January 31, 2018

Ms. Susan Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 2018-210

Dear Ms. Cosper:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the FASB's Proposed Accounting Standards Update, *Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* (the "proposed Update").

We recognize the importance of this proposed Update to certain stakeholders, particularly those in the financial services sectors. However, based on our outreach, many companies outside of the financial services sectors believe that the reclassification required by the proposed Update will not provide more decision-useful information. In addition, for many companies, the information necessary to determine the amount of the reclassification adjustment outlined in the proposed Update may not be readily available; thus, the cost and complexity of determining that adjustment likely exceeds the benefit. We address some of these complexities in more detail in the Appendix. For these reasons, we encourage the Board to make the one-time adjustment optional.

Alternatively, we believe there may be less complex approaches to reclassifying stranded tax effects out of accumulated other comprehensive income (AOCI). One approach would be to permit companies to reclassify all stranded tax effects from AOCI, not just those caused by the Tax Cuts and Jobs Act of 2017 (the "2017 Act"). This could be accomplished by determining the pre-tax amounts recorded in AOCI as of the date of enactment of the 2017 Act (or some other specified date), and multiplying those amounts by the statutory tax rate that will be in effect upon the expected reclassification of those amounts to net income. Under this approach, the tax effects remaining in AOCI would correspond to the deferred tax assets and liabilities for the temporary differences relating to gains and losses that have been accumulated in AOCI.

Another approach would be to permit companies to reclassify stranded tax effects related to certain components of AOCI (e.g., available-for-sale securities) while leaving others (e.g., cumulative foreign currency translation adjustments) stranded. We discuss both of these approaches in more detail in the Appendix.

The Appendix also contains our detailed responses to the Questions for Respondents in the proposed Update, and includes additional observations.

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If you have any questions, please contact David Schmid at (973) 236-7247 or Brett Cohen at (973) 236-7201.

Sincerely,

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Appendix

Question 1: Do you agree with the amendments in this proposed Update that would require a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the newly enacted federal corporate income tax rate? If not, why?

We encourage the Board to make adoption of the amendments in the proposed Update optional. While we recognize the benefit this proposed Update provides to certain stakeholders (particularly regulated stakeholders in the financial services sectors), we do not believe that benefit is universal. Based on our outreach, many companies outside of the financial services sectors believe that the reclassification required by the proposed Update will not provide more decision-useful information. In addition, many companies may not be able to easily determine the amount of the reclassification, causing the cost of implementation to significantly outweigh its benefit.

Complexities with the proposed Update

The proposed Update indicates that the amount of the reclassification from AOCI to retained earnings "...is the difference between the amount initially charged or credited directly to other comprehensive income at the previously enacted U.S. federal corporate income tax rate that remains in accumulated other comprehensive income and the amount that would have been charged or credited directly to other comprehensive income using the newly enacted 21 percent U.S. federal corporate income tax rate, excluding the effect of any valuation allowance previously charged to income from continuing operations."

We believe it may be difficult for many companies to determine the amount "that remains in accumulated other comprehensive income," especially for companies that have (a) experienced prior tax law or tax status changes, (b) have had prior business combinations for which a portion of the deferred tax assets and liabilities was initially recognized as part of purchase accounting while subsequent movements in those deferred taxes were reflected in OCI or (c) recognized or released valuation allowances in the past. Such companies may have recorded a deferred tax asset or liability on a change in net assets that was reflected in OCI in a period when a full valuation allowance existed, which would have resulted in no tax effect being recognized in OCI. Subsequently, the company may have released that valuation allowance, appropriately attributing the entire release to continuing operations, and then recorded the tax effects to OCI on subsequent remeasurements. For companies that had significant movements in valuation allowances over the years, or that have a valuation allowance currently, determining the tax effects that remain in AOCI could be particularly challenging.

We acknowledge that the proposed Update includes wording that attempts to address some of the complexities of determining the reclass amount caused by valuation allowances. However, we believe the wording in the proposed Update related to valuation allowances—"excluding the effect of any valuation allowance previously charged to income from continuing operations"—is unclear.

Consider, for example, the following simplified scenarios:

Scenario 1

During 2015, a company reported an unrealized loss on an available-for-sale security of $500 and at the same time, reported a deferred tax asset of $175 ($500 x 35%). The net effect ($325) was recorded in OCI. During 2016, the company experienced a further unrealized loss of $600 on the same security. It increased the deferred tax asset by $210 ($600 x 35%) to $385. However, in that same year, the company concluded that a full valuation allowance was needed on its deferred tax assets. As a result, the net loss in OCI for this security in 2016 was $600 (i.e., no tax effects due to the full valuation allowance), and the write off of the opening balance of the deferred tax asset of $175 was reported as tax expense in continuing operations. Assuming no other change in value of the investment prior to the tax law change on December 22, 2017, under existing GAAP, the company would record an equal and offsetting adjustment to the deferred tax asset and valuation allowance for $154 ($1,100 x 14%) to reflect the change in tax rates from 35% to 21%.

Scenario 2

During 2017, a company generated a capital loss carryforward of $1,000. Also during 2017 (before the tax law change), the company experienced unrealized gains on the remainder of its portfolio of available-for-sale debt securities of $800 that were recognized in OCI. Since the company has no other source of capital gains, it plans to sell the appreciated debt securities in a future period, if necessary, to use the capital loss carryforward before it expires. On that basis, the company records a deferred tax liability for the unrealized gains of $280 ($800 x 35%) with the offsetting deferred tax expense recognized in OCI, recognizes a deferred tax asset of $350 for the capital loss carryforward, and records a valuation allowance of $70 for the amount of the capital loss carryforward that is not supported by the existing unrealized gains. On the date of enactment of the 2017 Act, the company remeasures all of its deferred tax assets, deferred tax liabilities, and its valuation allowance, which net to zero, to reflect the new 21% rate.

In both Scenarios 1 and 2, the company's net deferred tax asset position on the balance sheet is zero; thus no net effect of the remeasurement is reported in continuing operations. It is therefore unclear how the proposed Update should be applied in this situation. One view might be that the company should not record a reclassification from AOCI to retained earnings for the remeasurement of its deferred taxes related to available-for-sale securities since the presence of the full valuation allowance resulted in no income statement impact as a result of the tax law change. An alternative view might be that, notwithstanding the existence of a valuation allowance (and a net deferred tax asset of zero in both scenarios), the company would be required to reclassify the amount that results from remeasuring deferred taxes that they had recorded in AOCI that remain in AOCI. So, for example, in Scenario 1, the company would be required to remeasure the $175 deferred tax benefit that was recorded in AOCI during 2015 and reclassify the remeasurement adjustment to retained earnings. And in Scenario 2, the company would be required to remeasure the $280 deferred charge that was recorded in AOCI during 2017 and reclassify the remeasurement adjustment to retained earnings.

It is also unclear whether a reclassification entry should be recorded for circumstances when the immediate effect of the 2017 Act is not limited to the difference in the federal corporate income tax rate. Consider, for example, a company that has historically accrued a deferred tax liability for its outside basis difference related to a controlled foreign corporation because it did not assert indefinite reinvestment. The company would adjust the deferred tax liability each period for the effect of foreign currency translation through OCI. At the date of enactment of the 2017 Act, the company would have reduced the deferred tax liability to the amount payable on the historical earnings and profits inherent in the outside basis difference in accordance with the provisions of mandatory deemed repatriation required under the new tax law, which is measured at specified rates for liquid assets and all other remaining earnings and profits, rather than 21%. Because, in this case, the effect of the tax law change on the deferred tax amounts related to the cumulative foreign currency translation adjustment is not specifically related to remeasuring a deferred tax amount to “the newly enacted rate of 21%,” it is unclear what amount, if any, would need to be reclassified between AOCI and retained earnings.

Similar questions have been raised regarding the deferred tax adjustments needed to reflect the prospective change to a territorial tax system and the state tax adjustments that were triggered automatically for those states for which the tax law conforms with the Internal Revenue Code. We believe the Board intends for these immediate tax effects of the 2017 Act to be included within the scope of the reclassification; however, the language as currently drafted is unclear.

Assuming it was the Board’s intent that these additional tax adjustments are to be reclassified to retained earnings, we observe that there could be unique challenges with those adjustments related to foreign currency translation adjustments. Short of performing a full backwards tracing exercise to identify the historical tax amounts related to each year’s OCI from the translation of outside basis differences and comparing those amounts to the ultimate tax effects that are now expected as a result of the mandatory deemed repatriation, it is unclear how the company should apply the proposed Update.

We are also concerned that the proposed Update may have unexpected consequences. For example, some companies enter into derivatives that act as after-tax net investment hedges. As a result of the 2017 Act, the change in the tax rate used to determine the tax effect of gains and losses on the hedging instrument would generally cause the company to be over-hedged since the tax rate assumed at designation would have been based on the previous statutory tax rate. Under current guidance, presuming the hedge was designed properly, there is no ineffectiveness related to the foreign currency translation since the effect of the tax rate change on the derivative instrument was recorded in continuing operations. In this case, the reclass entry to comply with the proposed ASU would actually create a disproportionate tax effect in AOCI related to the foreign currency translation.

Alternative approaches to be considered

We believe that there could be alternative approaches to determining the amount of the reclassification that could potentially reduce the complexity and provide more benefit to stakeholders, whether or not the adoption of the proposed Update is made optional.

One alternative is to permit companies to clear all stranded tax effects from AOCI, not just those caused by the 2017 Act. This could be accomplished by determining the pre-tax amounts accumulated in AOCI as of the date of enactment of the 2017 Act (or some other specified date), and multiplying those amounts by the statutory tax rate that will be in effect upon the expected reclassification of the AOCI items to net income. Under this approach, the tax effects remaining in AOCI would correspond to the deferred tax assets and liabilities for the temporary differences relating to gains and losses that have been accumulated in AOCI.

This approach would remove all historical stranded tax effects from AOCI instead of limiting the reclassification only to the stranded tax effects arising as a result of the 2017 Act. For some companies, this approach may be significantly less complex (if they have a ledger of all pre-tax items accumulated in AOCI). It also has the added benefit of eliminating any remaining stranded effects from AOCI, including, for example, a potentially significant disproportionate effect that was created in AOCI in 2010 in connection with the Affordable Care Act. In that case, companies with other post-employment benefit plans were required to adjust deferred taxes as a result of the elimination of the tax deductibility of retiree health care costs to the extent of federal subsidies received by plan sponsors that provide retiree prescription drug benefits equivalent to Medicare Part D coverage. This adjustment was required to be recorded entirely in continuing operations, thereby causing disproportionate effects to remain in AOCI as amounts are recycled into continuing operations.

Another alternative is to permit companies to reclassify stranded tax effects related to certain components of AOCI (e.g., available-for-sale securities) while leaving stranded tax effects of other components of AOCI (e.g., foreign currency translation adjustments). Certain categories of AOCI are easier to track than others, or by their nature are typically tracked in more detail. This approach could mitigate some of the complexities previously highlighted by permitting companies to choose not to reclassify stranded tax effects related to specific categories that either (a) present added complexity or (b) appear to yield counter-intuitive outcomes, such as is the case with the after-tax net investment hedge example described above.

Finally, for foreign currency translation adjustments, in particular, providing companies with the ability to forego a reclassification of stranded effects seems to align with the principles of ASC 830, *Foreign Currency Matters*, which prohibits the release of the cumulative foreign currency translation adjustment until a sale or a complete or substantially complete liquidation of an investment in the foreign entity.

We recognize that optionality — whether for the proposed Update as written, or in the form of the alternative approaches discussed above — can raise concerns about comparability. We believe this can be addressed via disclosure by requiring companies that opt to report a reclassification adjustment to disclose that fact, as well as what approach the company has used to determine the amount of the reclassification.

We also highlight that the concept of companies electing to reclassify between AOCI and retained earnings is currently permitted in certain situations under IFRS. For example, IFRS 9, *Financial Instruments*, permits a company to make an irrevocable election to present in OCI changes in the fair value of an investment in an equity instrument that is not held for trading. Amounts presented in OCI may not be subsequently transferred to profit or loss. However, the company may transfer the cumulative gain or loss within equity (i.e., from AOCI to retained earnings). Similar reclassification elections are available for pension obligations, revaluations of property, plant and equipment, and amounts in AOCI due to the "own credit" component of liabilities measured at fair value through profit or loss.

Question 2: Are the transition requirements appropriate? If not, what transition approach is more appropriate and why?

We agree with the proposed transition requirements.

Question 3: Do you agree that early adoption should be permitted?

Yes, we agree that early adoption should be permitted.

Question 4: Do you agree with the proposed effective date? If not, what effective date is more appropriate and why?

Yes, we agree with the proposed effective date.

Question 5: GAAP generally prohibits backwards tracing, which is the process of recognizing the effects of changes in deferred tax amounts in the current year in the same line item in which the deferred tax amounts were originally recognized (for example, other comprehensive income) in prior years. The Board did not allow backwards tracing as part of this project and is currently researching the merits of a broader project on backwards tracing. Should the Board add a broader project on backwards tracing to its active agenda? If so, why? Additionally, should the following alternatives to backwards tracing be considered in that broader project? If so, why?

> **a. Accounting for the release of the stranded tax effects from accumulated other comprehensive income**
>
> **b. Reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects associated with prior changes in other tax rates (for example, state and local taxes)**
>
> **c. Reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects associated with all future changes in tax rates.**

We do not believe the Board should add a broader project on backwards tracing to its active agenda for several reasons. First, during the Board's most recent agenda consultation, backwards tracing was not identified as a priority. We acknowledge that the agenda consultation was performed before the tax law change, and that the tax law change has focused attention on the significance of the stranded tax effects in AOCI caused by the tax law enactment. However, we expect that the proposed Update, if approved in some form, will address some of the most immediate financial reporting concerns.

Second, when the Board last had a backwards tracing project on its agenda, the Board concluded that, for a number of reasons, requiring backwards tracing was too complex and the benefits did not outweigh the added transparency of reporting certain events (e.g., changes in tax law, changes in tax status, and changes in valuation allowances) entirely in continuing operations. The majority of the challenges identified the last time the Board addressed this topic still exist today. For example, if a company established a valuation allowance in a year in which it had discontinued operations, a portion of that valuation allowance may have been allocated to the discontinued operation via the intraperiod allocation rules. If a decade later that company releases the valuation allowance, backwards tracing would require that a portion of that valuation allowance release be backwards traced to discontinued operations, even if the company has not presented discontinued operations in years.

Finally, we also note that with the increased usage of other comprehensive income, as well as changes in other accounting standards, the challenge of backwards tracing has been exacerbated. Consider, for example, a company that acquires a subsidiary immediately prior to a tax rate change. In that case, since most of the deferred tax assets and liabilities of the subsidiary were initially recorded in purchase accounting, backwards tracing of the effects of the tax law change would presumably require remeasuring goodwill, which would be inconsistent with the guidance in ASC 805, *Business Combinations*.

As a result, we believe that it would be beneficial for the Board to consider adding a more narrow project to its agenda related to reclassifying stranded tax effects in AOCI to retained earnings upon the occurrence of certain significant events. Such a project could contemplate an option to reset the tax effects in AOCI as of a given date (similar to our first alternative approach for the proposed Update discussed in Question 1) to remove all historical stranded effects. Then prospectively, a company could elect to reclassify stranded tax effects from AOCI to retained earnings upon the event that triggered the stranding (e.g., tax law change, establishment or reversal of a valuation allowance). As previously mentioned, this approach has parallels in IFRS. If such an approach is pursued, we encourage the Board to concurrently address the exception in ASC 740-20-45-7 that results in a “gross up” of tax effects between continuing operations and AOCI when there is a loss from continuing operations, even for companies with a full valuation allowance, as this exception can often be a source of stranded tax effects.