Q&A Section 3300

Deferred Taxes

.01 Background to Section 3100.02 — Revised Section 163(j) Limitation

As part of the Tax Cuts and Jobs Act (TCJA), Section 163(j) of the Internal Revenue Code was amended to limit interest deductibility for a broader population of companies for tax years beginning after 2017. In general, the Section 163(j) rules limit deductions for net interest expense to 30% of adjusted taxable income, except for certain small businesses. For purposes of this limitation, *adjusted taxable income* is defined similar to the financial measure commonly referred to as *earnings before interest, tax, depreciation, and amortization* (EBITDA) for tax years beginning before December 31, 2021, and similar to the financial measure commonly referred to as *earnings before interest and taxes* (EBIT) for tax years beginning after December 31, 2021. The disallowed interest deduction has an unlimited carryforward period.

Since the enactment of the TCJA, the revised Section 163(j) limitation has led to more entities having a deferred tax asset (DTA) for this type of carryforward. More specifically, entities with significant debt and interest expense may have experienced (and expect to continue to experience) disallowed interest deductions every year.

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.02 Evaluation of the Realizability of a Section 163(j) Carryforward

Inquiry — When an entity expects to generate future disallowed interest deductions, how should an entity assess realizability of its existing DTA related to disallowed interest deductions when there are (*a*) reversing deferred tax liabilities (DTLs) and (*b*) an expectation of future interest expense that also will be limited under Section 163(j)?

Reply — FASB *Accounting Standards Codification* (ASC) 740-10-30-2(b) requires that a valuation allowance be established for a DTA if it is more likely than not that the related tax benefit will not be realized. Realization of DTAs depends on the existence of sufficient taxable income of the appropriate character within the carryback and carryforward period available under the tax law. These are the four sources of future taxable income (refer to FASB ASC 740-10-30-18):

1. Taxable income in prior carryback years if carryback is permitted under the relevant tax law
2. Future reversals of existing taxable temporary differences
3. Tax-planning strategies
4. Future taxable income exclusive of reversing temporary differences and carryforwards

FASB ASC 740-10-30-17 states the following:

> All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years.

Entities should consider each source of income incrementally to determine the amount of the valuation allowance needed, if any. FASB ASC 740-10-30-18 also states that "if one or more sources are sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered." If, for example, existing DTLs are sufficient to support realization of DTAs and the reversal patterns are such that offset is expected to be available under the tax law (after considering any tax law limitations), there is no need to consider remaining sources of taxable income.

When applying the preceding guidance to evaluate the realizability of DTAs related to disallowed interest carryforwards under Section 163(j), an entity should not recognize a valuation allowance if the taxable income to be generated upon reversal of its existing DTLs (ignoring future income or loss and future interest expense included in future income or loss) is sufficient to realize those DTAs, after considering reversal patterns and the 30% limitation. Whether an entity will continue to be in an interest limitation position each year in the future (resulting in an inability to use the Section 163(j) carryforward) is not relevant if the reversal of existing taxable temporary differences is sufficient to support realization of existing DTAs. Rather, if one source of future taxable income (the second source mentioned previously) exists, and that source is believed to be sufficient, then no other sources of future taxable income need to be evaluated.

If the reversal of existing taxable temporary differences is not sufficient to realize existing DTAs (for example, the entity is in a net DTA position), then additional sources of taxable income (for example, projections of future taxable income exclusive of reversing temporary differences and carryforwards) would be considered. In these situations, future limitations would be relevant and need to be considered in the projections and in assessing the realizability of any remaining DTAs, whether related to Section 163(j) or otherwise. Future income projections may represent an incremental source of taxable income for purposes of realizing those DTAs but would not affect the assessment of DTAs already deemed realizable as a result of the reversal of existing taxable temporary differences.

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