The FASB issues new guidance for intra-entity transfer of assets other than inventory

October 2016

In brief

On October 24, 2016, the FASB (or the Board) issued Accounting Standards Update (ASU) 2016-16, Intra-Entity Transfers of Assets Other Than Inventory. The Board issued the ASU as part of its simplification initiative aimed at reducing complexity in accounting standards. Under the current guidance, ASC 810-10-45-8 and ASC 740-10-25-3(e) prohibit immediate recognition of current and deferred income tax impact for intra-entity asset transfers. The ASU eliminates this prohibition for all intra-entity asset transfers, except for inventory.

The new guidance will be effective for public business entities in fiscal years beginning after December 15, 2017. For all other entities, the new guidance will be effective for fiscal years beginning after December 15, 2018. Early adoption is only permitted as of the beginning of an annual reporting period. The new guidance must be adopted using a modified retrospective transition.

In detail

Ordinarily, there are tax effects when an asset is sold or transferred between affiliated companies that are consolidated for financial reporting purposes but file separate tax returns. The seller is typically required to pay income tax in the current period on the profit realized from the sale and the buyer’s tax basis in the asset equals the amount paid. In the consolidated financial statements, however, the pre-tax profit on the intercompany sale is eliminated, and the asset is reported at its carrying value prior to the intercompany sale. In this situation, a deductible temporary difference is created because the tax basis of the asset in the buyer’s jurisdiction is higher than its carrying amount in the consolidated financial statements.

Current US GAAP

Under current US GAAP, no immediate tax impact is recognized in the consolidated financial statements as a result of intra-entity transfers of assets. The current standard precludes an entity from reflecting a tax benefit or expense from an intra-entity asset transfer between entities that file separate tax returns, whether or not such entities are in different tax jurisdictions, until the asset has been sold to a third party or otherwise recovered. The current standard also prohibits recognition by the buyer of a deferred tax asset for the temporary difference arising from the excess of the buyer’s tax basis over the cost to the seller. The tax benefit from any step up in tax basis is recorded as it is realized each period, via deduction on the tax return.

The limited amount of authoritative guidance with respect to the exception for intra-entity asset transfers has led to diversity in practice and has been a source of complexity in financial reporting. In addition, the exception does not
reflect all of the income tax consequences in the financial statements, for the period in which intra-entity transfer occurs.

**New US GAAP**

In October 2014, the FASB added to its agenda, a project to eliminate the prohibition on the recognition of income taxes for intra-entity asset transfers. The project was part of the Board’s Simplification Initiative, the objective of which is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of information provided to users of financial statements.

After issuing an exposure draft in January 2015, performing extensive outreach, and re-deliberations to address the concerns raised by stakeholders, the FASB issued ASU 2016-16 on October 24, 2016.

ASU 2016-16 eliminates the exception under ASC 740-10-25-3(e), but for intra-entity transfers of inventory. ASU 2016-16 also modifies ASC 810-10-45-8 to require companies to record tax benefit or expense from intra-entity transfers, except for intra-entity inventory transfers.

Under the new guidance, the current and deferred income tax consequences of the intra-entity transfers will be reflected when the transaction occurs. The new US GAAP guidance is similar to IFRS for intra-entity transfers, except for inventory transactions. Income tax accounting under US GAAP for intercompany transfers of inventory remains unchanged.

The FASB’s decision to not change the income tax accounting for intra-entity inventory transfers was based on stakeholders’ feedback on the exposure draft and during subsequent outreach. Concerns were raised regarding the potential costs of making required system changes and the implementation of new processes and internal controls given that the volume of intra-entity transfers of inventory is significantly greater than the volume of other asset transfers. Concerns were also raised with respect to the interim provision computation and potential complexities with estimating annual effective tax rates. Additionally, stakeholders noted that inventory turnover cycle is typically short, so the exception under current US GAAP does not significantly affect the quality of information reported in the financial statements.

**Example**

The following example illustrates the impact of the difference between current US GAAP and the new guidance under ASU 2016-16 for the income tax consequences of intra-entity transfers. For simplicity purposes, the effect of currency translation is ignored in the example.

CoA and CoB are wholly owned subsidiaries of the same parent. CoA sells equipment to CoB for $150, with a profit of $50. Before the transaction, CoA had no temporary differences related to the equipment. CoA’s profit on the sale will be subject to income tax in the period of sale; CoB’s tax basis in the equipment is $150 or equal to the amount paid.

The group also now has tax basis in the equipment of $150 in CoB’s jurisdiction, which exceeds the consolidated book basis of $100 by $50 giving rise to a potential deferred tax asset of $15 ($50 basis difference × 30% rate).

The following income tax accounting entries are recorded in the consolidated financial statements when the equipment is sold from CoA to CoB:

<table>
<thead>
<tr>
<th>Description</th>
<th>Current US GAAP (debit / (credit))</th>
<th>New US GAAP (ASU 2016-16) (debit / (credit))</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred charge (balance sheet)</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>$(20)</td>
<td>$(20)</td>
</tr>
<tr>
<td><strong>To defer the current tax charge due in the seller’s jurisdiction.</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$15</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>$(15)</td>
<td></td>
</tr>
<tr>
<td><strong>To record the deferred tax asset in buyer’s jurisdiction.</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

As the equipment is depreciated (or sold outside the consolidated group), the income tax consequences are recognized in the financial statements under current US GAAP. Assume that the equipment is depreciated over 10 years using straight-line method for both financial statement and tax purposes.

The following income tax accounting entries are recorded in the consolidated financial statements each year as the equipment is depreciated:

<table>
<thead>
<tr>
<th>Description</th>
<th>Current tax expense</th>
<th>Income tax payable</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>To record the current tax due in the seller’s jurisdiction.</strong></td>
<td>$20</td>
<td>$(20)</td>
</tr>
</tbody>
</table>

The group has a current tax payable of $20 ($50 profit × 40% rate) in CoA’s jurisdiction as a result of the transaction.
Current US GAAP

<table>
<thead>
<tr>
<th></th>
<th>debit / (credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax expense</td>
<td>$2</td>
</tr>
<tr>
<td>Deferred charge (balance sheet)</td>
<td>(2)</td>
</tr>
</tbody>
</table>

To recognize income tax expense and reduce the deferred charge in the seller’s jurisdiction.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax payable</td>
<td>$1.5</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>($1.5)</td>
</tr>
</tbody>
</table>

To record the current tax benefit related to tax basis step up in the buyer’s jurisdiction.

New US GAAP (ASU 2016-16)

<table>
<thead>
<tr>
<th></th>
<th>debit / (credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax payable</td>
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<td>Current tax expense</td>
<td>($1.5)</td>
</tr>
</tbody>
</table>

To record the current tax benefit related to tax basis step up in the buyer’s jurisdiction.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>$1.5</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>($1.5)</td>
</tr>
</tbody>
</table>

To record the deferred tax expense related to book and tax depreciation difference.

PwC observation: Under current US GAAP, the impact on the effective tax rate resulting from the difference in seller’s and buyer’s statutory tax rates occurs either over time as the property is amortized or at the time of a third-party sale.

Under the new guidance, the impact of the sale is reflected in the effective tax rate at the time of the transaction.

Realizability of deferred tax assets

As discussed above, the amendments in ASU 2016-16 will require deferred tax assets resulting from intra-entity asset transfers (except for transfers of inventory) to be recorded for the difference between the buyer’s tax and book basis of the transferred assets. Realizability of such deferred tax assets, recorded at the time of adoption and for subsequent transactions, will need to be assessed to determine if a valuation allowance is required.

Interim reporting

The FASB did not provide specific guidance in ASU 2016-16 for the treatment of the tax effects of intra-entity asset transfers for interim reporting. Therefore, facts and circumstances will need to be evaluated under existing guidance in ASC 740, Income Taxes, in order to determine if the tax effects of an intra-entity transfer should be included in the computation of the estimated annual effective tax rate or treated as a discrete item in the interim period in which a transfer occurs.

Effective date and transition

For public business entities, the amendments in ASU 2016-16 are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. For all other entities, the amendments in ASU 2016-16 are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019.

Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. Therefore, early adoption should be in the first interim period if an entity issues interim financial statements.

PwC Observation: For a calendar year public business entity that issues interim financial statements, the new guidance can be early adopted only in the first quarter of 2017.

The amendments in ASU 2016-16 will be adopted on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Any valuation allowance for deferred tax assets recognized as a result of applying the amendments in ASU 2016-16 should also be recognized through a cumulative-effect adjustment to retained earnings. The cumulative-effect adjustment would consist of the net impact from (1) write-off of any unamortized tax expense previously deferred and (2) recognition of any previously unrecognized deferred tax assets, net of any necessary valuation allowance.

The ASU does not include new disclosure requirements; however, disclosures required at the time of adoption should include (1) the nature of and reason for the change in accounting principle, and (2) certain quantitative information about the effects of the accounting change. Such quantitative information may include (1) 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, (2) the effect of the new guidance on (a) continuing operations, (b) net income (or other appropriate performance indicator), (c) any other affected financial statement line items, and (d) affected per-share amounts for the current period.

The takeaway

Once ASU 2016-16 is adopted, an organization’s effective tax rate will be impacted in the period intra-entity asset transfers (other than inventory) occur.

Companies will need to ensure all data (buyer and seller) attributable to prior transactions within the scope of ASU
2016-16 is identified and assessed in order to properly account for the total cumulative-effect adjustment upon adoption. This may be challenging for calendar-year organizations considering early adoption in Q1 2017. The adoption of the new guidance may also require companies to consider changes to processes, controls, and systems to account for intra-entity asset transfers on a go-forward basis.

Let’s talk
You should not rely on the information contained within this alert without seeking professional advice. For a deeper discussion of how ASU 2016-16 may affect your business, please contact your PwC engagement team or a Tax Accounting Services network member listed here:

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