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Accounting, Audit & Corporate Finance Library

Editorial Materials

Accounting and Financial Statements (US GAAP)

Accounting for Income Taxes

Chapter 1 Introduction and Authoritative Literature for Accounting for income Taxes

100 Introduction

100 Introduction

Coverage of *PPC's Guide to Accounting for Income Taxes*

100.1 Not long after the introduction of the United States federal income tax in the early twentieth century, practitioners and academics began to question the proper accounting for income taxes in financial reports. The first formal accounting pronouncement concerning income taxes, Accounting Research Bulletin No. 23, *Accounting for Income Taxes*, was issued 70 years ago, but did little to quell the different theories. As subsequent pronouncements that addressed the accounting for income taxes were issued, differing opinions remained concerning the practical and theoretical approach to accounting for income taxes. It was not until the end of the twentieth century that these differences were substantially resolved with the issuance of SFAS No. 109, *Accounting for Income Taxes*. The Statement made significant changes to the methods used to account for income taxes in annual financial statements. SFAS No. 109 substantially superseded all other standards for accounting for income taxes in annual financial statements.

100.2 Similar to previous guidance, SFAS No. 109 required the financial statements to recognize the tax effects of transactions in the same period the transactions are recorded. But its liability method was fundamentally different from previous standards. SFAS No. 109 was subsequently incorporated into the FASB Accounting Standards Codification (ASC). The FASB ASC effectively combines SFAS No. 109 with all other authoritative literature that affects accounting for income taxes and organizes that literature primarily within a single ASC Topic—FASB ASC 740, *Income Taxes*. *PPC's Guide to Accounting for Income Taxes* provides an in-depth explanation of the rules under FASB ASC 740, which affect all GAAP financial statement services since GAAP is the same regardless of whether the financial statements are audited, reviewed, or compiled.

How the *Guide* Is Organized

100.3 *PPC's Guide to Accounting for Income Taxes* is organized as follows:

- *Chapter 1—Introduction and Authoritative Literature for Accounting for Income Taxes*—provides an overview of the authoritative literature governing accounting for income taxes. Appendix 1A, “Quick Start to Accounting for Income Taxes,” provides an overview of the current and deferred income tax calculation. Appendixes 1B and 1C provide practice aids that may be

used to compute and record income taxes for most entities. Appendix 1D provides a practice aid for assessing the reasonableness of income tax calculations. Appendix 1E provides a checklist for accounting for income taxes in accordance with FASB ASC 740. Appendix 1F provides a discussion of how to utilize Excel to compute income tax provisions. Appendix 1G provides guidance on accounting for uncertainty in income taxes.

- *Chapter 2—Temporary and Permanent Differences*— discusses temporary and permanent differences between accounting for transactions for financial statement and income tax reporting. Permanent differences will never be included in taxable income, while temporary differences will be included in both financial and taxable income but in different periods. Thus, temporary differences result in the recording of deferred income taxes. The chapter provides detailed guidance on identifying temporary differences and accounting for them. An appendix to the chapter describes the types of temporary differences commonly encountered by closely held businesses.

- *Chapter 3—Calculating Current Income Taxes*— describes the accounting for current income taxes. Since current income taxes represent taxes actually due for the year, the chapter focuses on current income tax rules and regulations with special emphasis on the alternative minimum tax system (AMT). The text of the chapter relies heavily on illustrations, which generally are designed to explain a single concept. An appendix to the chapter provides more complex illustrations of the major points. The illustrations in the text and in the appendix use actual tax rates and consider both the regular tax system and the AMT system.

- *Chapter 4—Calculating Deferred Income Taxes*— explains accounting for deferred income taxes. Similar to Chapter 3, the chapter relies heavily on illustrations. The chapter also provides guidance on selecting a tax rate, considering the need for a valuation allowance, and estimating future taxable income. Appendixes to the chapter provide illustrative calculations as well as a worksheet for considering the need for a valuation allowance.

- *Chapter 5—Presentation and Disclosure of Income Taxes*— addresses presentation and disclosure considerations, including balance sheet classification of deferred tax assets and liabilities, intraperiod tax allocation, and disclosures required by FASB ASC 740. The chapter provides excerpts from illustrative financial statements and sample wording for notes. Appendixes to the chapter illustrate more complex situations and provide additional examples of disclosures as well as an income tax disclosure checklist and worksheets for reconciling the expected and actual tax provision.

• *Chapter 6—Accounting for Income Taxes—Special Areas*— discusses the following special areas of accounting for income taxes:

- a. Interim financial statements.
- b. Accounting for a change in a company's tax status with special emphasis on changes to and from S corporation status.
- c. Consolidated financial statements.
- d. Equity method investees.
- e. Indefinite reversal criteria.
- f. Acquisition method business combinations.
- g. Special disclosures for nontaxable entities.
- h. Income taxes in personal financial statements.
- i. Tax benefits resulting from investments in affordable housing projects.
- j. Tax consequences of employee stock compensation.
- k. Accounting for acquired temporary differences in acquisitions not accounted for as business combinations.

l. Accounting for tax benefits recognized after a quasi reorganization.

m. Effect of deferred taxes on goodwill impairment.

Each section of the chapter provides illustrations of the major points and sample notes. Appendixes to the chapter include interim period tax expense worksheets as well as example calculations for many of the preceding items.

Using the *Guide*

100.4 Changes in tax law, combined with the accounting rules under FASB ASC 740, make accounting for income taxes even more difficult. For example, the Tax Reform Act of 1986 imposed an alternative minimum tax system that needs to be considered under the standards. To assist, *PPC's Guide to Accounting for Income Taxes* integrates relevant accounting and tax guidance into a useful tool for all accountants, whether they specialize in accounting, auditing, or tax.

100.5 Each chapter of the *Guide* is structured to stand alone and provides the essential guidance on the subject matter addressed. The chapters may either be read in their entirety for an overview of the issues and problems or used as a reference source to research a particular question. Each chapter contains a detailed table of contents to facilitate the location of specific topics.

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101 Authoritative Literature for Accounting for Income Taxes

Income Tax Guidance in FASB ASC 740

101.1 Most of the authoritative literature on accounting for income taxes is located in the following subtopics of FASB ASC 740, *Income Taxes*:

- FASB ASC 740-10, *Income Taxes—Overall*.
- FASB ASC 740-20, *Income Taxes—Intraperiod Tax Allocation*.
- FASB ASC 740-30, *Income Taxes—Other Considerations or Special Areas*.

101.2 **Income Tax Guidance Not Located in FASB ASC 740** Not all of the authoritative literature on accounting for income taxes is located in FASB ASC 740. For example, most industry-related income tax issues are not covered in FASB ASC 740. That guidance is generally found in the income taxes subtopic within the topic for that particular industry (i.e., XXX-740). The industries with income tax guidance include the following:

- Casinos
- Common Interest Realty Associations

- Depository and Lending Entities

- Health Care Entities

- Insurance Entities

- Investment Companies

- Oil and Gas Producing Entities

- Regulated Entities

- Steamship Entities

Note that discussion of industry-related income tax guidance is generally outside the scope of this *Guide*.

101.3 Also, the following broad accounting areas outside FASB ASC 740 include guidance on accounting for income taxes:

- Business Combinations (See section 606.)

- Equity Method Investees (See section 604.)

- Foreign Operations (See Appendix 2A and section 605.)

- Interim Periods (See section 601.)

- Investments in Qualified Affordable Housing Projects (See section 608.)
- Leveraged Leases
- Reorganizations (See section 608.)
- Share-based Payments (See Appendix 2A and section 608.)

101.4 **Index of Authoritative Literature for Income Taxes** Exhibit 1-1 provides a subject index of the authoritative literature for income taxes within and outside of FASB ASC 740, including the related FASB ASC references.

Exhibit 1-1

Index of Authoritative Literature for Income Taxes

Subject	FASB ASC Reference	
	Topic-Subtopic	Section-Paragraph
Accounting for Income Taxes— General	740-10	05-1 through 05-5, 05-7 through 05-10, 10-1 through 10-3, 15-1 and 15-2, 15-3 and 15-4, 25-1 through 25-4, 25-32 through 25-36, 25-38, 30-1 through 30-5, 30-8 through 30-12, 40-6, 50-1 through 50-14, 50-16 through 50-18, 55-1 and 55-2, 55-49 and 55-50, 55-79 and 55-80, 55-139 through 55-144, 55-168 and 55-169, 55-212 through 55-216
Accounting for Income Taxes—	740-10	55-59 through 55-63,

Tax Accounting Method Change		55-77, 55-205 through 55-207
Accounting for Income Taxes— Alternative Minimum Tax	740-10	55-31 through 55-33
Accounting for Income Taxes— Built-in Capital Gains	740-10	55-64 and 55-65
Accounting for Income Taxes— Carryforward and Carrybacks	740-10	55-34 through 55-38
Accounting for Income Taxes—Deferred Tax Assets	740-30	25-9 through 25-14
Accounting for Income Taxes—Deferred Tax Measurement	740-10	55-23 and 55-24
Accounting for Income Taxes—Deferred Tax Recognition	740-10	55-7 through 55-11, 55-120 through 55- 123
Accounting for Income Taxes— Graduated Tax Rates	740-10	55-136 through 55- 138
Accounting for Income Taxes— State and Local Taxes	740-10	55-25 and 55-26
Accounting for Income Taxes— Tax Planning Strategies	740-10	55-39 through 55-48, 55-159 through 55- 164
Accounting for Income Taxes— Temporary Differences	715-30 740-10	55-4 and 55-5 25-18 through 25-31, 55-12 through 55-22, 55-52 and 55-53, 55- 66, 55-149 through 55-158
	740-30	25-7 and 25-8
Accounting for Income Taxes— Valuation Allowance	740-10	30-16 through 30-25, 45-20, 55-124 through 55-128
Alternative Minimum Tax	740-10	25-42 through 25-44
Business Combinations	805-740	All

Casinos	924-740	All
Change in Tax Laws or Rates	740-10	25-47 and 25-48, 30-26, 35-4, 45-16 through 45-18, 55-129 through 55-135
Change in Tax Status	740-10	45-19
Common Interest Realty Associations	924-740	All
Consolidated Financial Statements	740-10 740-30	30-27 and 30-28 05-1 through 05-7, 15-1 through 15-4, 25-1 through 25-6, 25-15 through 25-19, 45-1 through 45-3, 50-1 and 50-2
	810-10	45-8
Contingencies	450-10	55-4
Convertible Debt	740-10	55-51
Deferred Taxes for Asset Purchases Not Considered Business Combinations	740-10	25-49 through 25-55, 35-5, 45-22 through 45-24, 55-170 through 55-204
Depository and Lending Entities	942-740	All
Equity Method Investees	323-10 323-30 323-740	35-7 through 35-11, 55-27 through 55-29 35-2 All
Financial Statement Presentation—General	740-10	45-1
Financial Statement Presentation—Balance Sheet	740-10	45-2 through 45-13, 45-27, 55-78, 55-205 through 55-211
Financial Statement Presentation—Comprehensive Income	220-10	45-10B through 45-12

Financial Statement Presentation—Income Statement	740-10	45-14 through 45-26, 45-28
Foreign Operations	830-10	45-18
	830-20	05-3, 45-3, 45-5
	830-30	45-21
	830-740	All
Goodwill Impairment	350-20	35-7, 35-20 and 35-21, 35-25 through 35-27, 35-76, 55-10 through 55-23
Health Care Entities	954-740	All
Indefinite Reversal Criteria	740-30	25-17 through 25-19, 45-1 through 45-3, 50-1 and 50-2
Insurance Entities	944-740	All
Interim Periods	270-10	45-17
	740-270	All
Intraperiod Tax Allocation—General	740-270	05-1, 15-1 and 15-2, 60-1
Intraperiod Tax Allocation—Income Tax Expense or Benefit	740-270	05-2, 45-1 through 45-5
Intraperiod Tax Allocation—Continuing Operations	740-270	45-6 through 45-9, 55-1 through 55-7
Intraperiod Tax Allocation—Continuing Operations and One Other Item	740-270	55-8 through 55-14
Intraperiod Tax Allocation—Other Comprehensive Income	740-270	55-18 through 55-24
Intraperiod Tax Allocation—Other Than Continuing Operations	740-270	45-10 through 45-14
Intraperiod Tax Allocation—Tax Credit Carryforward	740-270	55-15 through 55-17
Inventory Cost Capitalization	330-10	55-3 and 55-4

Investment Entities	946-740	All
Investment in Qualified Affordable Housing Projects	323-740 325-20	All 35-5 and 35-6
Investment Tax Credit	740-10	25-45 and 25-46, 45-26 through 45-28, 50-20
Leveraged Leases	840-30	25-8, 30-14, 35-33 through 35-52, 45-5 through 45-7, 50-6, 55-17 and 55-18, 55-39 through 55-56
Nonmonetary Transactions	845-10	30-9
Nontaxable Subsidies	740-10	55-54 through 55-57, 55-166 and 55-167
Oil and Gas Producing Entities	932-740	All
Other Tax Credits	740-10	25-39 through 25-41, 30-14 and 30-15
Payments to Taxing Authorities	740-10	55-67 through 55-76
Reorganizations	852-740	All
Regulated Entities	980-250 980-740	55-4 All
Sale-leaseback Transfer of Tax Benefits	840-40	55-29 through 55-34
Segment Reporting	280-10	50-22, 50-25
Share-based Payments	260-10 718-740	45-29 All
Significant Estimates	740-10	55-218 through 55-222
Special Areas	740-30	25-5, 50-2
Special Deductions	740-10	25-37, 30-13, 55-27 through 55-30, 55-145 through 55-148

Steamship Entities	995-740	All
Tax Indemnification in Lease Agreements	460-10 840-10	55-23A 25-10 and 25-11, 25-53
Transactions With Shareholders	740-10	45-21
Uncertainties in Income Taxes	740-10	05-6, 15-2AA, 25-5 through 25-17, 25-56 and 25-57, 30-6 and 30-7, 30-29, 35-1 through 35-3, 40-1 through 40-5, 45-10A and 45-10B, 45-11 and 45-12, 45-25, 50-15 and 50-15A, 50-19, 55-3 through 55-6, 55-81 through 55-119, 55-217, 55-223 through 55-229

101.5 Because most of the authoritative literature on accounting for income taxes is contained in FASB ASC 740, this *Guide* generally focuses on the concepts of FASB ASC 740 unless specifically stated. The following paragraphs provide a brief synopsis of some of the aspects of FASB ASC 740.

101.6 **The Scope of FASB ASC 740** FASB ASC 740 provides guidance on the following aspects of accounting for income taxes:

- a. Computing deferred tax assets or liabilities.
- b. Presenting income tax expense in the income statement.
- c. Disclosing information about income taxes.
- d. Recognizing the effects of operating loss carrybacks and carryforwards.

e. Accounting for changes in tax rates.

f. Accounting for changes in a company's tax status.

101.7 FASB ASC 740 applies to all income taxes including federal, foreign, state, and local (including franchise) taxes based on income. The guidance applies to a company's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method and to foreign companies that prepare financial statements in accordance with U.S. generally accepted accounting principles.

101.8 **The Liability Method** FASB ASC 740 uses the concept of comprehensive tax allocation; that is, the tax effects of events that will ultimately affect both pretax accounting income and taxable income are reported in the period that the events occur. FASB ASC 740 requires an asset and liability approach for accounting for income taxes, commonly called the *liability method*. It focuses on the balance sheet and on calculating deferred tax assets and liabilities. Its objective is to measure the *future tax effects* of differences between events recorded for financial and income tax purposes at a particular point in time—the balance sheet date. Deferred income tax provisions are the differences between deferred tax balance sheet accounts during the year. Under FASB ASC 740, the basic calculation of the annual tax provision consists of the following elements:

a. Calculate the current tax provision for the year.

b. Calculate the tax effects at the end of the year of (1) differences between transactions recorded in the financial statements and those recorded in the tax return and (2) loss and tax credit carryforwards.

c. Provide a valuation allowance for the portion of deferred tax assets for which there is not more than a 50% chance of realization.

d. Subtract the deferred tax asset and liability at the beginning of the year from the amounts at the end of the year in steps b. and c. to obtain the deferred tax provision.

e. Add the difference to the current tax provision to obtain the total tax provision.

101.9 Under the liability method prescribed by FASB ASC 740, the amount of deferred taxes reported in the balance sheet is determined based on the tax rates that are expected to be in effect in the period that differences between the financial statements and the tax returns reverse. The initial calculations of deferred taxes are considered to be estimates and are subject to adjustment if tax rates change, if taxes are repealed, or if new taxes are imposed. Thus, at any point in time, deferred taxes recorded in the balance sheet represent the tax effect of reversals of differences between the financial statements and tax return when the differences are added to or subtracted from other sources of taxable income. The deferred tax effect is measured using the flat tax rate (34% under current federal tax law or 35% if taxable income exceeds \$10 million) or, when graduated rates are a significant factor, using the average tax rate that would apply to the estimated average annual taxable income during the reversal period. Therefore, calculating the tax effect requires estimating what that rate will be and what taxable income will be during the reversal period.

101.10 An overview of the basic requirements of FASB ASC 740 is included in Appendix 1A to this chapter. Detailed explanations of the requirements are provided in Chapters 2-6.

101.11 **Accounting for Uncertainty in Income Taxes** GAAP for uncertainty in income taxes in FASB ASC 740 defines a *criterion* that an individual tax position must meet before that position can be recognized in an entity's financial statements. The guidance requires a presumption that the tax position will be audited by a tax examiner. The position should not be recognized in the financial statements unless it is *more likely than not* (greater than 50%) to pass a tax audit based solely on the technical merits of the position. Thus, the basic calculation of the annual tax provision (in items a and b at paragraph 101.8) only considers tax positions that satisfy the more-likely-than-not criterion, which may not agree to the tax positions used for the tax return. GAAP for uncertainty in income taxes also provides guidance for measurement, classification, and disclosure of tax positions that do not meet the more-likely-than-not criterion for annual and interim financial statements.

101.12 Historically, temporary differences (the foundation of deferred income taxes) arise when the reported tax basis of an asset or liability differs from its reported amount in the financial statements. When uncertainty exists, however, a deferred temporary difference equals the difference between the portion of a reported tax basis of an asset or liability that is more likely than not to pass a tax audit based solely on the technical merits of the position and the reported amount in the financial statements.

101.13 Discussions and illustrative examples in this *Guide* generally assume that tax positions satisfy the more-likely-than-not requirements of GAAP for uncertainty in income taxes unless specifically stated otherwise. (Accordingly, tax positions supporting income tax returns are the same as those used to support the income tax provision for financial reporting purposes.) However, GAAP for uncertainty in income taxes is discussed thoroughly in Appendix 1G and throughout the *Guide*, including illustrative examples and disclosures covering topics such as identifying tax positions, evaluating and measuring tax positions, determining the effect on the current and deferred tax provisions, and reporting tax positions that do not meet the more-likely-than-not criterion in the financial statements.

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102 Income Tax Laws

102.1 GAAP for income taxes is closely tied to income tax laws. Under the liability method required by FASB ASC 740, deferred taxes recorded in the balance sheet are based on tax laws in effect at the financial statement date. Thus, accountants must be familiar with federal income tax laws and those of other jurisdictions, when applicable. This *Guide* gives an overview of the federal income tax laws that are likely to be encountered most frequently by accountants and explains the effect of those laws on the income tax amounts recorded in the financial statements. Although this *Guide* is designed to provide accurate information regarding income tax laws, because of their complex and transient nature, it is not a substitute for a careful study of the relevant laws or the professional judgment that must be exercised in every circumstance. Because state, local, and foreign tax provisions vary widely among jurisdictions, this *Guide* only discusses them in a general manner.

Federal Taxes

102.2 The current federal tax system for corporations consists of a regular tax system and an alternative minimum tax system. (Certain C corporations are exempt from the alternative minimum tax. See further discussion at paragraph 102.5.) The basic concept underlying the two systems is that companies should pay a minimum amount of federal taxes based on the earnings reported in their financial statements. Simply stated, companies that are not exempt from the alternative minimum tax calculate their income tax liability under both methods, and their tax liability is the higher amount. This section briefly discusses both the regular rate schedule and the alternative minimum tax system and highlights several issues related to other tax jurisdictions.

102.3 **Regular Tax Rates** As of the date of this *Guide*, regular corporate tax rates are as follows:

Taxable Income	Tax Rate
First \$50,000	15%
\$50,001 to \$75,000	25%

\$75,001 to \$100,000	34%
\$100,001 to \$335,000	39%
\$335,001 to \$10,000,000	34%
\$10,000,001 to \$15,000,000	35%
\$15,000,001 to \$18,333,333	38%
Over \$18,333,333	35%

Chapter 3 discusses regular tax rates in greater detail, and Exhibit 3-1 provides a table for calculating current taxes that incorporates the surtaxes into the marginal tax rates.

102.4 Net Operating Losses Deferred tax amounts are determined by applying existing tax laws, including those related to net operating loss deductions, to temporary differences that are scheduled to reverse in future years. Current federal tax rules permit companies to carryback or carryforward net operating losses—generally the excess of allowable deductions over gross income—to offset the taxable income of another year. All of the illustrations in this *Guide* are based on the current statutory provisions for tax years beginning after August 5, 1997, which allow net operating losses to be first carried back two years (beginning with the second preceding year) with any unabsorbed loss carried forward 20 years (beginning with the first year immediately following the loss year). See further discussion at paragraph 303.4.

102.5 Alternative Minimum Tax System Perhaps the most significant provision of the Tax Reform Act of 1986 is the corporate alternative minimum tax rules, which were conceived to ensure that all companies pay at least a minimum amount of tax. Under the rules, a company's tax liability is the greater of taxes calculated using either the regular tax system or the alternative minimum tax (AMT) system. In reality, the AMT rules are structured so that companies calculate two tax amounts: one based on the regular tax rules and a tentative minimum tax (TMT) based on the AMT rules. If TMT exceeds the regular tax, an additional tax equal to the excess, referred to as the AMT, also must be paid. The AMT is calculated by adjusting taxable income as determined in accordance with the regular tax system by certain adjustments and preference items to obtain *alternative minimum taxable income (AMTI)* and applying a flat 20% tax rate to AMTI in excess of an exemption amount. The exemption allowed is \$40,000, which is reduced by 25% of the amount by which AMTI exceeds \$150,000. Thus, if AMTI is \$310,000 or more, the exemption is zero. The AMT calculation is summarized as follows:

	Taxable income
+ or -	Adjustments
+	Preference items
=	Alternative minimum taxable income (AMTI)

	before exemption
-	Exemption
=	AMTI
×	20%
=	Alternative minimum tax (AMT)

Since the Taxpayer Relief Act of 1997, certain C corporations have been exempt from the alternative minimum tax. Beginning with the 1997 tax year, existing corporations were exempt from AMT if their three-year average annual gross receipts did not exceed \$5 million for the 1997 tax year and \$7.5 million for subsequent tax years. Current tax laws state that a new corporation receives an automatic AMT exemption in the first year of existence. The corporation remains exempt in its second year if gross receipts from the first year do not exceed \$5 million, and the corporation remains exempt in its third year if average gross receipts from the first two years do not exceed \$7.5 million. The corporation remains exempt in subsequent years as long as its average gross receipts for the three prior years do not exceed \$7.5 million. (See further discussion at paragraph 302.3.)

102.6 Within limitations, tax rules allow the excess of the alternative minimum tax over the regular tax to be carried forward indefinitely to reduce regular tax in future years. However, the credit cannot reduce the tax liability below the alternative minimum tax.

102.7 The regular tax system and the alternative minimum tax system are discussed in detail in Chapter 3.

Other Tax Jurisdictions

102.8 In calculating deferred taxes, FASB ASC 740-10-30-5 requires separate calculations to be made for each tax jurisdiction. Thus, if a company is subject to state, local, or foreign income taxes in addition to federal taxes, deferred taxes should be determined for each tax jurisdiction and the results combined to obtain the amounts to record in the financial statements. However, separate calculations are not necessary if the effect of applying a combined federal and state tax rate to the federal temporary differences is not materially different from separate calculations.

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103 Tax Accounting Workpapers

IRS Access

103.1 During an IRS audit, the agent may request a copy of the tax adviser's workpapers. Normally, this does not present much of a problem since the workpapers simply reflect information provided by the taxpayer. Furthermore, these documents can be obtained by the IRS through an administrative summons. Accordingly, it usually is advisable to provide the agent with copies of specific workpapers when requested. Consequently, all tax workpapers should be prepared with the understanding that the IRS can, if necessary, obtain access to them.

103.2 The Supreme Court held that tax accrual workpapers prepared by a CPA firm were not privileged and had to be disclosed to the IRS [*Arthur Young*, 465 U.S. 805, 53 AFTR 2d 84-866 (1984)]. Note that the privilege procedures for tax practitioners apply only to the extent the communication is for tax advice in a noncriminal matter before the IRS or in a federal court [IRC Sec. 7525(a)]. The courts have held this definition to a very strict standard and it does not include documents used in return preparation or accountant's workpapers [*U.S. v. Frederick*, 182 F.3d 496, 83 AFTR 2d 99-1870 (7th Cir. 1999), *cert den.* 528 U.S. 1154 (2000)].

103.3 The IRS has established guidelines in the Internal Revenue Manual (IRM 4.10.20) for Revenue Agents to follow in requesting accountant's workpapers. These guidelines apply in all cases except fraud cases. [The guidance (guidelines) of the Internal Revenue Manual (IRM) referred to in this discussion adhere to the guidance from IRS Announcement 2002-63 and Chief Council Notices CC-2003-012 and CC-2004-010.] The guidelines differentiate tax accounting workpapers as follows:

a. *Tax Reconciliation Workpapers.* Workpapers that are used in assembling and compiling financial data for the tax return. These papers typically include final trial balances for each entity and a schedule of consolidating and adjusting entries. They include information used to trace financial information to the tax return.

b. *Tax Accrual Workpapers*. Workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, reported on and disclosed in audited financial statements. These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.

103.4 Under these guidelines, the IRS agent (agent) is instructed to routinely request tax reconciliation workpapers at the beginning of the examination from either the taxpayer or the taxpayer's accountant. However, the guidelines are more restrictive for the agent's authorization to request tax accrual workpapers. The guidelines emphasize that tax accrual workpapers should be "requested with discretion and not as a matter of standard examining procedure."

103.5 Generally, according to the Internal Revenue Manual (IRM), before the agent can request the taxpayer's tax accrual workpapers, the agent must satisfy the IRS's *unusual circumstances standard*. Under the unusual circumstances standard, the agent should only request the tax accrual workpapers when "such factual data cannot be obtained from the taxpayer's records or from available third parties, and then only as a collateral source for factual data." Specifically, the IRM states that *unusual circumstances* exist when all of the following apply:

- a. The agent needs additional facts for a specific issue,
- b. The agent has requested from the taxpayer and applicable third parties all of the known facts related to the specific issue,
- c. The agent has sought a supplementary analysis of facts related to the specific issue, and
- d. The agent has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the specific issue.

103.6 The IRM states that the request should be "limited to the portion of the workpapers that is material and relevant to the examination." Also, the agent should initially request the tax accrual workpapers from the taxpayer, but requests of the taxpayer's accountant or independent auditor are also acceptable.

103.7 For requests of tax accrual workpapers supporting tax returns filed on or after July 1, 2002, the unusual circumstances standard does not apply when the tax return claims a tax benefit from abusive tax avoidance transactions, which are commonly referred to as *listed transactions*. {The IRS

defines listed transactions as transactions identified, or substantially similar to transactions identified, as tax avoidance transactions in IRS notices, regulations, or other public guidance [Regs. 1.6011-4(b)(2) and 301.6111-2(b)(2)].} The movement away from the unusual circumstances standard when requesting tax accrual workpapers reflects a much more aggressive approach in the tax shelter area.

103.8 Currently, for any tax return claiming benefits from listed transactions, IRS agents *must* request the tax accrual workpapers. However, the degree of access depends on whether the listed transaction was timely and properly disclosed on the tax return (as described by IRS Reg. 1.6011-4). If the listed transaction was properly disclosed, IRM guidelines state that the agents will routinely request only the tax accrual workpapers that pertain to the specific listed transaction for the tax return under examination.

103.9 However, under any of the following circumstances, the agents will routinely request *all* tax accrual workpapers for the year under examination:

- a. The listed transaction is not properly disclosed.

- b. The listed transaction is properly disclosed, but in connection with the examination of the return, there are reported financial irregularities.

- c. The listed transactions were properly disclosed, but the agents determine that the taxpayer claimed benefits from more than one of the listed transactions.

Furthermore, in all of these circumstances, the agents may also request tax accrual workpapers for years not under examination if they may be directly relevant to the examination of the listed transaction(s) or financial irregularities.

103.10 If a transaction becomes a listed transaction subsequent to the filing of the tax return, the agents will routinely request the tax accrual workpapers if the transaction is a listed transaction at the time of the request.

103.11 **Workpapers for Uncertainty in Income Taxes** The primary concern for taxpayers in complying with GAAP for uncertainty in income taxes is that the required disclosures would provide a “roadmap” for the IRS and other taxing authorities. The FASB considered this argument and eliminated certain disclosure requirements for *nonpublic* entities that caused the greatest concern for taxpayers. Another concern for both taxpayers and IRS agents was how the IRS would eventually classify workpapers for uncertainty in income taxes with respect to IRS access to such workpapers.

103.12 IRS Memo AM 2007-012 stated that “documentation resulting from the issuance of FIN 48 [GAAP for uncertainty in income taxes codified in FASB ASC 740-10] is considered tax accrual

workpapers,” so the IRS would have to satisfy the unusual circumstances standard (discussed in paragraph 103.5) to acquire such workpapers. The decision was based on the reasoning that FASB guidance does not dictate the documentation requirements for taxpayers and auditors. Rather, the SEC, PCAOB, and AICPA establish such requirements, which are not affected by FASB guidance.

103.13 The IRS's Large and Mid-Size Business Division [(LMSB) currently named the Large Business and International Division] submitted a memo to its auditors and updated its field examiners' guide to reflect the latest IRS policy with respect to disclosures and workpapers for uncertainties in income taxes as follows:

- Financial statement disclosures and other public documents should be considered by examiners when conducting risk assessments.
- If the examiner is unsure of the implications of a disclosure, the examiner should discuss the information with appropriate taxpayer personnel—similar to any other tax information that may raise a red flag.
- Workpapers are a subset of tax accrual workpapers, and thus, subject to “our current policy of restraint.”

103.14 **Workpapers for Effective Tax Rate Reconciliation** Shortly after IRS Memo 2007-012 was issued, the IRS distinguished another subset of tax accounting workpapers from tax accrual workpapers. Effective tax rate reconciliation workpapers are used to satisfy a FASB ASC 740 disclosure requirement to reconcile the reported amount of income tax expense attributed to continuing operations to the amount of income tax expense that would result if domestic statutory tax rates were applied to pretax income from continuing operations. The IRS issued Chief Council Notice CC-2007-015, which stated that effective tax rate reconciliation workpapers are not considered tax accrual workpapers because they are not prepared for the purpose of determining the proper reserve amount for tax contingencies. Also, effective tax rate reconciliation workpapers are not audit workpapers because they are not retained by the auditor for audit documentation purposes. Thus, similar to tax reconciliation workpapers, the IRS can routinely request effective tax rate reconciliation workpapers during an examination.

103.15 **Workpapers for Schedule UTP** The IRS's tax schedule for uncertain tax positions (Schedule UTP) is consistent with GAAP in that a tax position should generally not be included on Schedule UTP if the tax position is either immaterial or it is sufficiently certain so that a liability for unrecognized tax benefits (LUTB) is not required for financial reporting purposes. (See the discussion beginning at paragraph 103.22 for when an uncertain tax position should be included on Schedule UTP.)

103.16 Although hopeful that workpapers supporting Schedule UTP would be treated as those supporting uncertainty in income taxes for financial reporting purposes, the concern among taxpayers was that IRS examiners could routinely request the taxpayer's Schedule UTP workpapers to assess the strength of its tax positions. After the initial year of Schedule UTP, the IRS's Large Business and International Division submitted a memo to its auditors regarding Schedule UTP. Some of the many IRS policy decisions regarding Schedule UTP in the audit process include the following:

- For issues that are disclosed on the Schedule UTP, IRS examiners may ask the taxpayer for information about the relevant facts affecting the tax treatment of the position and information about the identity of the tax issue.
- IRS examiners may not ask the taxpayer to explain his or her rationale for determining a tax issue was uncertain, or for information about the hazards of the position or an analysis of support for or against the tax position.
- IRS examiners may not ask the taxpayer why a Schedule UTP issue is uncertain, nor can the examiners ask the taxpayer for copies of workpapers used to prepare Schedule UTP, any tax accrual workpapers, or any documents privileged under the modified policy of restraint (such as financial reporting workpapers for uncertainty in income taxes).

These policy decisions should alleviate some taxpayer concern regarding the protections provided to Schedule UTP workpapers. The following paragraphs discuss the specifics of IRS Schedule UTP.

Schedule UTP

103.17 For federal income tax reporting purposes, a public or privately held corporation must file Schedule UTP if all of the following apply:

- The corporation files IRS Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC.
- The corporation or a related party issued audited financial statements prepared using GAAP, IFRS, or a country-specific accounting standard that reports all or a portion of the corporation's operations for all or a portion of the corporation's tax year.
- The corporation has at least one tax position that must be reported on Schedule UTP.

- The corporation's total assets equal or exceed \$10 million.

Thus, Schedule UTP will ultimately apply to all corporations that satisfy the first three criteria. For pass-through entities and tax-exempt entities, the IRS has announced that it will consider whether to extend all or a portion of the requirements to later tax years.

103.18 Schedule UTP is filed as part of Form 1120 and is comprised of three parts. Tax positions taken by the corporation during the current year's tax return are reported on Part I. Tax positions taken by the corporation on a prior year's tax return not previously reported on a Schedule UTP are included on Part II. Concise descriptions of all tax position listed in Parts I and II are reported on Part III.

103.19 Parts I and II of Schedule UTP require the following for each tax position listed: (a) a UTP number for identification purposes, (b) the primary internal revenue code sections relating to the tax position, (c) whether it is a temporary or permanent difference (for GAAP purposes), (d) the EIN of the pass-through entity related to the tax position, if any, (e) whether the size of the tax position is at least 10% of all other uncertain tax positions listed, (f) whether the UTP is a transfer pricing tax position, and (g) the ranking of all tax positions listed (with 1 being the largest size). Part II also requires a six-digit number indicating the year and final month of the year (YYYYMM) in which the tax position was taken. When determining the size of a tax position (for items e and g above), all tax positions listed in both parts must be considered. Whether a tax position is reported on Schedule UTP and, if so, whether it belongs on Part I or Part II appears fairly straightforward, but as discussed beginning at paragraph 103.22, there are subtleties that may cause confusion.

103.20 Part 3 of Schedule UTP requires a concise description for each UTP listed in Parts I and II. The instructions to Schedule UTP state that “a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. In most cases, the description should not exceed a few sentences . . . [and] should not include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position.”

103.21 Due to identified problems with the quality of certain Schedule UTP disclosures, the IRS's Large Business and International Division (LB&I) is mailing letters to inform certain taxpayers that a review of their Schedule UTP determined that one or more of the concise descriptions they provided did not meet the Schedule UTP requirements and that future descriptions should follow the examples in the Schedule UTP Instructions. The letters are part of the IRS's education and outreach effort regarding Schedule UTP, which also includes guidance for preparing concise UTP descriptions. The guidance emphasized that descriptions “that do not clearly identify the taxpayer's tax position and/or that do not provide sufficient relevant facts to apprise the IRS about the nature of the issue do not meet the requirements of the instructions.” The guidance also provided a few examples of sufficient and insufficient descriptions. For instance, an insufficient concise description of “This is a research credit issue” would be better stated as follows:

The taxpayer incurred support department costs that were allocated to various research projects based upon a methodology the taxpayer considers reasonable. The issue is whether the taxpayer's method of allocating these costs is acceptable by the IRS.

This description concisely identifies the tax position and the nature of the uncertainty without including an assessment of the hazards of the tax position or an analysis of the support for or against the position.

103.22 Note that tax positions taken in years prior to the initial tax year for which a Schedule UTP was applicable should not be reported on Schedule UTP even if a LUTB (reserve) is recorded in audited financial statements issued in the initial year for which a Schedule UTP was applicable or later. More importantly, the final Schedule UTP does not require disclosure of the rationale for an uncertain tax position, assessment of the strength or weakness of the position, or a specific UTP amount. Also, as discussed in paragraph 103.15, Schedule UTP requirements for reporting UTPs is consistent with the more-likely-than-not recognition threshold in GAAP for uncertainty in income taxes. Specifically, a tax position should not be reported on Schedule UTP for a particular year unless—

- a. a tax position [claiming a deduction, loss, or credit (other than using NOL or credit carryforwards)] is taken on the corporation's tax return, and
- b. either (1) an income tax reserve for a tax position is recorded in the financial statements of the corporation or related party or (2) no income tax reserve was recognized because of the corporation's expectation to litigate the tax position.

For Schedule UTP purposes, recording an income tax reserve consists of either recognizing an LUTB for the tax position or reducing (not recognizing) a deferred tax asset for an unused NOL or credit carryforward related to the tax position.

103.23 For example, assume a tax position is taken on a corporation's 20X1 tax return (such as completely deducting an expenditure). Following GAAP for uncertainties in income taxes when preparing the financial statements that include the 20X1 tax year, the corporation determines it is more-likely-than-not that the expenditure should have been capitalized and amortized over five years, resulting in the recognition of a liability for an unrecognized tax benefit on the corporation's 20X1 financial statements. Although the uncertainty of the tax position with respect to this expenditure will last through 20X5 for financial reporting purposes (unless the uncertainty is sufficiently reduced and the liability derecognized within five years), the tax position for this expenditure will only appear on Schedule UTP in 20X1 because it does not affect subsequent tax returns.

103.24 Now assume the same facts except that following GAAP for uncertainties in income taxes when preparing the financial statements that include the 20X1 tax year, the corporation determines it

is more-likely-than-not that the expenditure should have been expensed. Thus, the corporation does not establish a liability for an unrecognized tax benefit for the transaction. Because the corporation did not establish a LUTB for the tax position taken on the 20X1 tax return for reasons other than expected successful litigation, the tax position does not have to be included on the corporation's 20X1 Schedule UTP.

103.25 However, in 20X2, new information involving the transaction leads the corporation to determine it is more-likely-than-not that the expenditure should have been capitalized and amortized over five years. The change in judgment results in the recognition of a liability for unrecognized tax benefits on the corporation's 20X2 financial statements for the tax position taken on the 20X1 tax return. Because the corporation took a tax position on its tax return for which it established a LUTB on its financial statements, the corporation must include the transaction on its 20X2 Schedule UTP. Also, since the corporation did not include the 20X1 tax position on its 20X1 Schedule UTP, it should report the 20X1 tax position on Part II of the 20X2 Schedule.

103.26 Next, assume the corporation makes an unrelated expenditure in 20X1 that it capitalizes and amortizes over five years for tax purposes. For financial reporting purposes, the corporation determines it is more-likely-than-not that the expenditure should not have been amortized or expensed, resulting in the recognition of a LUTB that will increase each of the four subsequent years as the transaction is amortized for tax purposes. In this situation, following the Schedule UTP reporting requirements as discussed at the end of paragraph 103.20, the tax position should be reported on Schedule UTP, Part I for each year of the five-year amortization period, because (a) the corporation established and maintained a LUTB for the tax position in each of the audited financial statements during the five-year period and (b) the corporation's tax position resulted in amortization deductions in each tax return during the five-year period. However, in year 20X6, the corporation would not report the transaction on Schedule UTP because although the corporation maintains the LUTB for financial reporting purposes, the transaction did not affect the 20X6 tax return.

103.27 Item a of paragraph 103.22 excludes the use of NOL or credit carryforwards from the reporting requirements of Schedule UTP. This exclusion agrees with the financial reporting logic of only recognizing a deferred tax asset associated with a carryforward if the related loss or credit is based on a tax position that meets the MLTN recognition criterion in FASB ASC 740 (as discussed in Appendix 1G, paragraph B40).

103.28 For example, assume a corporation shows a 20X1 tax return net operating loss equal to its only deduction. The corporation elects to carry forward the NOL to reduce a future tax liability. However, when preparing the financial statements that include the 20X1 tax year, the corporation determines it is more-likely-than-not that the taxing authority would not allow the deduction. Thus, the corporation would not recognize a deferred tax asset for its tax NOL because the underlying tax position creating the NOL does not satisfy the MLTN recognition criterion. (The corporation would not establish an LUTB for the uncertain tax position of claiming the deduction because there was no tax benefit realized in the 20X1 tax return.) On its 20X1 Schedule UTP, the corporation should include the tax position to take the deduction because not recognizing the related NOL satisfies items a and b(1) of paragraph 103.22. However, the corporation should not report on Schedule UTP the fact that

it did not recognize the loss carryforward.

103.29 In 20X3, the corporation uses its NOL carryforward to reduce the tax liability reported on its tax return. When preparing the financial statements that include the 20X3 tax year, the corporation continues to believe it is more-likely-than-not that the taxing authority would not allow the deduction upon examination. Because the tax benefit of the 20X1 deduction was actually received for tax reporting during 20X3, the corporation should recognize a LUTB (with an offset to current tax expense) in its 20X3 financial statements. However, the tax position to use the NOL carryforward should not be reported on the corporation's 20X3 Schedule UTP because it does not satisfy item a of paragraph 103.22. Logically, use of the NOL carryforward for tax reporting in 20X3 is only possible due to the underlying uncertain tax position to claim the deduction in 20X1. Because the underlying tax position was reported in the 20X1 Schedule UTP, reporting the use of the NOL carryforward in the 20X3 Schedule UTP would, in essence, result in double counting.

103.30 In this example, the amount of the uncertain tax deduction and the 20X1 NOL carried forward were the same. However, the Schedule UTP reporting requirements would not change even if those amounts were different. That is, if a portion of the deduction was used to lower taxable income to zero on the 20X1 tax return and the remaining portion became an NOL carryforward, the deduction would still be reported on the 20X1 Schedule UTP because it would satisfy both items a and b(1) of paragraph 103.22. [A tax position was taken on the tax return with a reserve (an LUTB for the portion of the deduction realized in the 20X1 tax return) recorded in the financial statements.] Similarly, if the 20X1 NOL was greater than the amount of the deduction, the deduction would be reported on the 20X1 Schedule UTP because it would also satisfy both items a and b(1) of paragraph 103.22. [A tax position was taken on the tax return with a reserve (not recognizing a deferred tax asset for the portion of the unused NOL related to an uncertain tax position) recorded in the financial statements.] For both of these scenarios, when the corporation uses the NOL carryforward in 20X3 to reduce the tax liability reported on its tax return, the corporation would not report the tax position to use the NOL carryforward on its 20X3 Schedule UTP because it does not satisfy item a of paragraph 103.22 for the same reason indicated in paragraph 103.29.

103.31 Note that item b(2) of paragraph 103.22 results in an inconsistency between recognizing UTPs for financial reporting purposes and disclosing UTPs for tax purposes under Schedule UTP. For example, assume the same facts in the scenario discussed at paragraph 103.23 except that although the corporation determines it is more-likely-than-not that the expenditure should have been capitalized and amortized over five years, it does not recognize a LUTB because of the corporation's expectation to litigate its tax position to immediately deduct the entire expense. Thus, although the corporation would not recognize a LUTB for GAAP purpose, it would have to disclose the tax position on Schedule UTP because it satisfies both of the criteria listed at items a and b(2) of paragraph 103.22. An implication of this inconsistency is that the pool of potential tax positions for disclosure on Schedule UTP is not limited to those that resulted in a total or partial LUTB under GAAP for uncertainties in income taxes. Tax positions taken on the corporation's tax return should be reviewed to identify those that did not result in any LUTB due to expectations of successful litigation of the tax position.

103.32 In conjunction with the issuance of Schedule UTP, the IRS issued Announcement 2010-76 to clarify its position for requesting legal opinions and other documents supporting an entity's tax positions as follows:

- Disclosure of an uncertain tax position on Schedule UTP will not waive any privileges under the attorney-client privilege, the tax-advice privilege in IRC Sec. 7525, or the work product doctrine unless (a) the entity has engaged in an activity or taken action that would waive these privileges or (b) the IRS requests tax accrual workpapers because of unusual circumstances or the entity claimed benefits from listed transactions. (See the discussion beginning at paragraph 103.5 concerning the unusual circumstance standard and listed transaction standard.)
- Upon routine IRS request of an entity's tax reconciliation workpapers (as discussed beginning at paragraph 103.3), the entity may redact the following information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP: (a) working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP; (b) the amount of any LUTB related to a tax position reported on Schedule UTP; and (c) computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a major tax position (as defined in item e of paragraph 103.19).

This clarification essentially confirms the statement in IRS Memo AM 2007-012 (discussed at paragraph 103.12) that documentation supporting the disclosure of an uncertain tax position is considered tax accrual workpapers.

Evidential Matter

103.33 Due to the more aggressive stance the IRS has taken with tax accrual workpapers, some taxpayers may not prepare or maintain appropriate documentation of the income tax accrual calculation. However, suppressing tax accrual documentation may also interfere with the ability of the taxpayer's independent auditor to issue an unmodified report on the taxpayer's financial statements.

103.34 Interpretation No. 1 of AU-C 500, *Audit Evidence* (AU-C 9500.01-.22), emphasizes that the client is responsible for the tax accrual, the underlying support for the accrual, and the related disclosures, but requires that auditor's income tax accrual workpapers include appropriate details to allow reviewing and supervising auditors to understand the nature, timing, extent, and results of the audit procedures, as well as any significant findings, conclusions reached, and significant judgments made in reaching those conclusions. Limitations on the auditor's ability to access the information considered necessary to audit the tax accrual, such as through improper taxpayer documentation or refusing auditor access to the documentation, will affect the auditor's ability to issue a nonqualified opinion on the taxpayer's financial statements.

103.35 The Interpretation acknowledges that a taxpayer may provide its outside legal counsel, third-party tax advisors, or internal tax or legal counsel with income tax accrual information. In such situations, the taxpayer may ask those sources to provide the auditor with an opinion on the adequacy of the income tax accrual, and perhaps, attempt to limit the auditor's access to the documentation that supports the counsel's (or advisor's) opinion. The Interpretation states that an auditor is not allowed to accept the analysis or opinion of third party (or the taxpayer's in-house) advisors or legal counsel "without careful consideration and application of the auditor's tax expertise and knowledge about the entity's business."

103.36 To document the auditor's *careful consideration* of an opinion stated by an outside (or internal) advisor or legal counsel, the interpretation requires the auditor to obtain access to the opinion even if the taxpayer, advisors, or legal counsel attempt to restrict access through attorney-client (or similar) privilege. Once obtained, the auditor's documentation should include either (a) the actual advice or opinions rendered or (b) other sufficient documentation or abstracts, which support the analysis and conclusions. Also, the auditor may accept the taxpayer's analysis summarizing an outside adviser's (or legal counsel's) opinion if the taxpayer provides "sufficient appropriate audit evidence" to the auditor.

Documentation

103.37 Although AU-C 500 states that supporting documentation includes information obtained by the auditor from inquiry, observation, inspection, confirmation, recalculation, reperformance, and analytical procedures, it does not discuss the quantity, type, and content of audit documentation. However, Interpretation No. 1 does provide some guidance on the type of supporting documentation necessary for income tax accruals. Specifically, the Interpretation states that the auditor's documentation of tax accruals includes the following:

- a. Copies of the client's documents, schedules, or analyses (or auditor-prepared summaries thereof) to support the auditor's conclusions regarding the appropriateness of the taxpayer's accounting and disclosure of significant tax-related contingency matters.

- b. Procedures performed and conclusions reached by the auditor, including the taxpayer's documentary support for its financial statement amounts and disclosures.

- c. Significant elements of the taxpayer's analysis of tax contingencies or reserves, including roll-forward of material reserve changes.

- d. Taxpayer's position and support for its income tax related disclosures, such as its effective tax rate reconciliation.

e. Taxpayer's support for its intraperiod allocation of income tax expense or benefit to continuing operations and to items other than continuing operations.

f. Taxpayer's basis for assessing deferred tax assets and related valuation allowances and its support for applying the *indefinite reversal criteria* in FASB ASC 740-30-25-17, *Accounting for Income Taxes—Special Areas*, including its specific plans for reinvestment of undistributed foreign earnings. (See the paragraphs beginning at 605.1 for further discussion of the indefinite reversal criteria.)

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