four sources of taxable income **must** be considered to determine the correct amount of VA
- Historic results carries more weight than future estimates
- More difficult to conclude a valuation allowance is not needed with negative evidence
- Examples include:
  - Cumulative losses in recent years
  - History of NOL or credit carryforwards expiring unused
  - Expected losses in near-term
  - Differences in carryforward period from federal

Valuation Allowances

- Four sources of taxable income
  - Taxable income in prior carryback years
  - Future reversals of temporary differences
  - Tax planning strategies
  - Future taxable income
- SALT specific complexities and considerations:
  - State 382 limitations
  - State NOL sharing rules for combined groups
  - Loss suspension or limitation rules (and impacts on expiration)
  - Anticipated changes to apportionment, combined group makeup, etc.
- *Supporting the removal of a valuation allowance can be a significant undertaking*

Uncertain Tax Positions

Accounting for Uncertainty in Income Taxes

- Tax position definition—any position taken or expected to be taken in a tax return that directly or indirectly affects amounts reported in the financial statements
- A brief note on terminology: FIN 48 reserves, unrecognized tax benefits (UTBs), uncertain tax positions (UTPs)
- ASC 740-10: two-step model for recognition, measurement, and disclosure related to uncertain tax positions
  - Assess whether the position meets the recognition threshold
  - If the tax position meets the recognition threshold, move on to measurement

Common State Uncertain Tax Positions

- Nexus non-filing positions
- Intercompany transactions
- Apportionment computation
  - Service revenue sourcing
  - Throw-out/throw-back
- Business vs. non-business determinations
- Apportionment factor inclusion/sourcing for certain capital gains
- Filing methodologies
- P.L. 86-272 positions

Recognition under ASC 740-10-25-6

- *"An entity shall initially recognize the financial statement effects of a tax position when it is more-likely-than-not, based on the technical merits, that the position will be sustained upon examination"*

- *"The more likely-than-not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position"*

- *"The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date."*

The More-Likely-Than-Not Criteria

- Assumption that the tax position will be examined by the relevant taxing authority
- Technical merits of the tax position
  - Sources of authority in tax law
  - Past administrative practices and precedents, to the extent they are "widely understood"
  - Facts and circumstances of the tax position
- Each tax position is considered without the consideration of offset or aggregation with other positions

Measurement

- Once a tax position is determined to meet the recognition threshold, the next step is to determine the amount of benefit that should recorded
- The amount recorded is that amount that is greater than 50% likely to be realized upon settlement with the tax authority
- This determination can be:
  - An all or nothing basis, or
  - A cumulative probability basis (when there are two or more realizable outcomes)

Changes in Recognition and Measurement

- The assessment of uncertain tax positions is a continuous process and
  - should occur at each reporting date
- A change in a reserve for unrecognized tax benefits could be based on:
  - A change in law
  - Recent court decision
  - New regulations
  - Settlement of an audit
  - Change in management's assessment
- Effectively settled—conditions outlined in ASC 740-10-25-10
- Statute of limitation issues

ASU 2023-09

ASU 2023-09

- The FASB issued ASU 2023-09 in Dec. 2023:
  - ASC 740: FASB releases ASU 2023-09: Improvements to Income Tax Disclosures
- The effective date for public business entities is fiscal years beginning after Dec. 15, 2024, and interim periods within fiscal years beginning on or after Dec. 15, 2025
- The effective date for other than public business entities is fiscal years beginning after Dec. 15, 2025, and interim periods within fiscal years beginning on or after Dec. 15, 2026
- Early adoption is permitted
- Entities would apply the amendments prospectively, with an option for retrospective adoption

Targeted Improvements to Disclosures – Taxes Paid

- All entities will be required to disclose income taxes paid, disaggregated by federal, state, and foreign taxes, net of refunds received on an annual basis
- Income taxes paid will be disaggregated by individual jurisdiction on the basis of a quantitative threshold of 5% of total income taxes paid
- The 5% threshold will be calculated from the absolute value of each jurisdiction over the absolute value of the total income taxes paid

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Targeted Improvements to Disclosures – Taxes Paid

Income taxes paid (net of refunds received) for the years ended December 31

($ in 000s)		20X3	20X2	20X1
U.S. federal		1,355	1,500	2,000
U.S. states	California	215	250	300
	Minnesota	180	*	245
	New Jersey	*	180	*
	New York	*	200	275
	Other	65	85	110
	Subtotal	460	715	930
Foreign	U.K.	750	1,000	1,300
	India	*	(200)	300
	Ireland	155	*	*
	Japan	200	160	*
	Other	80	140	265
	Subtotal	1,185	1,100	1,865
Total		3,000	3,315	4,795

- The amount of income taxes paid during the year does not meet the five percent disaggregation threshold.

Targeted Improvements to Disclosures – Effective Rate

- Public business entities will be required to disclose rate reconciliation information using specific categories in **both dollars and percentages**:
  - State and local income tax, net of federal income tax effect
  - Foreign tax effects (e.g., foreign rate differential and other local country items)
  - Enactment of new tax laws
  - Effect of cross-border tax laws (e.g., GILTI, FDII, FTCs)
  - Tax credits
  - Valuation allowances
  - Nontaxable or nondeductible items
  - Changes in reserves for tax positions
- Nonpublic business entities will be required to provide qualitative disclosure about specific categories and individual jurisdictions that result in a significant difference between the statutory tax rate and the effective tax rate

Targeted Improvements to Disclosures – Effective Rate

- Public business entities are required to "provide a qualitative description of the states and local jurisdictions that make up the majority (greater than 50 percent) of the effect of the state and local income tax category." ASC 740-10-50-12B

- Public business entities are instructed to identify the jurisdictions composing the "majority of the effect . . . beginning with the state or local jurisdiction that has the largest effect and in descending order add states or local jurisdictions with the next largest effect until the aggregated effect is greater than 50 percent [of the state and local income tax category]." ASC 740-10-50-12B

- Provide additional information for reconciling items that meet a quantitative threshold (if the effect of those reconciling items is equal to or greater than 5 percent of the amount computed by multiplying pretax income [or loss] by the applicable statutory income tax rate). ASC 740-10-50-12A

- For entities other than public business entities, ASU 2023-09 requires qualitative disclosure about specific categories of reconciling items and individual jurisdictions that result in a significant difference between the statutory tax rate and the effective tax rate