



January 27, 2015

Mr. Russell G. Golden, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Reference: File Reference NO. 2015-200-I and File Reference NO. 2015-210-II

Dear Chairman Golden:

The Committees on Corporate Reporting (CCR) and Taxation (COT) of Financial Executives International (FEI) wish to share our views on the Financial Accounting Standards Board's (FASB) project on *Accounting for Income Taxes: Intra-Entity Asset Transfers and Balance Sheet Classification of Deferred Taxes*. FEI is a professional association representing the interests of more than 10,000 chief financial officers, treasurers, controllers, chief tax officers, and other senior-level financial executives from over 8,000 major companies throughout the United States, Canada, and Japan. CCR is a technical committee of FEI that reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. COT formulates FEI's statements and positions on matters pertaining to tax legislation, policies, practices, rules, and regulations based on its expertise in tax matters. This statement represents the views of CCR and COT and not necessarily the views of our members individually.

The purpose of this letter is to share the concerns of CCR and COT regarding the Board's tentative decision on October 22, 2014 to amend ASC 740 and supersede the existing guidance governing the computation of deferred taxes on intra-entity asset transfers. As discussed below, we believe that the proposed rule fails to achieve the objectives of the simplification initiative and produces a financial statement result that has the potential to confuse financial statement users and undermine the credibility of financial reporting. Accordingly, we respectfully request the Board to reconsider its tentative decision.

Background

In January 2014, the FASB announced a Simplification Initiative to identify and evaluate areas of U.S. U.S. GAAP where complexity and costs can be reduced while maintaining or improving the usefulness of the information required to be reported for users of financial statements. CCR and COT strongly support this initiative. One of the topics for potential simplification proposed by others is accounting for the tax consequences of intra-entity transfers. Members of CCR and COT have met individually with the FASB staff regarding the consequences of these potential amendments to the income tax accounting rules.

At its October 22, 2014 meeting, the Board tentatively decided to require recognition of the current and deferred income tax consequences of an intra-entity transfer when the transfer occurs. This supersedes the current rule that defers the recognition of income tax consequences until the asset(s) have been sold to an outside party. As a result, sales between affiliates will generate a tax effect in earnings while the pre-tax profit will continue to be eliminated.

CCR and COT observe that changing the income tax accounting for intra-entity transfers has been debated for many years. Ten years ago, the FASB reached a tentative decision to change the guidance in this area under the short-term convergence project related to income taxes (December 15, 2004). On April 20, 2005, CCR and COT submitted a joint letter to the FASB that addressed its concerns with that proposal and recommended that the Board not change the accounting for both technical and practical reasons.

Our views on the desirability of these proposed amendments have not changed. Further, we wish to raise certain additional concerns with the proposal as it relates to the FASB's desired outcome from work in this area. We understand that the broad objective of the Simplification initiative is to undertake steps to simplify U.S. GAAP over a relatively short time period. More specifically, the projects are intended to improve or maintain the usefulness of the information reported to investors while reducing costs and complexity in financial reporting. We do not believe that this change accomplishes either of these goals for the following reasons:

- Practices and procedures under the existing guidance are well-established and understood. We are not aware of diversity in practice or concerns that the current approach, under which the impact of intercompany transactions has no earnings effect, yields results that are not understandable or costly to prepare. To the contrary, it makes intuitive sense that the tax accounting would be aligned with the pre-tax accounting treatment.
- The proposal will require transition to a different set of requirements that will be as complex to implement as the original principles were. Companies will need to modify their existing processes to accommodate the income tax accounting for intra-entity asset transfers without the benefit of improved financial reporting to justify the change.
- Given that it is difficult to argue that either the current approach or the proposed rule is demonstrably simpler, as both require routines and controls to produce the desired application, we believe, that the approach that already has existing processes in place, should be the preferred approach.
- Since the guidance will require a tax provision on a transaction that does not otherwise produce pre-tax gains or losses at the consolidated entity level, it is likely to create more confusion and increase the possibility of errors.
- Assessing a valuation allowance on a deferred tax asset generated from an intra-entity transaction adds to complexity. Under the current guidance, the purchaser would not set up a deferred tax asset and would instead recognize the tax effects when the asset is sold outside the group (or, as it is depreciated/amortized for tax purposes). With the required recognition, there is a need to evaluate the realizability of the deferred tax asset, which involves a level of judgment and analysis that does not exist today under current U.S. GAAP.
- It is important to note that the deferred tax impact is proposed to be recorded at the tax rate of the purchaser not at the rate of the seller, which we find to be counterintuitive.

While the Committees believe that the fact that the proposal does not achieve goals of the simplification initiative is, by itself, grounds to rescind the tentative decision, we also observe the proposal appears to run counter to the principles underlying the preparation of consolidated financial statements as well as those of deferred tax accounting. As we stated in our comment letter in 2005:

A longstanding accounting principle, codified in ARB 51, *Consolidated Financial Statements* (ARB 51), is that consolidated financial statements should not include gain or loss on transactions among members of the consolidated group. As discussed in paragraphs 121-124 of FAS 109, the Board recognized the primacy of this fundamental principle in deciding to reject the FAS 96 approach to accounting for the tax effects of intercompany transfers and instead adopting the paragraph 9(e) exception in FAS 109. CCR strongly supported that decision during the due process leading to the issuance of FAS 109 and continues to do so today.

Given the significant differences in income tax rates among tax jurisdictions and the complex supply chains utilized by global manufacturing companies, we do not believe that recognition of a net tax benefit or expense at the time of transfers within the consolidated group (potentially long before recognition of income from the sale to a third party) would be an improvement to financial reporting. In addition, we believe financial statement users would be concerned that period-to-period tax provisions and earnings were being affected, potentially significantly, by transfers of goods between members of the consolidated group that had supposedly been eliminated for the consolidated financial statements. As financial statement preparers, we are also concerned that the counterintuitive nature of the results obtained under the Board's proposal could be misinterpreted as earnings manipulation even though this is not the case.

The conceptual underpinning of the proposed standard is that an intercompany transfer of assets between tax jurisdictions is a taxable event that establishes a new tax basis in the buyer's tax jurisdiction and that the new tax basis of those assets would be deductible on the buyer's tax return when the cost of those assets as reported in the consolidated financial statements is recovered. That model, however, would not record the correct amount of tax were the asset to be recovered for its book carrying amount, consistent with the basic design of deferred tax accounting under ASC 740. Referring back to our 2005 letter, we stated that:

This model fails to recognize the fact that transfer pricing is governed by laws intended to assure that companies pay taxes on the proportion of total profits earned in each taxing jurisdiction. Under the inventory transfer pricing rules of most tax jurisdictions, the new tax basis in the buyer's jurisdiction in the above model would not be fully deductible on the buyer's tax return in a transaction that results in recovery of only the carrying value of the inventory and a taxable loss in the buyer's tax jurisdiction. In fact, the situation described in the model (i.e., reporting profits in the shipper's tax jurisdiction and losses in the buyer's tax jurisdiction), is exactly the situation that the transfer pricing rules are designed to prevent.

As a practical matter, if the transferred inventory could only be sold for an amount equal to the shipper's cost, as presumed by FAS 109, the shipper would adjust its intercompany billing to the buyer to equal the amount actually realized. This action is entirely within the control of the consolidated enterprise, can be implemented at little or no cost to the

enterprise, and would eliminate both the seller's taxable gain and the buyer's non-deductible loss. As such, the actual future tax consequences of recovering the inventory at the amount reported in the financial statements would be the recovery of taxes paid by the seller at time of shipment. In this context, the deferred tax assets related to the increase in tax basis in the buyer's tax jurisdiction is, at best, a contingent asset and taxes paid by the seller represent a prepayment of taxes that are fully recoverable if, upon completion of the earnings process by sale of the inventory to an unrelated party, the intercompany profit invoiced to the buyer cannot be realized. The current accounting under FAS 109 is fully consistent with that reality.

Overall, CCR and COT believe that this proposal undermines the objectives of the Simplification initiative and would recommend that the Board discontinue work in this area on that basis. We appreciate the Board's consideration of these concerns. Representatives of CCR and COT would be pleased to meet with the Board and Staff at your convenience to address any remaining questions.

Sincerely,



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Chair, Committee on Corporate Reporting
Financial Executives International



Keith G. Butler
Chair, Committee on Taxation
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