Accounting Implications of the 1984 Tax Act

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*HEADNOTE: This tax legislation poses some accounting issues, the answers to which may involve FASB action. The authors define the major accounting questions and discuss alternative views on the resolution of these matters.**

In July, 1984 President Reagan signed into law the Deficit Reduction Act of 1984. The Act consists of two divisions: the Tax Reform Act of 1984 and the Spending Reduction Act of 1984. While the new law will certainly receive considerable attention from tax professionals, financial accountants will also need to consider the accounting implications of the legislation. Of special interest to financial accountants are provisions relating to Domestic International Sales Corporations, LIFO conformity, taxation of stock life insurance companies, dividends received deductions and employee stock ownership plans.

Domestic International Sales Corporation

Since 1971 corporations have been permitted to form Domestic International Sales Corporations (DISCs), when income from that operation was derived predominantly from export sales and rentals. Although a portion of DISC income was included directly in the taxable income of its shareholder, tax deferral on the remaining DISC income was permitted under certain conditions. That tax could be deferred indefinitely until the income was actually distributed to the shareholder or the DISC failed to qualify as a DISC.

Deferral of income tax on a portion of DISC income created a timing difference between taxable income and financial reporting pretax income, the accounting for which was prescribed by APB No. 23, "Accounting for Income Taxes—Special Areas." The Opinion states that undistributed earnings of a subsidiary, including the portion of DISC earnings eligible for tax deferral, may result in a timing difference on which deferred taxes should be provided. Deferred income taxes would not be provided "if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation." The authors performed a survey of the Fortune 300 industrial com-

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* The FASB has released for comment proposed TBs addressing the accounting issues relating to the effects of the legislation on DISCs and stock life insurance companies.

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panies, using the AICPA's NAARS data base. The survey indicated that 113 companies disclosed the existence of a DISC. Of these companies, 31 provided deferred taxes on accumulated DISC income, and the others provided no deferred taxes presumably on the basis that the appropriate requirement was met.

The Tax Reform Act of 1984 establishes the Foreign Sales Corporation (FSC) as a replacement for the DISC, effective January 1, 1985. In addition to effectively† eliminating the DISC, the new law provides that accumulated DISC earnings distributed subsequent to December 31, 1984 will not be subject to federal taxation. Accordingly, deferred taxes previously provided on accumulated DISC earnings should be released to income as a reduction of income tax expense. APB Opinion No. 23, paragraph 12, states that "If it becomes apparent that some or all of the undistributed earnings of a subsidary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period . . ." The same logic should apply when the remittance will be tax-free.

. . . DISC earnings distributed subsequent to . . . 1984 will not be subject to federal taxation.

The requirement to release DISC deferred taxes is clear; the period in which to give effect to the release and the manner of doing so are less clear. A company may wish to release DISC deferred taxes in its pre-enactment interim or annual financial statements that are issued subsequent to enactment. Such an approach, which effectively treats enactment of the legislation as a Type I subsequent event, is based (a) on paragraph 12 of APB Opinion No. 23, (b) the view that the DISC provisions of the legislation are effective retroactively to prior years' deferred DISC income and (c) the example in paragraph 70 of FASI 18, "Accounting for Income Taxes in Interim Periods." It could also be argued, however, that effect should not be given to the legislation until issuance of the first financial statements with a period ending subsequent to enactment, treating enactment as a Type II subsequent event. This approach is based on the analogy to SFAS 31, "Accounting for Tax Benefits Related to U.K. Tax Legislation concerning Stock Relief." Finally, some contend that the effective date of the DISC provisions of the legislation is January 1, 1985 and that no effect should be given prior to that date.

There are also differing opinions on how the release of DISC deferred taxes should be effected in interim financial statements. The possibilities are: (a) prospectively through adjustment of the estimated effective annual tax rate, (b) as a discrete item in the period the deferred taxes are released and (c) by restating prior interim periods. The authoritative accounting literature for recording the effects of tax law changes of this nature in interim periods (SFAS 16, "Prior Period Adjustments"; SFAS 31; FASI 18) could be read to support any of the alternatives.

It is likely that the FASB will provide guidance for both of these issues to avoid diversity in practice.

Calculating the amount of DISC deferred taxes previously provided may not be a simple matter. It should be relatively easy for companies that have calculated deferred taxes on the DISC timing difference separately from other timing differences, using the liability method permitted by APB No. 23. But many companies may have aggregated the DISC timing difference with all other timing differences in calculating the deferred tax provision each year (the so-called "aggregate net change" method) and, thus, the DISC timing difference would have lost its individuality.

In this situation, the amount of DISC deferred taxes to release is the cumulative difference between prior years' actual tax provisions as previously calculated and those same tax provisions calculated without including deferred DISC income in the pretax accounting income on which those provisions were based. This approach will result in assigning deferred taxes to the cumulative DISC timing difference at the company's incremental tax rate, rather than its overall effective tax rate. If significant, the amount of DISC deferred taxes released to income should be disclosed.

The Tax Reform Act of 1984 overrules the Insilco decision, . . .

The principal difference between the DISC and the newly created FSC, from an accounting standpoint, is that a portion of FSC export income will be exempt from federal taxation, rather than deferred. Accordingly, the amount of exempt FSC income should be treated as a permanent difference and no deferred taxes should be provided.

LIFO Conformity

In January 1981, the Treasury Department issued final regs. relating to the LIFO conformity requirements. Although the rules are complex, their primary emphasis is that LIFO may not be used for tax purposes unless it is also used for financial reporting purposes. An exception to this rule was provided by the *Insilco* case. In this case, the Tax Court held that the LIFO conformity rules were met if a subsidiary reports to its parent on a LIFO basis and that basis is used in the consolidated tax return, even though the parent converts the inventory to a FIFO basis in preparing its consolidated financial statements. The Tax Reform Act of 1984 overrules the *Insilco* decision, and companies that have relied on that decision must now either adopt FIFO for tax purposes or LIFO for consolidated financial statement purposes for the subsidiary that had been using LIFO for tax purposes (the LIFO subsidiary).

† DISCs will continue for companies whose qualified export receipts are less than $10,000,000 annually.

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A change from FIFO to LIFO for financial reporting has several accounting implications. First, such a change constitutes a change in accounting principle, the accounting for which is prescribed by APB No. 20, "Accounting Changes." The Opinion indicates that, once adopted, an accounting principle should be consistently applied for events and transactions of a similar type unless a company justifies the use of an alternative principle as preferable in its circumstances. For SEC registrants, a preferability letter from the company's independent accountants must be filed with the SEC when such a change is made. The reason generally given to justify a change to LIFO is that the method achieves a better matching of revenue and expense since it matches the most recent inventory acquisition costs against current sales. While this rationale has merit, an assertion that LIFO is preferable must be evaluated according to the specific facts and circumstances of each company wishing to change.

... whether partial adoption of LIFO should be permitted for financial reporting purposes.

A change from FIFO to LIFO for a company's LIFO subsidiary would constitute partial adoption of LIFO unless the company changes to, or already uses, LIFO for all of its inventories. Partial adoption of LIFO is a controversial issue that is unsettled in practice. Some believe partial adoption should be permitted only if the inventories to be accounted for by the LIFO method can be distinguished from the company's other inventories, and the rationale justifying LIFO as preferable is not applicable to those other inventories. Supporters of this view contend that (a) absent a valid business reason, more than one inventory method cannot be preferable for the same company, (b) partial adoption of LIFO would enable a company to manipulate earnings by arbitrarily deciding when and to what extent to adopt LIFO and (c) the principal reason for adopting LIFO for only certain inventories is to avoid a large income statement effect in one year. Others believe that partial adoption of LIFO should be permitted without having to justify the retention of the old accounting method for the non-LIFO inventories. They contend that (a) APB No. 20 requires only that the change to LIFO be justified, (b) authoritative accounting literature does not require that all assets in a given category be accounted for by a single method (e.g., GAAP permits the use of more than one depreciation method for plant and equipment) and (c) some matching of the most recent acquisition costs with current sales is better than no such matching. The Accounting Standards Executive Committee (AcSEC) is presently considering a draft Issues Paper, "Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories." One of the items covered is whether partial adoption of LIFO should be permitted for financial reporting purposes. Until authoritative guidance is given on this subject or practice becomes settled, each situation will have to be evaluated on its own merits.

Another issue to consider when changing from FIFO to LIFO for financial reporting purposes is whether the change should be accounted for prospectively or through a cumulative effect adjustment. While APB No. 20 requires a cumulative effect adjustment for most changes in accounting principle, it indicates in paragraph 26 that computing the cumulative effect may, in rare situations, be impossible. The Opinion identifies a change from FIFO to LIFO as a likely example of such a situation and most companies that have changed to LIFO have done so prospectively. Calculating the cumulative effect of a change from FIFO to LIFO may not be impossible, however, when the change is in response to the reversal of the *Insilco* decision. It may be appropriate to calculate the cumulative effect adjustment by assuming that the LIFO method was adopted for financial reporting purposes coincident with its use for tax purposes. Complexities could still arise, however, with intercompany profit eliminations and any difference between tax and book bases of inventories resulting from purchase accounting adjustments.

Taxation of Stock Life Insurance Companies

Prior to the new tax law, stock life insurance companies were subject to a unique three-phase system of taxation. The annual tax liability was determined by applying normal corporate tax rates to the aggregate of:

Phase

- I The lesser of gain from operations or taxable investment income, as defined,
- II 50% of the excess, if any, of gain from operations over taxable investment income (the remaining 50% was added to policyholders' surplus); and
- III reductions in policyholders' surplus, as defined:

SFAS No. 60, "Accounting and Reporting by Insurance Enterprises," indicates that deferred taxes should not be provided on timing differences affecting income or loss from operations if a company expects, in the future, to be taxed on the basis of its taxable investment income (Phase I). The Statement also indicates that no deferred taxes should be provided on the portion of the difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus unless an eventual reduction in policyholders' surplus is anticipated (Phase III). Because of this situation, the proportion of timing differences on which deferred taxes have been provided varies considerably from company to company.

The Tax Reform Act of 1984 repeals the three-phase tax structure and replaces it with a single-phase structure, effective January 1, 1984. Under the new law, stock life insurance companies will be taxed on a basis generally similar to all other corporations. Insurance companies will continue to be taxed at normal corporate rates; however, the new law includes a special life insurance deduction, the effect of which is to reduce the effective statutory tax rate

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on life insurance income from 46 percent to 34.5 percent. Additionally, the new law converts certain timing differences to permanent differences.

As a result of the legislation, cumulative timing differences at December 31, 1983 will affect insurance companies' future income tax liabilities. Since deferred taxes may not have been provided on all such cumulative timing differences, a question arises whether stock life insurance companies should adjust their deferred tax accounts as a result of the legislation.

. . . the new law includes a special life insurance deduction, . . .

There are essentially two schools of thought on this issue: (1) the effects of the change in the law should be recognized currently by adjusting the deferred tax accounts to the amount that would have been recorded had the new law always been in effect (the liability approach) and (2) the effects of the change in the law should be recognized prospectively as the cumulative timing differences reverse (the deferred approach). The first approach is based on the liability method of interperiod tax allocation; some interpret SFAS No. 60 as endorsing the liability method for life insurance tax accounting. The second approach derives from the view that the new law essentially represents a change in the tax rate which, according to the deferred method of interperiod tax allocation prescribed by APB No. 11, "Accounting for Income Taxes," would not result in a current adjustment of the deferred tax accounts. A third, hybrid approach would release to income currently any deferred taxes that had been provided on the timing differences that the new law converted to permanent differences (liability approach) and recognize prospectively all other effects of the legislation (deferred approach).

An Issues Paper on this subject has been prepared by the AICPA Insurance Companies Committee and presented to AcSEC for its consideration. Five members of AcSEC supported the liability approach; seven members supported the deferred approach; one member supported the third approach. AcSEC unanimously agreed that the Issues Paper should be forwarded to the FASB for its consideration. It is likely the FASB will provide guidance on this matter.

Dividends Received Deduction

The dividends received deduction generally permits a corporate shareholder to deduct 85 percent of dividends received from other domestic corporations. The Tax Reform Act of 1984 essentially limits this deduction to the portion of the investment that is not financed by debt; this provision generally applies only to investments acquired subsequent to the date of enactment of the law. The possibility of a reduced dividends received deduction will have to be considered when providing deferred taxes on undistributed earnings in accordance with APB Opinion No. 24, "Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)."

That Opinion requires deferred taxes to be provided on the timing difference created by an excess of investee earnings over current dividend payments for investments in common stock (other than subsidiaries and corporate joint ventures) accounted for by the equity method for financial reporting purposes and by the cost method for tax purposes. The amount of deferred taxes to be provided will depend on whether the undistributed earnings are expected to be realized through sale of the investment or future dividends. The Opinion states that "If evidence indicates that an investor's equity in undistributed earnings of an investee will be realized in the form of dividends, an investor should recognize income taxes attributable to the timing difference as if the equity in earnings of the investee that the investor included in income was remitted as a dividend during the period, recognizing available dividend-received deductions . . ."

In situations where deferred taxes are provided on the assumption that the earnings will be realized through dividends, the dividends received deduction then available should be used in the calculation. The portion of the investment not financed by debt, and therefore the available dividends received deduction, can change over time. The effects of such change should be reflected in the cumulative deferred taxes provided on undistributed earnings.

Employee Stock Ownership Plans

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer stock is held for the benefit of employees. The new tax law allows the employer a tax deduction for dividends paid on stock held by an ESOP provided the dividends are paid out currently to employees.

APB No. 11 requires that the tax provision be allocated among "(a) income before extraordinary items, (b) extraordinary items, (c) adjustments of prior periods . . . and (d) direct entries to other stockholders' equity accounts." If the dividends are charged directly to retained earnings, then we believe the tax benefit obtained from the deduction for dividends paid to an EOSP should be credited directly to retained earnings.

Summary

This article highlights the more significant accounting implications of the tax Reform Act of 1984. The law has numerous specific provisions; it is likely that additional accounting issues will surface as this very detailed law is implemented. Careful attention also should be given to developments at the FASB. Not only is the Board likely to provide guidance on certain of the accounting issues discussed in this article, it is also expected to complete its reconsideration of all aspects of accounting for income taxes in 1985. Ω

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