

High Tech Accounting

Updates, New Issues, Tips

□ Panel:

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Agenda

- FIN 48
- FAS 52
- APB 23
- Tax Holidays
- New Legislation
- FIN 18



FIN 48



Tax Position

- FIN 48 applies to all tax positions accounted for in accordance with FAS 109.
- The term *tax position* refers to a “position . . . that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods.”
- A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets.
- The term tax position also encompasses, but is not limited to
 - a decision not to file a tax return
 - an allocation or shift of income between jurisdictions
 - the characterization of income or a decision to exclude reporting taxable income in a tax return
 - a decision to classify a transaction, entity or other position in a tax return as tax exempt.



Recognition

- An enterprise initially recognizes the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.
 - The terms *examined* and *upon examination* include resolution of the related appeals or litigation process, if any.
 - The recognition threshold is met when the taxpayer concludes that . . . it is more likely than not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort. (FIN 48—Appendix A)
 - The appropriate unit of account for what constitutes an individual tax position and whether the more-likely-than-not recognition threshold is met for a tax position is a matter of judgment.



Recognition

- It is presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of the relevant information
- The technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law).
 - *What the past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises are widely understood, those practices and precedents shall be taken into account*
- Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.



Recognition—Administrative Practices

- The Board became aware of certain administrative practices and precedents under which taxing authorities do not object to a limited number of tax positions that may be deemed technical violations of the tax law. The Board understands that those administrative practices and precedents are broadly understood by preparers, tax practitioners, and auditors. This Interpretation permits an enterprise to consider administrative practices and precedents, as applicable, in applying the provisions of this Interpretation. (Fin 48, Appendix B--Background Information and Basis for Conclusions)
- The Board decided to permit consideration of administrative practices and precedents to achieve greater consistency and comparability and to achieve more representationally faithful financial reporting in those limited circumstances in which taxing authorities permit what might be deemed technical violations of the tax law. (Fin 48, Appendix B--Background Information and Basis for Conclusions)



Administrative Practices Considered

- The FIN 48 more-likely-than-not recognition threshold is not limited to published statutory, caselaw, and administrative support. Rather, the standard can also be satisfied by widely understood administrative policy.
- Consider the following example:
 - Taxpayer, a U.S. corporation, has conducted business in Country X for 10 years. Taxpayer has taken the position that its operations in Country X do not rise to the level that Taxpayer is required to file a return in Country X. Because Taxpayer has not filed a return for the past 10 years the statute of limitations in Country X has not commenced.
 - It is the administrative practice of Country X only to assess tax on non-filers for the prior three tax years.
 - Taxpayer does not have to report an unrecognized tax benefit relating to Country X tax before the prior three tax years.



Measurement

- A tax position that meets the more-likely than not recognition threshold shall . . . be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority.
- *Relatively few tax disputes are ultimately settled in litigation, and very few are taken to the court of last resort. Generally, the taxpayer and the taxing authority negotiate a settlement to avoid the costs and hazards of litigation. As a result, the measurement of the tax position is based on management's best judgment of the amount the taxpayer would ultimately accept in a settlement with taxing authorities. (FIN 48—Appendix A)*

IRS FIN 48 Activity—Audits

- LMSB-04-0507-045 (FIN 48 Implications—LSMB Field Examiners’ Guide)
 - The disclosures required under FIN 48 should give the Service a somewhat better view of a taxpayer’s uncertain tax positions; however the disclosures do not have the specificity that would allow a perfect view of the issues and amounts at risk. For example there may be a contingent tax liability listed in the tax footnotes of a large multi-national taxpayer with a description called “tax credits”, however, tax credits could be US, foreign, or state tax credits. So the tax credits in this example may or may not in this case have a US tax impact
 - Even with the lack of specificity, tax footnotes included in financial statements . . . should be carefully reviewed . . . as part of the audit planning process. For example, if a taxpayer reflecting a contingent tax liability in the year under audit for Subpart F income does not reflect Subpart F in the tax return, questions could develop about why Subpart F income does not appear in the tax return, but is mentioned in the tax footnotes creating a contingent tax liability.
- “In the international context . . . there is not a lot of specificity in the [FIN 48] disclosures. But you can discern certain things from the disclosures when you see additional accruals to the reserves for things like interest. (Barry Schott, Deputy Commissioner Int’l LMSB. 2007 TNT 242-4)
- FIN 48 disclosures are the “centerpiece of our revenue agent training this year. 16 TPR 129 (June 27, 2007).



IRS FIN 48 Activity—Resolution of Issues

- “While we understand that unrecognized tax benefits present contingent liabilities on balance sheets for which interest must be regularly accrued, and perhaps penalties, and while that may have an impact on loan covenants and net worth, we have to protect the government’s right to having the time necessary to adequately examine returns for compliance.” LMSB-04-0507-045
- “It should be anticipated that taxpayers and their representatives will use various approaches to reach and document effective settlement of specific issues and entire examinations as early as possible, and that they may be less willing than previously to extend the statute of limitations to points beyond an expected examination closing date.” LMSB-04-0507-045



IRS FIN 48 Activity—Resolution of Issues

- “We anticipate that taxpayers will desire to have certainty regarding otherwise uncertain tax positions much sooner on average than in the past. . . . We can remind taxpayers that candor, transparency and the right motivations, coupled with programs and processes we have in place today can quickly generate certainty on tax issues. Those programs and processes include:
 - (a) Pre filing:
 1. Industry Issue Resolution
 2. Pre-filing Agreements
 3. APAs
 4. Compliance Assurance Programs
 - (b) Post-Filing:
 1. Joint Audit Planning
 2. LIFE
 3. Advanced Issue Resolution
 4. Appeals Fast Track Program
 5. Accelerated Issue Resolution
 6. Early Referral to Appeals.”

LMSB-04-0507-045

Settlement of an Uncertain Tax Position

- FIN 48-1 provides that an uncertain tax position is considered effectively settled if:
 - the taxing authority has completed all of its required or expected exam procedures (incl. appeals)
 - the company does not intend to appeal or litigate the tax position; and
 - it is remote that the taxing authority will reexamine the tax position.
 - *See* IRM 1.2.1.4.1, P-4-3 (IRS will not reopen an audit absent fraud, material factual representation or similar circumstances; substantial inconsistency with an established IRS position; or serious administrative omission)
 - *But cf.* LSMB -04-0507-045 “The Service has no plans to modify its policy against reopening examinations. However, since FIN 48 does require more information to be disclosed about uncertain tax positions than was the case before FIN 48 was issued, it is possible that reopenings will occur more frequently because of the potentially increased availability of information warranting reopening.
- It is not necessary that a tax position be examined to be considered as effectively settled.



FIN 48 IDR

- IRS asks for break-down of FIN 48 amount by
 - tax year
 - between domestic and foreign jurisdictions
 - by type of tax and taxing authority
 - between temporary and permanent differences
- IRS asks for breakdown of interest/penalties by type of tax



Section 482

- Reliance on correlative adjustments in other country / competent authority / use of foreign tax credits
- Outbound Transfers of Workforce in Place, LSMB Industry Directive Feb 2, 2007
 - Note contrary authority under sec. 936 and contrary IRS position
- Commensurate with Income Standard
 - Royalty decrease. See AM-2007-07 (Mar. 15, 2007)
- Cost Sharing Buy-In. See LSMB Industry Directive (Apr. 5, 2007)
- Services
- Stock Option Compensation for Services
- Cost Sharing Stock Options. See *Xilinx v. Commissioner*, 125 T.C. No. 4 (2005), *on appeal*.
- Use of APAs



Treaty Issues

- Permanent Establishment
 - Failure to file in local jurisdiction
 - Reliance on local administrative practice. *See* state tax example in FIN 48.
 - Income attributable to PE
- Zero withholding on dividends
- Reliance on Treasury Technical Explanation
- Use of Other Treaties/OECD Model Treaty



Section 987

- Use of profit and loss method of accounting (987(1) and (2))
 - New proposed regulations do not permit
 - Old proposed regulations, Code and legislative history permit (require?)
- Remittances from partnerships
- Contributions to corporations and partnerships
- Change in method of accounting



Compliance

- Gain recognition agreements
 - New reasonable cause standard
 - Not standardized
- DCL filings
 - Same new reasonable cause standard as GRAs
- Regulations on tax accounting elections
- Check the Box Elections
 - LTR 200712017 on improper election



Foreign Tax Credit Issue

- Technical Taxpayer Proposed Regulations §1.901-2(f)(1).
 - IRS authority to issue regulations?
- Base difference rule. §904(d)(2)(H); Treas. Reg. §1.904-6(a)(1)(iv); T.D. 8916
- Partnership Allocation of Creditable Foreign Tax Expenditure Treas. Reg. §1.704-1(b)(4)(viii).



Section 367

- Notices 2006-85 and 2007-48 (“Killer B” Transactions)
 - Note that foreign corporation would continue to be treated as a corporation. This is not consistent with §367.
- Notice 2008-10 (“Deadly D”)
 - Note alternate §304 characterization is supported by caselaw.



Subpart F Issues

- Contract Manufacturing
 - New proposed regulations
 - Caselaw under other Code provisions
- Branch Rule
- Precedence of E&P Limitation over High Tax Kickout
 - *cf.* §§954(b)(4)/952(C)(1)(A) and Treas. Reg. 1.954-1(d)(4)(ii)



Other Issues

- Contribution of IP to a controlled entity (“*duPont* issue”)
- Non-patent cross licensing of IP. *Cf.* Rev. Proc 2007-23.



FAS 52



Statement 52 Terminology

- Functional Currency—the currency of the primary economic environment in which the entity operates (which potentially could be different than the local currency of the entity’s country)
- Foreign Currency—a currency that is other than the functional currency of the subject entity
- Reporting Currency—the currency in which an enterprise prepares its financial statements (usually U.S. dollar)



Statement 52 Terminology (Cont'd)

- FC Transaction Gain or Loss—effect of change in exchange rates between functional currency and foreign currency the transaction is denominated
- Translation Adjustments—result of translating financial statements from entity's functional currency into reporting currency
- Cumulative Translation Adjustment (CTA)—a separate component of equity, used to recognize translation adjustments



Overview of Statement 52

- Identify the functional currency
 - Self contained foreign entities
 - Extensions of parent operations
 - Highly inflationary economies
- Prepare financial statements in the functional currency (i.e., determine FC transaction gains or losses)
- Translate financial statements from functional currency to reporting currency



Foreign Currency Translation/ Remeasurement

- If functional currency is not the reporting currency—translate using current exchange rates
 - Translation adjustments recorded in the CTA
- If functional currency is reporting currency (including highly inflationary economies)—remeasured the financial statements
 - Monetary assets and liabilities remeasured using current exchange rates
 - Nonmonetary assets and liabilities remeasured using historical exchange rates



Local Currency is Functional Currency

- Measure deferred tax assets and liabilities for temporary differences (inside basis) between:
 - FC financial statement carrying amounts (US GAAP)
 - FC tax bases, including indexing, in foreign tax jurisdiction
- Record in FC in subsidiary's financial statements
- Then, foreign deferred tax assets and liabilities are translated into reporting currency like other assets and liabilities



Local Currency is Functional Currency

- Translation adjustments are not recognized in income statement, recognized in CTA
- CTA creates a temporary difference between parent company's financial statement carrying amount of investment in foreign sub and parent's tax basis—outside basis
- Consider APB Opinion 23 policy—indefinite reversal criteria for unremitted earnings
 - Compare:
 - Full reinvestment
 - No reinvestment
 - Partial reinvestment



Reporting Currency is Functional Currency

- Nonmonetary assets/liabilities remeasured using historical rates
- Statement 109 prohibits recognition of deferred taxes on temporary differences resulting from changes in exchange rates or indexing for tax purposes related to nonmonetary assets/liabilities in this situation

Reporting Currency is Functional Currency (Cont'd)

- Measure deferred tax assets and liabilities for temporary differences (inside basis) between:
 - Foreign (local) currency financial statement carrying amounts (US GAAP), and
 - Foreign (local) currency tax bases, *excluding* indexing, in foreign tax jurisdiction
- Remeasure deferred tax assets and liabilities into reporting currency using the exchange rate at the balance sheet date
- Transaction gain/loss recognized in the deferred tax provision or separately; disclosed in the aggregate transaction gain/loss under Statement 52



Change to the Functional Currency

- To the reporting currency when an economy becomes “highly inflationary” (EITF Topic D56)
- From the reporting currency when an economy ceases to be “highly inflationary” (EITF Issues 92-4 and 92-8)



Change to the Functional Currency (Cont'd)

- Address tax considerations when the functional currency changes from LC to the RC
 - CTA related to prior periods remains in equity at the date of change
 - The “historical” accounting (book) basis of nonmonetary assets are the translated amounts at the end of the latest period prior to the change in FC
 - Prior deferred taxes resulting from indexing are reversed when realized; record no deferred taxes resulting from indexing after date of change



Change from the Reporting Currency

- Address tax considerations when the functional currency changes from RC to the LC
 - Nonmonetary assets/liabilities are translated into the local currency (FC) at current exchange rates and become the new functional currency accounting bases
 - Difference between the new functional currency accounting bases and the FC tax bases represent temporary differences
 - Effects on deferred tax assets/liabilities for change in functional currency are included in CTA



APB Opinion 23



APB Opinion 23

- Investment in foreign subsidiaries
 - **Intent and ability to permanently reinvest**
 - **Applicable only to foreign subsidiaries and foreign corporate joint ventures**
- Only applies to outside basis differences



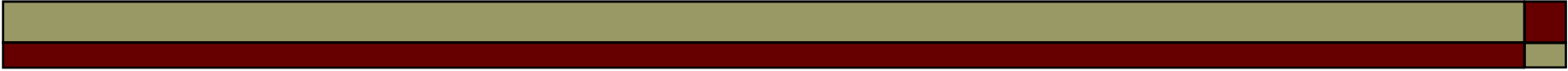
APB Opinion 23 Outside Basis Differences

- APB 23 exceptions
 - Applies to entire excess of financial carrying amount over the tax basis of investment
- Deferred tax asset generally not permitted unless it is expected to reverse in the “foreseeable future”



APB Opinion 23

- How to substantiate an APB 23 position?
- Consistency is important
- Specific reinvestment plans
 - Forecasts and budgets
 - Working capital needs
 - Parent does not need the cash
 - Past history
 - Tax implications of repatriation
 - Loan restrictions
 - Changes in tax law (e.g. Section 965)



APB Opinion 23 – Emerging Issues

- Do not forget to factor in the impact of CTA
 - Distinguish between CTA on capital and retained earnings
 - Distinguish between CTA on permanently reinvested versus non-permanently reinvested earnings
 - Effective hedge on net investment in foreign subsidiary – FAS 133
 - Gains and losses are included in CTA (“ineffective” hedge goes to P&L)
 - APB 23 does not apply to this
 - Different tax rates may apply
 - Should CTA be tax effected with our without consideration of FTCs?



APB Opinion 23 – Emerging Issues

- Treatment of branches
 - Can APB 23 ever apply?
- Companies considering a change in APB 23 policy
 - Discrete event
 - Change associated with the beginning of the year CTA balance versus the current year
- Section 956 guidance
- Section 965 redux?
- Consistency with FIN 48 position
 - FTCs
 - Section 482
 - Subpart F



Tax Holidays



Tax Holidays

- FAS 109, par. 183 and 184 – No deferred tax asset for any tax holiday whether “general” or “unique”
- Scheduling of reversal of timing differences
- Tax expense may be created during the holiday if timing differences are generated which will reverse post holiday
- Can you group items together when scheduling out reversals? Do reversals happen on a FIFO basis or LIFO basis?



Tax Holidays – Example Facts

- ❑ Construction of Asset A in Year 1 for \$100; Asset A is placed in service for GAAP and tax purposes in Year 1
- ❑ Construction of Asset B in Year 1 for \$100; Asset B is placed in service for GAAP purposes in Year 1 and for tax purposes in Year 2
- ❑ Local jurisdiction provides for a 30% initial allowance in Year 1 for tax purposes and a 5 year depreciable life on the remaining basis using the straight line method
- ❑ GAAP depreciates on a straight line basis over 10 years
- ❑ Tax holiday runs from Year 2 through Year 8 (7 years)
- ❑ 50% tax rate (without a tax holiday)
- ❑ Do you set up deferred taxes on a group or asset by asset basis?

Tax Holidays – Example Asset A

	Basis	Year 1	Year 2	Year 3	Year 5	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Tax	100	(44)	(14)	(14)	(14)	(14)					
GAAP	100	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)
Difference		(34)	(4)	(4)	(4)	(4)	10	10	10	10	10
Tax Rate		50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
CY Deferred Tax		(17)	(2)	(2)	(2)	(2)	5	5	5	5	5
DTA/(DTL)		(17)	(19)	(21)	(23)	(25)	(20)	(15)	(10)	(5)	0

Tax Holidays – Example Asset B

	Basis	Year 1	Year 2	Year 3	Year 5	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Tax	100	0	(44)	(14)	(14)	(14)	(14)				
GAAP	100	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)
Difference		(10)	(34)	(4)	(4)	(4)	(4)	10	10	10	10
Tax Rate		50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
CY Deferred Tax		5	(17)	(2)	(2)	(2)	(2)	5	5	5	5
DTA(DTL)		5	(12)	(14)	(16)	(18)	(20)	(15)	(10)	(5)	0

Tax Holidays – Example Asset A & B Combined

	Basis	Year 1	Year 2	Year 3	Year 5	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Tax	200	(44)	(58)	(28)	(28)	(28)	(14)				
GAAP	200	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)
Difference		(24)	(38)	(8)	(8)	(8)	6	20	20	20	20
Tax Rate		50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
CY Deferred Tax		(12)	(19)	(4)	(4)	(4)	3	10	10	10	10
DTA/(DTL)		(12)	(31)	(35)	(39)	(43)	(40)	(30)	(20)	(10)	0



New Legislation



Emergency Economic Stabilization Act

Enacted October 3, 2008

- **Retroactive extension of research credits**
 - Extends credit for two years (until December 31, 2009).
 - Increased ASC percentage from 12% to 14% for taxable years ending in 2009.
 - Terminates AIC for taxable years beginning after December 31, 2008.

- **Financial Reporting Issues**
 - Effects of tax law change will be recorded in period in which law was enacted.
 - The tax effect of the law change attributable to current year “ordinary” income is recorded by updating the estimated annual tax rate.
 - The portion of the effect of the change related to prior year is recorded as a discrete item.



Financial Reporting on Federal R&D Credits

- **For calendar year companies**
 - No impact on Q3 provision.
 - Calculate the entire year R&D credits at year-end provision.



Financial Reporting on Federal R&D Credits

□ **For fiscal year companies**

- No impact on quarterly provision for quarters ended on or before September 30, 2008.
- Current year benefit included in the estimated annual tax rate in the quarter after September 30, 2008.
- Prior year credits should be a discrete item in the quarter after September 30, 2008.



Example 1 – FYE 12/31/2008

□ **Assumptions:**

- Projected 2008 Federal R&D credit is \$200.
- Projected 2008 pre-tax book income is \$5,000
- Projected 2008 permanent difference is \$1,000
- YTD Q3 pre-tax book income is \$2,000
- Statutory tax rate is 35%
- At year-end, all the above projection amounts are the same as the actual amounts

Example 1 – FYE 12/31/2008

□ Q3 vs. Q4 Provision

		<u>Q3</u>		<u>Year-end</u>	
Pre-tax Book Income	\$5,000	\$1,750	35%	\$1,750	35%
Perm. Differences	\$1,000	\$350	7%	\$350	7%
2008 Federal R&D credits	\$(200)	<u>\$0</u>	<u>0%</u>	\$(200)	(4)%
FY09 Estimated Effective tax rate		\$2,100	42%	N/A	N/A
YTD Q3 Provision before Discrete Item	\$2,000*42%	\$840		N/A	N/A
YTD Q3 Provision		\$840	42%	N/A	N/A
Annual Provision		N/A	N/A	\$1,900	38%



Example 2 – FYE 3/31/09

□ **Assumptions:**

- Federal R&D credit for period from 1/1/08 to 3/31/08 is \$50.
- Projected FY09 Federal R&D credit is \$200.
- Projected FY09 pre-tax book income is \$5,000
- Projected FY09 permanent difference is \$1,000
- YTD Q2 pre-tax book income is \$1,200
- YTD Q3 pre-tax book income is \$2,000
- Statutory tax rate is 35%

Example 2 – FYE 3/31/09

- Q1 – No Federal R&D credits
- Q2 – No Federal R&D credits
- Q2 vs. Q3 Provision

		<u>Q2</u>		<u>Q3</u>	
Pre-tax Book Income	\$5,000	\$1,750	35%	\$1,750	35%
Perm. Differences	\$1,000	\$350	7%	\$350	7%
Projected FY09 Federal R&D credits	\$(200)	<u>\$0</u>	<u>0%</u>	<u>\$(200)</u>	<u>(4)%</u>
FY09 Estimated Effective tax rate		\$2,100	42%	\$1,900	38%
YTD Q2 Provision before Discrete Item	\$1,200*42%	\$504	42%	N/A	N/A
YTD Q3 Provision before Discrete Item	\$2,000*38%	N/A	N/A	\$760	38%
Discrete Item – FY08 R&D Credit Recapture (Q3 only)	\$(50)	<u>\$(0)</u>	<u>0%</u>	<u>\$(50)</u>	<u>(2.5)%</u>
YTD Q2 Provision		\$504	42%	N/A	N/A
YTD Q3 Provision		N/A	N/A	\$710	35.5% ⁵⁵



Housing and Economic Recovery Act of 2008

Enacted July 30, 2008

□ **Acceleration of AMT and Research Credits**

- Allows companies to accelerate utilization of unused AMT or Research.
- Credits in lieu of the 50% “bonus” depreciation.
- Credits are refundable.

□ **Financial Reporting Implications**

- Most likely to impact entity’s with a valuation allowance against their DTA’s.
- Entity’s with no valuation allowance against their R&D and AMT DTA’s will generally have no tax rate impact.
- The effect should be included in income from continuing operations.
- Effect of tax law change recorded when tax law enacted.



California New Tax Legislation

Enacted September 30, 2008

- **Suspension of Net Operating Loss Utilization and limitation on credit usage**
 - Suspension of NOL's for tax years 2008 and 2009.
 - Taxpayer is limited to offsetting only 50% of the California Regular Tax Liability with available credits.
 - Most likely to impact entity's with full valuation allowances that will record their provision based on their current tax expense.



California Underpayment Penalty

- **Penalty increases from 10% to 20% on under-reporting of tax liabilities of \$1M or more.**
 - This may effect FIN 48 reserves.
 - Effective as of the signature of the bill on October 1, 2008.



FIN 18



Interim Reporting

- **Agenda**
- Overview
- Changing forecast
- Exception to the use of an estimated annual effective tax rate
- Recognition of new tax legislation
- Intraperiod allocation in interim periods
- The effects of FAS 123R during interim periods



Interim Reporting - Overview

- APB 28, par. 19 states that
 - “At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year.”
 - “The rate so determined should be used in providing for income taxes on a current year-to-date basis.”
 - “However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.”



Interim Reporting - Overview

- FIN 18, par. 6 states that:
 - “The tax (or benefit) related to ordinary income is to be computed using an estimated annual effective tax rate, and
 - “The tax (or benefit) related to all other items is to be individually computed and recognized when the event occurs (“discrete period items”).”



Interim Reporting - Overview

- What is “ordinary income”?
 - Ordinary income refers to income (or loss) from continuing operations before income taxes (or benefit), excluding significant “unusual or infrequently” occurring items. Extraordinary items, discontinued operations, and cumulative effects of changes in accounting principles are also excluded from ordinary income. (FIN 18, par.5)



Interim Reporting - Overview

- Examples of “Unusual or infrequent items”
 - Closing of prior year audits
 - Expiration of the statute of limitations for prior tax years
 - Subsequent recognition, derecognition, or change in measurement for an uncertain tax position arising due to a change in judgment or new information
 - FIN 48 interest and penalties
 - Change in tax law
 - Change in tax status
 - Change in the realizability of deferred tax assets
 - Change in judgment regarding unremitted foreign earnings
 - Change in estimate related to prior year income tax provisions
 - In-process R&D identified through business combination



Interim Reporting - Overview

- Computation steps
 - Determine projected income, permanent and temporary differences, credits, and carryforwards for the entire year.
 - Calculate the projected total provision for the year.
 - Calculate the effective tax rate (“ETR”) for the year.
 - Apply the ETR to the year to date earnings
 - Adjust interim provision for discrete items, if any.
 - Subtract prior quarter year-to-date tax provision to get current quarter provision.



Interim Reporting – Example 1

□ **Assumption**

- Projected FY09 pre-tax book income is \$5,000.
- Projected FY09 permanent difference is \$1,000.
- YTD Q2 pre-tax book income is \$1,200.
- Statutory tax rate is 35%.

Interim Reporting – Example 1

		<u>Q2</u>	
Pre-tax Book Income	\$5,000	\$1,750	35%
Perm. Differences	\$1,000*35%	<u>\$ 350</u>	7%
FY09 Estimated Effective tax rate		\$2,100	42%
YTD Q2 Provision before Discrete Item	\$1,200*42%	\$504	42%
YTD Q2 Provision		\$504	42%



Interim Reporting – Example 2

- **Assumption**
- **Same as Example 1 but now with IPR&D**
 - Projected FY09 pre-tax book income is \$4,800.
 - Projected FY09 permanent difference is \$1,000.
 - YTD Q2 pre-tax book income including IPR&D is \$1,000.
 - Statutory tax rate is 35%.
 - IPR&D Booked in the quarter is \$200 derived from tax free transaction. (No tax Basis).

Interim Reporting – Example 2

		<u>Q2</u>	
Pre-tax Book Income (drop discrete amount)	\$5,000	\$1,750	35%
Perm. Differences	\$1,000*35%	\$ 350	7%
FY09 Estimated Effective tax rate		\$2,100	42%
YTD Q2 Income w/out discrete Item	\$1,200*42%	\$504	42%
YTD Q2 Provision		\$504	42%

Interim Reporting – Example 2

		<u>Q2</u>	
Discrete Item	\$(200)	\$(70)	35%
Perm. Differences	\$200	<u>\$ 70</u>	(35)%
FY09 Estimated Effective tax rate on discrete item		\$0	0%
YTD Discrete Q2 Provision			



Interim Reporting – Change of Forecast

- Best current estimate
 - The estimated ETR should represent the best estimate of the composite tax provision in relation to the best estimate of worldwide pre-tax book ordinary income.
 - Any change in forecast after the interim balance sheet date but before financial statement issuance should be incorporated in the tax provision.



Interim Reporting – Change of Forecast

- Subsequent event
 - If a significant subsequent event occurs after the interim balance sheet date but before financial statement issuance, should the company update the annual forecast ordinary income?



Interim Reporting – Change of Forecast

- Subsequent event
 - There are two different opinions:
 - FIN 18 concludes that the company's best current estimate of its annual consolidated effective rate should be based on information available prior to the date of issuance.
 - AU Sec. 560.05 states that subsequent event should not result in the adjustment of the financial statements.
 - The key is to choose one approach and keep **consistency** as an accounting policy.



Interim Reporting – Exception to regular method

- FIN 18, par.8 states that
 - “If a reliable estimate cannot be made, the actual effect tax rate for the year-to-date maybe the best estimate of the annual effective tax rate.”
 - Also, if a small change in the estimated ordinary income could produce a significant change in the effective tax rate, such an estimate of annual rate would not be reliable. (FIN 18, par.82)
 - However, the company should report this exceptional method in the interim period.



Example 2 – Discrete Method

□ **Assumption**

- Projected FY09 pre-tax book income is \$5,000. However, it is not reliable according to management.
- Projected permanent difference is \$1,000.
- YTD Q2 pre-tax book income is \$1,200.
- YTD Q2 permanent difference is \$400.
- Statutory tax rate is 35%.

Example 2 – Discrete Method

	<u>Discrete method</u>			<u>Forecast Method</u>		
Pre-tax Book Income	\$1,200	\$ 420	35%	\$5,000	\$1,750	35%
Perm. Differences	\$ 400	\$ 140	11.7%	\$1,000	<u>\$ 350</u>	7%
FY09 Estimated Effective tax rate	N/A	N/A	N/A		\$2,100	42%
YTD Q2 Provision before Discrete Item	N/A	N/A	N/A	\$1,200	\$504	42%
YTD Q2 Provision		\$ 560	47%		\$504	42%



Interim Reporting – Exception to regular method

- Multiple jurisdictions
 - When a company operates in multiple jurisdictions and one jurisdiction is unable to provide reliable estimate of its ordinary income, the company shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall estimate of the ETR and interim period tax (or benefit).



Example 3 – Multiple Jurisdictions

□ Assumption

- Operates in US and Country A.
- Projected FY09 worldwide pre-tax book income is \$5,000.
- Projected FY09 US pre-tax book income is \$3,000.
- Projected FY09 Country A pre-tax book income is \$2,000.
- Projected FY09 US permanent difference is \$1,000.
- Projected FY09 Country A permanent difference is \$0.
- YTD Q2 US pre-tax book income is \$1,200.
- YTD Q2 Country A pre-tax book income \$1,000.
- US Statutory tax rate is 35%.
- Country A statutory tax rate is 20%.

Example 3 – Multiple Jurisdictions

	<u>US</u>		<u>Country A</u>		<u>Total</u>
Pre-tax Book Income	\$3,000	\$1,050	\$2,000	\$400	\$5,000
Perm. Differences	\$1,000	<u>\$ 350</u>	\$0	<u>\$0</u>	
FY09 Estimated tax provision		\$1,400		\$400	\$1,800
FY09 Estimated annual effective tax rate					36%=1,800/5,000
YTD Q2 Provision before Discrete Item	\$1,200		\$1,000		\$792=(1,200+1,000)*36%
YTD Q2 Provision					\$792 (36%)



Example 4 – Multiple Jurisdictions

□ **Assumption**

- Operates in US, Country A, and Country B.
- Projected FY09 worldwide pre-tax book income is \$4,000, the breakdown is: US \$3,000, Country A \$2,000, and Country B \$(1,000).
- Projected FY09 US permanent difference is \$1,000.
- Projected FY09 permanent difference for Country A and B is \$0.
- YTD Q2 US pre-tax book income is \$1,200.
- YTD Q2 Country A pre-tax book income \$1,000.
- YTD Q2 Country B pre-tax book loss is \$(400). It is expected that the tax benefit of loss will not be recognized at the end of year.
- US Statutory tax rate is 35%.
- Country A statutory tax rate is 20%.
- Country B statutory tax rate is 10%.

Example 4 – Multiple Jurisdictions

	US	Country A	Combined excluding loss entity	Country B	Total WW
Pre-tax Book Income	\$3,000	\$2,000	\$5,000	\$(1,000)	\$4,000
Perm. Differences	\$1,000	\$0	\$1,000	\$0	
FY09 Estimated tax provision	\$1,400	\$400	\$1,800	\$0	\$1,800
FY09 Estimated annual ETR			36%		36%
YTD Q2 Provision (2,200 * 36%)			\$792	\$0	\$792 (YTD ETR = 44%; \$792/\$1800)
YTD Q2 Provision			\$792		\$792



Interim Reporting – FAS 123R

Consideration

- Recognize the windfalls and shortfalls discretely
 - The company should not estimate the incremental effect of windfalls or shortfalls.
 - If a company incurs a net loss for the interim period but forecast taxable income for the full annual year, the company should still recognize the windfall tax benefit.



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