PROPOSED FASB STAFF POSITION

No. FAS 109-a

Title: Application of FASB Statement No. 109, *Accounting for Income Taxes,* for the Tax Deduction Provided to U.S. Based Manufacturers by the American Jobs Creation Act of 2004

Comment Deadline: December 1, 2004

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) that provides guidance on the application of FASB Statement No. 109, *Accounting for Income Taxes*, to the provision within the American Jobs Creation Act of 2004 (the Act), which provides tax relief to U.S. domestic manufacturers.[1]

Background and Issue

2. On October 22, 2004, the Act was signed into law by the President. This Act includes tax relief for domestic manufacturers by providing a tax deduction up to 9 percent (when fully phased-in) of the lesser of (a) "qualified production activities income," as defined in the Act, or (b) taxable income (after the deduction for the utilization of any net operating loss carryforwards).

3. As a result of this Act, an issue has arisen as to whether this deduction should be accounted for as a special deduction or a tax rate reduction under Statement 109.

FASB Staff Position

4. The FASB staff believes that the domestic manufacturing deduction's characteristics are similar to special deductions illustrated in paragraph 231 of Statement 109 because the domestic manufacturing deduction is based on the future performance of specific activities, including the level of wages. Accordingly, the FASB staff believes that the deduction provided for under the Act should be accounted for as a special deduction in accordance with Statement 109 and not as a tax rate reduction.

5. The FASB staff also reminds preparers that the special deduction should be considered by an enterprise in (a) measuring deferred taxes when the enterprise is subject to graduated tax rates and (b) assessing whether a valuation allowance is necessary as required by paragraph 232 of Statement 109. See Appendix A for examples of the application of paragraphs 27 and 232 of Statement 109 for the impact of the domestic manufacturing deduction upon enactment of the Act in 2004.

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[1]This FSP refers to and describes a provision within the Act. While those comments reflect the best efforts of the FASB staff to describe relevant aspects of the Act, this FSP shall not be considered a definitive interpretation of any provision of the Act for any purpose.

Effective Date and Transition

6. This FSP is effective upon issuance.

7. An enterprise that previously recognized the domestic manufacturing deduction as a tax rate reduction shall restate its financial statements in accordance with paragraph 27 of APB Opinion No. 20, *Accounting Changes*, to reflect the deduction as a special deduction as prescribed in paragraphs 231 and 232 of Statement 109 and provide the disclosures required by paragraph 28 of Opinion 20 and paragraph 14 of FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, if applicable.

Appendix A

EXAMPLES OF TREATING THE DOMESTIC MANUFACTURING DEDUCTION AS A SPECIAL DEDUCTION

The following examples[2] illustrate the requirements of paragraphs 27 and 232 of Statement 109 to consider the domestic manufacturing deduction upon enactment of the Act by an enterprise with a December 31, 2004 year-end.

Example 1

Assumed Facts:

• Expected taxable income (excluding the domestic manufacturing deduction and net operating loss carryforwards) for the year 2005	$1,000
• Expected qualified production activities income for the year 2005	$500
• Net operating loss carryforward at December 31, 2004, which expires in 2005	$100
• Statutory income tax rate if taxable income exceeds $380	35%
• Statutory income tax rate if taxable income is equal to or less than $380	30%
• Domestic manufacturing deduction: 9 percent of the lesser of (1) qualified production activities income or (2) taxable income	$45

Conclusion:

The enterprise should have a net deferred tax asset balance of $35 for the net operating loss carryforward ($100 × 35%). The domestic manufacturing deduction had no impact on the tax rates nor did it result in a need for the enterprise to recognize a valuation allowance on its existing net operating loss carryforward because expected taxable income of $955 ($1,000 – $45) exceeds the $100 net operating loss carryforward.

[2]The examples are not intended to reflect actual tax rates that have been enacted under U.S. tax law. For instance, the examples use a statutory rate that applies to all taxable income, regardless of the level of taxable income. However, the U.S. tax law contains a graduated tax rate structure that is not reflected in the examples.

Example 2

Assumed Facts:

• Expected taxable income (excluding the domestic manufacturing deduction and net operating loss carryforwards) for the year 2005	$400
• Expected qualified production activities income for the year 2005	$500
• Net operating loss carryforward at December 31, 2004, which expires in 2005	$100
• Statutory income tax rate if taxable income exceeds $380	35%
• Statutory income tax rate if taxable income is equal to or less than $380	30%
• Domestic manufacturing deduction: 9 percent of the lesser of (1) qualified production activities income or (2) taxable income	$36

Conclusion:

After considering the impact of the Act, the enterprise should have a net deferred tax asset balance of $30 for the net operating loss carryforward ($100 × 30%) because the domestic manufacturing deduction reduces expected taxable income of the enterprise needed to recover its net operating loss carryforwards to the lower tax rate ($400 – $36). Assuming the net operating loss was recognized prior to the Act, the enterprise would have recognized a deferred tax asset of $35 for the net operating loss carryforward. Therefore, a deferred tax expense of $5 should be recognized in the period the Act was enacted to reduce the deferred tax asset account to the appropriate balance.

Additionally, the enterprise does not need to recognize a valuation allowance on its existing net operating loss carryforward because expected taxable income of $364 ($400 – $36) exceeds the $100 net operating loss carryforward.

Example 3

Assumed Facts:

• Expected taxable income* (excluding the domestic manufacturing deduction) for the year 2005	$400
• Expected qualified production activities income for the year 2005	$500
• Taxable temporary differences** at December 31, 2004, that are expected to reverse in 2005	$100
• Statutory income tax rate if taxable income exceeds $380	35%
• Statutory income tax rate if taxable income is equal to or less than $380	30%
• Domestic manufacturing deduction: 9 percent of the lesser of (1) qualified production activities income or (2) taxable income	$36

*Including reversing temporary differences
**Related to both qualifying and nonqualifying production activity

Conclusion:

After considering the impact of the Act, the enterprise should have a net deferred tax liability balance of $30 ($100 × 30%) because the domestic manufacturing deduction reduces expected taxable income of the enterprise to the lower tax rate ($400 – $36). Assuming the taxable temporary differences arose prior to the Act, the enterprise would have recognized a $35 deferred tax liability for those differences. Therefore, a $5 deferred tax benefit should be recognized in the period the Act was enacted to reduce the deferred tax liability balance to the appropriate amount.

Example 4

Assumed Facts:

• Expected taxable income (excluding the domestic manufacturing deduction and net operating loss carryforwards) for the year 2005	$21,000
• Expected qualified production activities income for the year 2005	$50,000
• Net operating loss carryforward at December 31, 2004, which expires in 2005	$20,000
• Statutory income tax rate if taxable income exceeds $380	35%
• Statutory income tax rate if taxable income is equal to or less than $380	30%
• Domestic manufacturing deduction: 9 percent of the lesser of (1) qualified production activities income or (2) taxable income	$1,890

Conclusion:

The enterprise would recognize a valuation allowance for the portion of the net operating loss carryforward that is expected to expire as a result of considering the domestic manufacturing deduction in the expected taxable income, which otherwise would not have been necessary.

Assuming the net operating loss was recognized prior to the enactment of the Act, the enterprise would have recognized a deferred tax asset of $7,000 from the net operating loss carryforward ($20,000 × 35%). Therefore, an enterprise would recognize a valuation allowance of $311.5 ($890 × 35%) in the period the Act was enacted, which is calculated as follows:

Expected taxable income (excluding the domestic manufacturing deduction) for the year 2005	$21,000
Less the manufacturing deduction	1,890
Expected taxable income including the manufacturing deduction	$19,110
Net operating loss carryforward	20,000
Net operating loss expected to expire	$890
Tax Rate	35%
Valuation allowance	$311.5