Evaluation of the realizability of a Section 163(j) carryforward

The Tax Cuts and Jobs Act limited the deductibility of interest expense under Internal Revenue Code section 163(j). In December 2019, the American Institute of Certified Public Accountants issued Q&A Section 3300, Deferred Taxes, which addresses how an entity should evaluate the realizability of its existing deferred tax assets (DTAs) related to disallowed interest deductions when an entity expects to generate future disallowed interest deductions, there are reversing deferred tax liabilities (DTLs) and an expectation of future interest expense that also will be limited under Section 163(j).

Per the Q&A, realization of DTAs depends on the existence of sufficient taxable income of the appropriate character within the carryback and carryforward period available under the tax law. There are four sources of taxable income that companies may consider as support for the realization of DTAs:

- Taxable income in prior carryback year(s) if carryback is permitted under the tax law
- Future reversals of existing taxable temporary differences
- Tax planning strategies
- Future taxable income exclusive of reversing temporary differences and carryforwards

Entities should consider each source of income incrementally to determine the amount of the valuation allowance needed, if any. To the extent 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. In situations where a valuation allowance is required, consideration of each source is required to determine the amount of the valuation allowance that is recognized for deferred tax assets.

When applying the preceding guidance to evaluate the realizability of DTAs related to disallowed interest carryforwards under Section 163(j), an entity should not recognize a valuation allowance if the taxable income to be generated upon reversal of its existing DTLs (ignoring future income or loss and future interest expense included in future income or loss) is sufficient to realize those DTAs, after considering reversal patterns and the general limitation of business interest expense to 30 percent of adjusted taxable income under Section 163(j). Whether an entity will continue to be in an interest limitation position each year in the future (resulting in an inability to use the Section 163(j) carryforward) is not relevant if the reversal of existing taxable temporary differences is sufficient to support realization of existing DTAs. Rather, if one source of future taxable income (the second source mentioned previously) exists, and that source is believed to be sufficient, then no other sources of future taxable income need to be evaluated.
If the reversal of existing taxable temporary differences is not sufficient to realize existing DTAs, additional sources of taxable income would be considered. In these situations, future limitations would be relevant and need to be considered in the projections and in assessing the realizability of any remaining DTAs, whether related to Section 163(j) or otherwise. Future income projections may represent an incremental source of taxable income for purposes of realizing those DTAs but would not affect the assessment of DTAs already deemed realizable as a result of the reversal of existing taxable temporary differences.

**FASB issues standard to simplify the accounting for income taxes**

The Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. ASU 2019-12 removes the following exceptions to the general principles in Topic 740:

- Exception to the incremental approach for intraperiod tax allocation when there is a loss from continuing operations and income or a gain from other items (e.g., discontinued operations or other comprehensive income)
- Exceptions to the accounting for basis differences when there are ownership changes in foreign subsidiaries and foreign equity-method investments
- Exception to the interim period income tax accounting when a year-to-date loss exceeds the anticipated loss for the year

The ASU also simplifies the accounting for income taxes by, among other specifications:

- Requiring that an entity recognize a franchise tax (or similar tax) that is partially based on income as an income-based tax and account for any incremental amount incurred as a non-income-based tax
- Requiring that an entity evaluate when a step up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill originally was recognized and when it should be considered a separate transaction
- Requiring that an entity reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the interim period that includes the enactment date

For public business entities, ASU 2019-12 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early adoption of the amendments is permitted, including adoption in any interim period for (a) public business entities for periods for which financial statements have not yet been issued and (b) all other entities for periods for which financial statements have not yet been made available for issuance.

**SEC**

**SEC proposes to amend definition of “accredited investor”**

The SEC recently issued a proposed rule, *Amending the “Accredited Investor” Definition*, which, if finalized, would add new categories of qualifying natural persons and entities and make certain other modifications to the existing definition of “accredited investor” in the SEC’s rules. In particular, the proposed amendments to the “accredited investor” definition would:

- Add new categories to the definition that would permit natural persons to qualify as accredited investors based on certain professional certifications and designations
- With respect to investments in a private fund, add a new category based on the person’s status as a “knowledgeable employee” of the fund
• Add limited liability companies that meet certain conditions, registered investment advisers and rural business investment companies (RBICs) to the current list of entities that may qualify as accredited investors

• Add a new category for any entity, including Indian tribes, owning “investments,” as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered

• Add “family offices” with at least $5 million in assets under management and their “family clients,” as each term is defined under the Investment Advisers Act

• Add the term “spousal equivalent” to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors

The SEC also proposed amendments to the “qualified institutional buyer” definition in Rule 144A under the Securities Act of 1933 to add limited liability companies and RBICs to the types of entities that are eligible for qualified institutional buyer status if they meet the $100 million in securities owned and investment threshold in the definition. The proposed amendments also would add a “catch-all” category that would permit institutional accredited investors under Rule 501(a), of an entity type not already included in the qualified institutional buyer definition, to qualify as qualified institutional buyers when they satisfy the $100 million threshold.

AUDITING

ASB issues revised standard for agreed-upon procedures engagements

The Auditing Standards Board (ASB) recently issued Statement on Standards for Attestation Engagements (SSAE) 19, Agreed-Upon Procedures Engagements. This SSAE supersedes AT-C section 215, Agreed-Upon Procedures Engagements. The most significant changes in SSAE 19 include the following, among others:

• The SSAE no longer requires that all of the parties to the engagement (i.e., the engaging party, the responsible party (where applicable), and users of the practitioner's report) take responsibility for the sufficiency of the agreed-upon procedures for their purposes. Instead, the standard requires that the engaging party agrees, or will be able to agree, to the procedures and acknowledges that the procedures are appropriate for the intended purpose of the engagement.

• SSAE 19 no longer requires the practitioner to restrict the use of all agreed-upon procedures reports to the specified parties that assume responsibility for the sufficiency of the procedures. Instead, the practitioner should consider whether to include an alert, in a separate paragraph, that restricts the use of the practitioner’s agreed-upon procedures report, taking into account the understanding with the engaging party regarding the nature of the engagement, the intended purpose of the engagement and the intended users of the agreed-upon procedures report.

• The SSAE requires the inclusion of a statement in the practitioner’s report indicating that the practitioner is required to be independent of the responsible party and to meet the practitioner’s other ethical responsibilities, in accordance with relevant ethical requirements related to the engagement.

SSAE 19 is effective for agreed-upon procedures reports dated on or after July 15, 2021. Early implementation is permitted.
INTERNATIONAL

IAASB enhances and modernizes ISA 315

The International Auditing and Assurance Standards Board (IAASB) recently issued *International Standard on Auditing (ISA) 315 (Revised 2019)*, its revised standard for identifying and assessing risks of material misstatement. In this revised standard, the IAASB made enhancements and clarifications to encourage a more consistent and robust risk assessment, focusing on why procedures are required. The revisions also modernized the standard to reflect the evolving environment in which businesses operate, in particular with respect to technology. ISA 315 (Revised 2019) is effective for financial statement audits for periods beginning on or after December 15, 2021.

Proposal: How information is communicated in financial statements

The International Accounting Standards Board has issued an Exposure Draft, *General Presentation and Disclosures*, to improve how information is communicated in the financial statements, with a focus on financial performance.

Among other changes, the Exposure Draft proposes that an entity present the following new subtotals in the statement of profit or loss:

- Operating profit or loss
- Operating profit or loss and income and expenses from integral associates and joint ventures
- Profit or loss before financing and income taxes

In addition, the Exposure Draft proposes to require an entity to disclose “management performance measures” in a single note. Management performance measures are subtotals of income and expenses that (a) are used in public communications outside financial statements; (b) complement totals or subtotals specified by International Financial Reporting Standards (IFRS); and (c) communicate to users of financial statements management’s view of an aspect of an entity’s financial performance. In this note, companies would be required to explain why the measures provide useful information, explain how they are calculated, and provide a reconciliation to the most comparable profit subtotal specified by IFRS.

The Exposure Draft also includes proposed new guidance to help companies disaggregate information in the most useful way for investors. Further, the Exposure Draft proposes requiring all entities to disclose unusual income and expenses in a single note. The Exposure Draft introduces a definition for “unusual income and expenses” and proposes related application guidance.

The Exposure Draft is available for comment until June 30, 2020.