

**SJSU TEI**

**November 2009**

# FAS 109 in Down and Recovering Economies

## Panel Members

- David Gaul, Tax Director – Cypress Semiconductor
- Joe Hogan, Tax Partner – Ernst & Young LLP
- Jeff Sokol, Tax Partner – Deloitte; SJSU Faculty
- David Yasukochi, Tax Partner – BDO LLP
- Rich Johnson, Tax Partner – PricewaterhouseCoopers
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# FAS 109 in Down and Recovering Economies

## Agenda

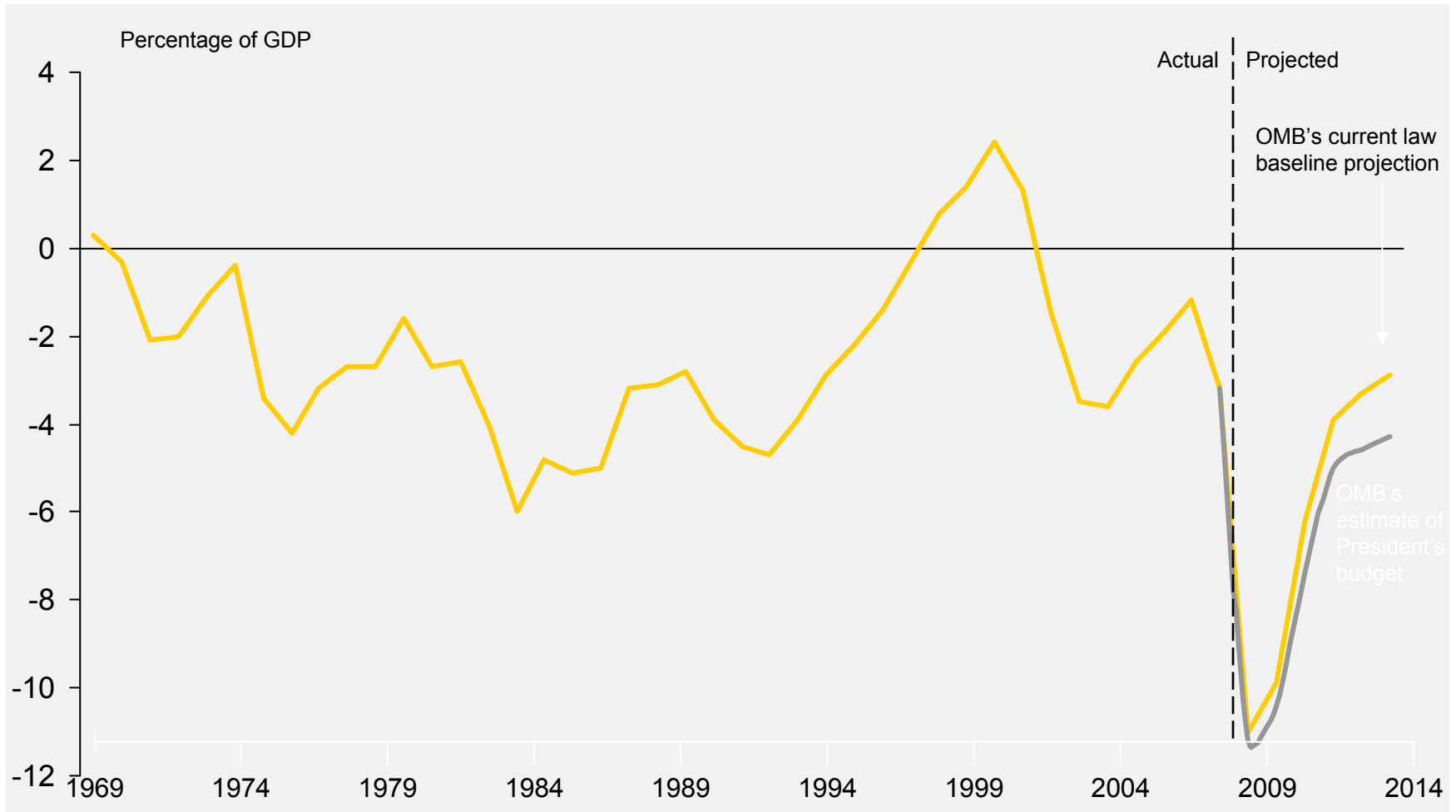
- Tax accounting for potential tax reform
- Goodwill impairment
- APB23 (ASC 740-30)
- Valuation allowances/Intraperiod allocations
- Interco transactions/Debt restructurings
- FAS141R (ASC 805)
- Income tax accounting tidbits

# Tax accounting considerations for potential tax reform

November 2009

Joe Hogan, Tax Partner  
Ernst & Young LLP

# Total deficits or surpluses as a percentage of GDP



# Focus on international tax reform

- Statements by President Obama on 4 May 2009:
  - “It’s a tax code full of corporate loopholes that makes it perfectly legal for companies to avoid paying their fair share.”
  - “It’s a tax code that makes it all too easy for...companies to abuse overseas tax havens to avoid paying taxes at all.”
  - “For years, we’ve talked about ending tax breaks for companies that ship jobs overseas and giving tax breaks to companies that create jobs here in America. That’s what our budget will finally do.”
- Statements by Rep. Richard Neal, Chairman of the House Ways & Means Select Revenue Measures Subcommittee, on 30 July 2009:
  - “...let’s keep working to make sure these [international tax proposals in the Administration’s budget] only come up in the context of reform.”
  - “...there’s no question that we have to compare how the US fits into the global economy when we debate our tax rules.”
  - “...I think 2010 sets up the perfect situation for major reform. With all of the 2001 and 2003 tax cuts expiring, we already will be in a big thinking mode”
  - “[Chairman Rangel] offered a comprehensive reform bill last Congress.... He did this after a conversation with the Treasury Secretary, where they both agreed that major reform is timely.”

# Effects of tax law changes, in general

- Effective date vs. enactment date
  - Proposed effective date for many Obama administration proposals is years beginning 1 January 2011 for calendar-year taxpayers.
- Effects on taxes currently payable or refundable for the current year
  - Reflect in computation of the estimated annual effective tax rate beginning in the first interim period that includes the enactment date of the new legislation
- Effects on taxes currently payable or refundable for a prior year
  - Recognize as a discrete event as of the enactment date
- Effects on DTAs or DTLs as of the beginning of the year
  - Recognize as a discrete event as of the enactment date
- Consider financial statement disclosure requirements

# Proposal: foreign tax credit pooling

- Foreign tax credit pooling effectively eliminates high and low tax pools
  - Deemed paid foreign taxes would be determined on a consolidated basis by aggregating foreign E&P and foreign taxes of foreign subsidiaries

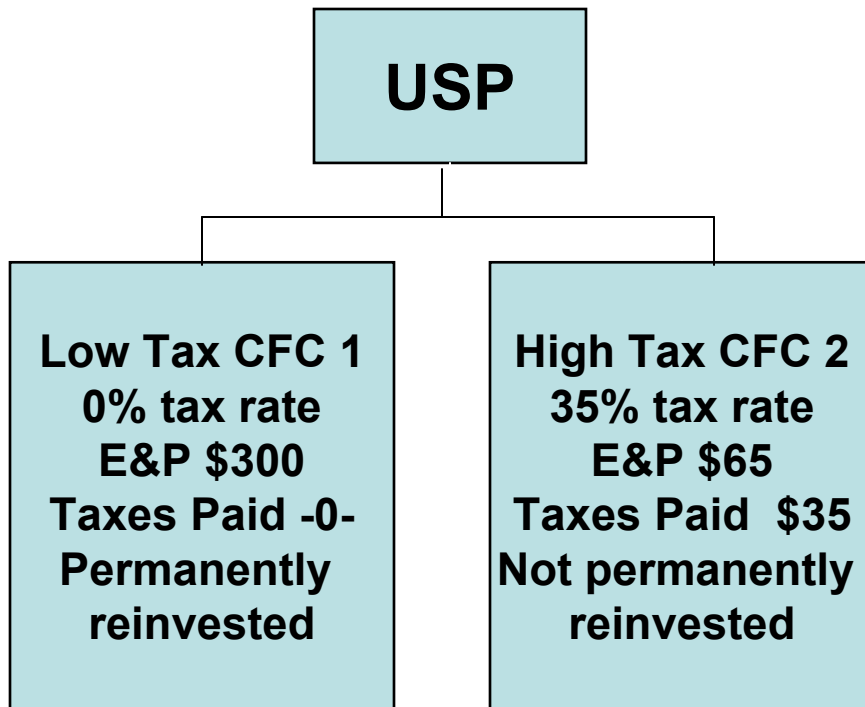
# Proposal: foreign tax credit pooling

## Income tax accounting considerations

- As of date of enactment, may affect deferred tax balances for non-permanently reinvested subsidiaries
  - For companies with some subsidiaries that assert permanent reinvestment and others that **do not assert** permanent reinvestment
  - Caution: transition rules or grandfathering rules (or adoption of a different version of this provision) could change the tax result
- At effective date, current tax expense may be affected
- Effective tax rate could be impacted

# Proposal: foreign tax credit pooling

## Example



▶ **Current tax law:**  
Hypothetical CFC 2 FTC fully offsets tax on deemed repatriation  
No DTL on outside basis difference in CFC 2

▶ **Proposed legislation:**  
Foreign income taxes are averaged  
Tax on deemed repatriation of \$65 (\$24.92\*) would not be fully offset by hypothetical FTC of \$6.20\*\* DTL of \$18.72 on outside basis difference in CFC 2

\*  $\$65 \text{ deemed repatriation} + 6.20 = 71.20 \times 35\% \text{ tax rate} = \$24.92 \text{ tax}$

\*\*  $\$65 / 365 \text{ E\&P} = 17.8\% \times \$35 \text{ tax paid} = \$6.20 \text{ FTC}$

# Proposal: limitation on check-the-box elections

- Foreign eligible entities with a single owner could be disregarded for federal US tax purposes only if: (1) they are organized in the same country in which the owner is organized or created or (2) a US person wholly owns them (except for tax avoidance cases).
  - Conversion of first-tier (for tax avoidance) and second-tier (or lower) foreign disregarded entities (FDEs) to corporations
    - May result in deemed §351 exchanges and/or liquidations
  - Includes retroactive reversals of some prior elections

# Proposal: limitation on check-the-box elections

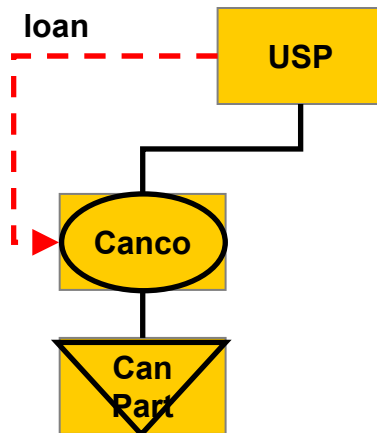
## Income tax accounting considerations

- As of date of enactment, conversion of disregarded entities into corporations may have immediate tax effect
  - Current and deferred taxes
  - Valuation allowance analysis for other attributes
  - Consider effect of company's plans for permanent reinvestment
- Effective tax rate could be impacted

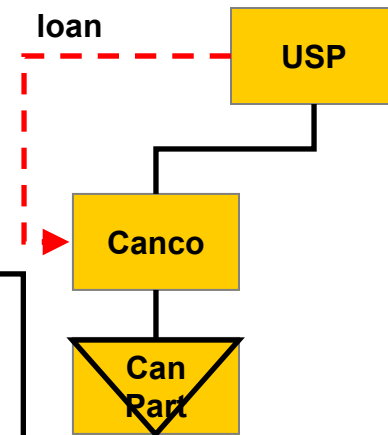
# Example: Check-the-box reform effects

## 1<sup>st</sup> Tier Entities

### Current State



### Conversion Impact



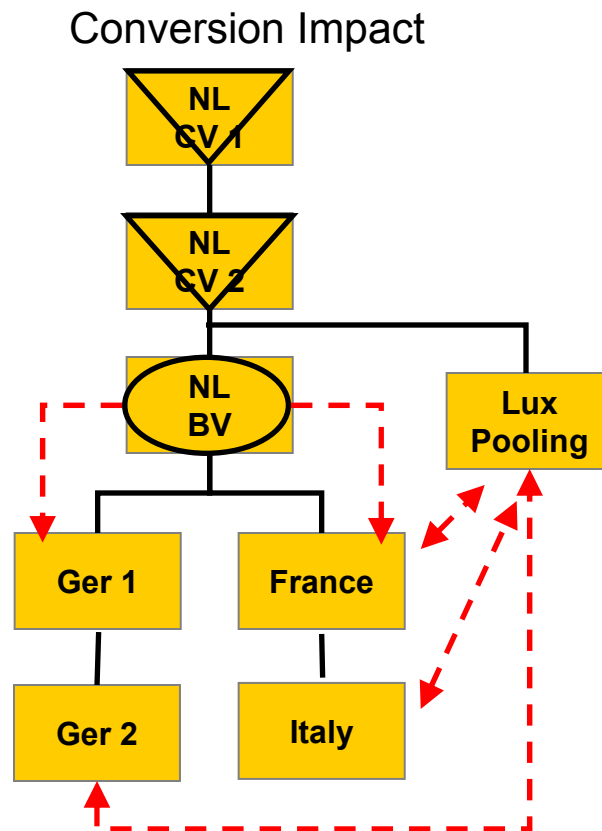
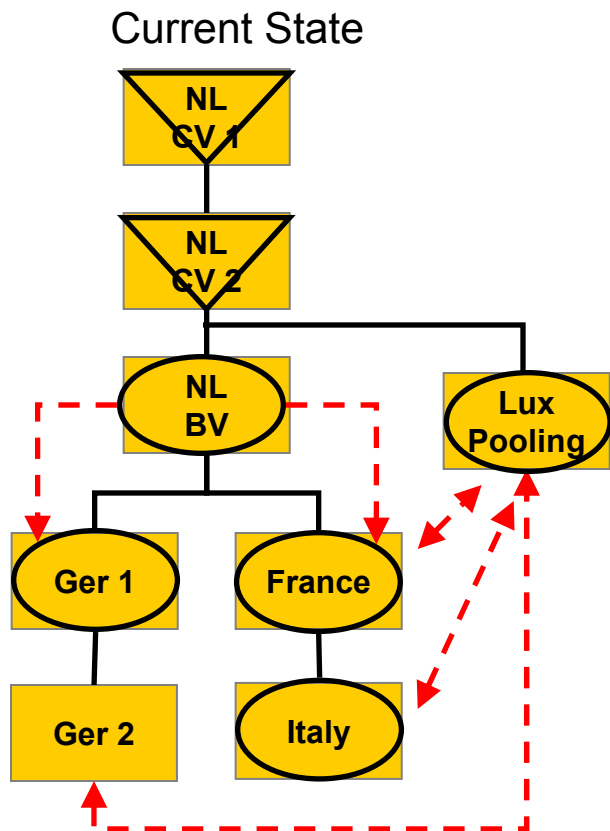
- Branch loss recap
- OFL
- DCL
- Other impacts

### Tax accounting implications:

- Current or deferred tax expense on any recapture income
- Ongoing effective tax rate increase either through increased foreign or US tax (depending on strategic decision regarding leverage in the future)

# Example: Check-the-box reform effects

## 2<sup>nd</sup> Tier Entities



### Tax Accounting Implications:

- Assumed chain owned by US Parent
- Current tax exp. for §304, Busted §351
- Potential ongoing ETR increase for Subpart F, §956

- §304 – Ger 2
- Busted 351 – France & Italy
- Springing debt – Lux

# Proposal: deferral of deductions

- Proposed deferral of deductions in US return related to foreign-source income that is not currently subject to US income tax
  - Amount of expenses allocated and apportioned to foreign-source income is generally determined under current Treasury regulations.
  - Deferred expenses would be carried forward to subsequent years and combined with foreign-source expenses in that year before determining deductible amount in such year.

# Proposal: deferral of deductions

## Income tax accounting considerations

- As of date of enactment, valuation allowance analysis may be affected
- Companies may change plans for permanent reinvestment
- At effective date, current tax expense may be affected
- Effective tax rate could be impacted

# Further significant potential domestic tax law changes

- NOL Carryback extension
  - Valuation allowance considerations
  - Various related tax planning considerations
- Reduction to US statutory tax rate
  - Deferred tax valuation
  - Ongoing effective tax rate implications
- Repeal of inventory tax return accounting methods: last-in first-out (LIFO) and lower of cost or market (LCM)

# Goodwill Impairment (ASC 350)

November 2009

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Deloitte; Faculty - SJSU

# Goodwill Impairment (ASC 350)



# Goodwill Impairment (ASC 350) – Steps 1 and 2

- Two-step analysis in order to determine whether an impairment is required and in what amount for a reporting unit
- Step 1
  - Compare fair value of a reporting unit with its carrying amount.
  - If the fair value is less than the carrying unit, need to perform analysis in step 2. Otherwise, no impairment.
- Step 2
  - Compare the implied fair value of goodwill with its carrying amount.
  - An impairment loss is measured by the excess of the carrying amount of goodwill over its implied fair value.

# Goodwill Impairment

## “Step 1” – Tax Considerations

- To determine the fair value of a reporting unit, the valuation is likely to be impacted by the form of the transaction (whether the unit would be bought or sold in a nontaxable or taxable transaction).
  - Which structure yields the highest economic value to the seller (EV = FV less **taxes**)?
  - Feasibility of assumed structure?
  - Remember that reporting units are not necessarily aligned with legal entities / specific acquisitions.

# Goodwill Impairment

## “Step 2” – Tax Considerations

- Step 2 is essentially a hypothetical acquisition accounting exercise
  - Assume equity value is the Step 1 value for the reporting unit
  - Valuation of assets and liabilities performed to determine hypothetical amounts (as if acquisition accounting)
  - Deferred taxes remeasured (again, as if acquisition accounting)
  - Need to ensure the revised deferred tax amounts are determined consistent with Step 1 assumptions (e.g., a taxable transaction would result in different deferred tax amounts relative to a nontaxable transaction)
  - Revised non-goodwill intangibles as well as DTAs and DTLs are factored into the impairment computation but are not actually recorded to the GL.

# Goodwill Impairment – Example - Facts

	Book Value	Tax Basis	FMV
Assets, excl. goodwill	1,200	700	900
Goodwill	800	N/A	
Total Assets	2,000		
Deferred tax liability*	200		
Equity	1,800		
Total liabilities & equity	2,000		

\*Deferred tax liability of \$200 is 40% of difference between \$1,200 NBV and \$700 of tax basis in assets.

# Example – Step 1 (Tax Component)

- Determine whether the unit would be bought or sold in a nontaxable or taxable transaction.

	Taxable	Nontaxable
Valuation	1,700	1,450
Tax costs of disposition	(600)	(250)
Net value	1,100	1,200

- \$1,200 reporting unit value is less than \$1,800 carrying value – proceed to Step 2.

## Example – Step 2 (Tax Component)

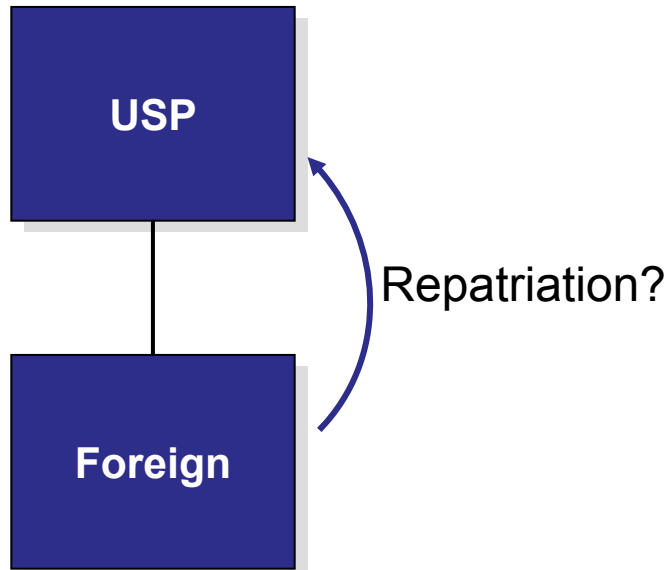
	Book Value	Hypo- thetical	Impairment
Assets, excl. goodwill	1,200	900	
Goodwill	800	380	420
Total Assets	2,000	1,280	
Deferred tax liability	200	80	
Equity	1,800	1,200	
Total liabilities & equity	2,000	1,280	

\*Deferred tax liability of \$80 is 40% of difference between \$900 FV and \$700 of tax basis in assets.

# Goodwill Impairment – Tax Accounting

- Computed impairment may relate to deductible or nondeductible goodwill (assumed all nondeductible in the example).
  - Impairments of nondeductible goodwill generally result in ETR increase
  - Impairments of deductible goodwill give rise to changes in deferred tax balances
  - Remember that reporting units do not necessarily align with legal entities / specific jurisdictions / historical acquisitions and so need to allocate impairment generally on a pro-rata basis, if needed

# APB 23 (ASC 740-30) – General Rule



- General rule is that all earnings are presumed repatriated, thus DTL is recorded for incremental taxes
- Exception for permanently reinvested earnings

# APB 23 (ASC 740-30)



# APB 23 (ASC 740-30) – Basic Considerations

- Facts and circumstances analysis, not an election per se
  - Need a reality check on cash needs in the current economy
  - Tax consequences of repatriation ought to be considered
- Documentation
  - Whether there is sufficient documentation as to rationale for permanent reinvestment representation is a top PCAOB review issue
  - “Indefinite reversal criteria”
    - Sufficient evidence must show that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation
    - Specific evidence showing the company’s plan for indefinitely reinvesting undistributed earnings

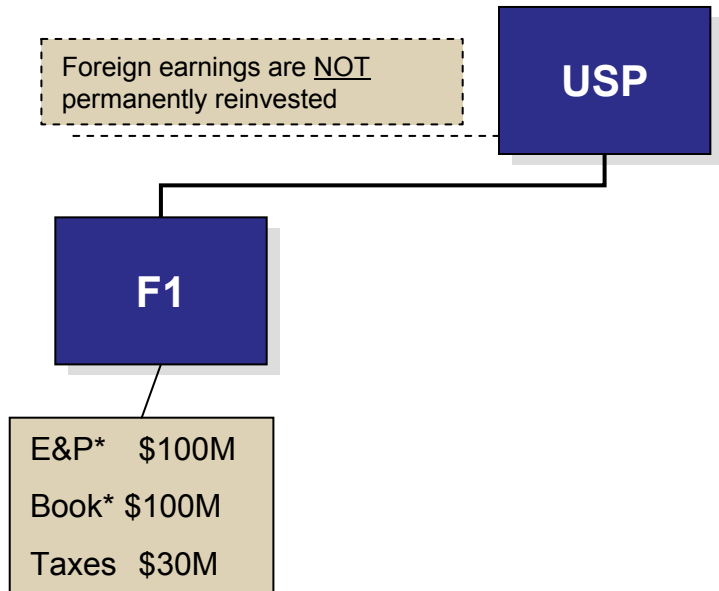
# APB 23 (ASC 740-30) – Repatriation Considerations

- What to worry about when you are not permanently reinvesting 100% of foreign earnings (a partial list):
  - Can there be partial reinvestment?
  - Should the DTL computation reference E&P or “basis difference?”
  - Should the FTC (DTA) reference book taxes or actual taxes accrued/paid?
  - For purposes of the FTC, should the indirect credit assume book earnings or E&P as the denominator?
  - Should CTA be tax-effected 100% or not with respect to capital possibly considered permanent?
  - How do multiple tiers of legal entities figure into the analysis (incl. hovering deficit and similar issues)?
  - How should ETR volatility related to effects of accounting for stock option exercises be managed / communicated?
  - How is the DTL impacted by tax contingency reserves?

# APB 23 (ASC 740-30) – DTL Considerations

- Implications of accruing incremental taxes:
  - Generally results in deferred tax expense (and ETR increase).
  - Consider muted (delayed) effect when accruing DTL while a valuation allowance exists as an offset to DTAs
  - Consider balance sheet (i.e., goodwill) accounting treatment if DTL recorded in connection with acquisition accounting

# APB 23 (ASC 740-30)

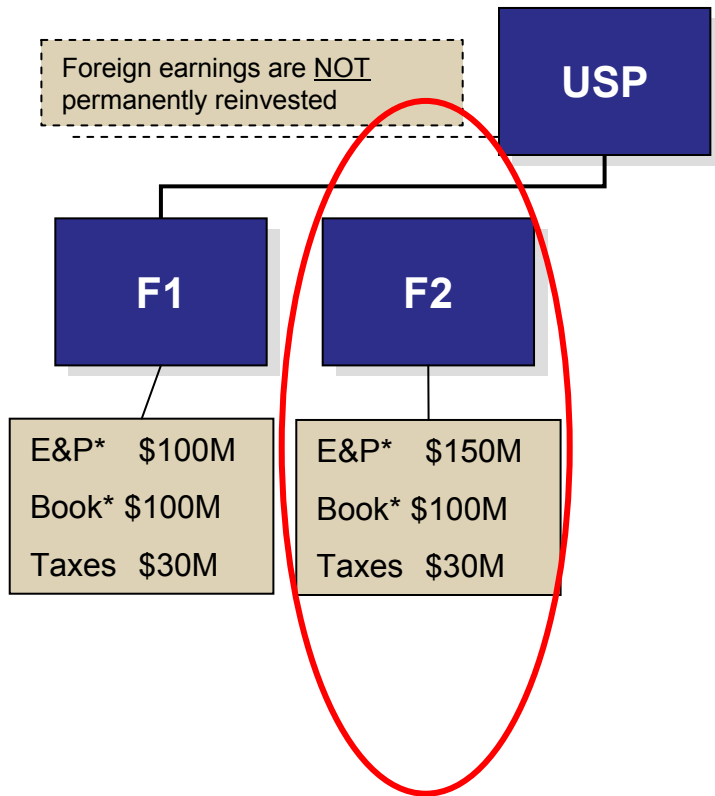


\* Pre tax amounts

- Book basis > tax basis by 70 for sub (unremitted earnings)
- Assume 30% local tax rate; 35% US tax rate

DTL Calculation	
Dividend	70
x Tax Rate	35%
DTL	(25)
FTC	30
Effect of Gross Up	(11)
Net FTC (DTA)	20
<b>Net DTL?</b>	<b>(5)</b>
Basis Diff	70
E&P	70
%	100%
Tax Pool	30
FTC	30

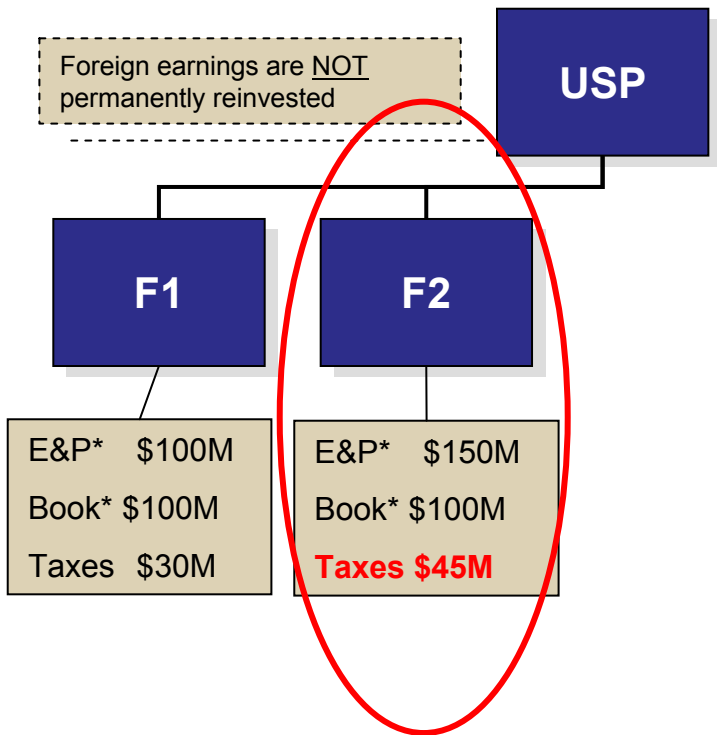
# APB 23 (ASC 740-30)



- Book basis > tax basis by 70 for each sub (unremitted earnings)
- Assume 30% local tax rate; 35% US tax rate
- What if E&P ≠ current year book earnings (assume attributable to a timing difference relevant only for US E&P purposes)?

	Book Approach	E&P Approach	Another Approach
Dividend	70	120	70
x Tax Rate	35%	35%	35%
DTL	(25)	(42)	(25)
FTC	30	30	18
Effect of Gross Up	(11)	(11)	(6)
Net FTC (DTA)	20	20	11
<b>Net DTL?</b>	<b>(5)</b>	<b>(23)</b>	<b>(13)</b>
Basis Diff	70	70	70
E&P	70	120	120
%	100%		58%
Tax Pool	30	30	30
FTC	30	30	18

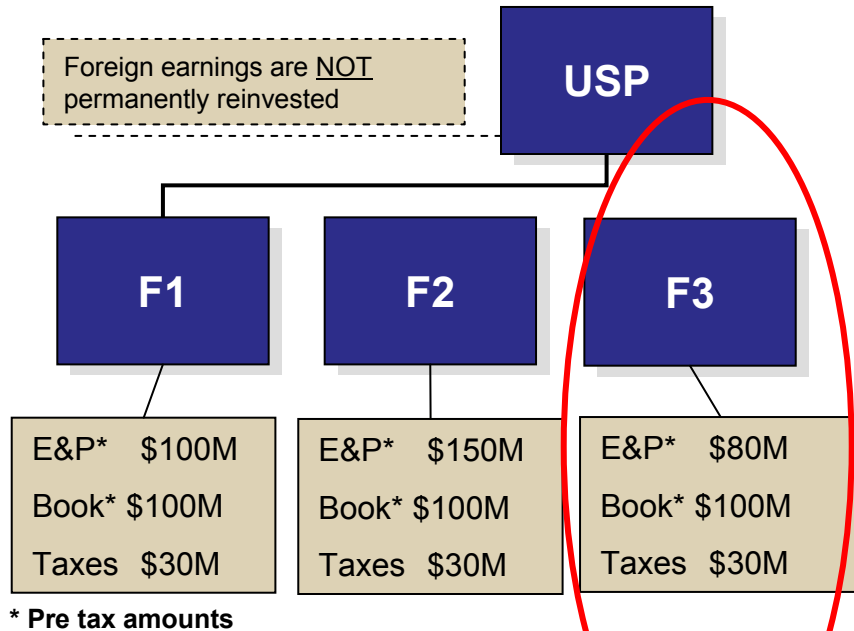
# APB 23 (ASC 740-30)



- Book basis > tax basis by 70 for each sub (unremitted earnings)
- Assume 30% local tax rate; 35% US tax rate
- What if E&P ≠ current year book earnings
  - (assume attributable to a timing difference relevant for local tax and US E&P purposes)?

	Book Approach	E&P Approach	Another Approach
Dividend	70	120	70
x Tax Rate	35%	35%	35%
DTL	(25)	(42)	(25)
FTC	30	45	26
Effect of Gross Up	(11)	(16)	(9)
Net FTC (DTA)	20	29	17
<b>Net DTL?</b>	<b>(5)</b>	<b>(13)</b>	<b>(7)</b>
Basis Diff	70	70	70
E&P	70	120	120
%	100%		58%
Tax Pool	30	45	45
FTC	30	45	26

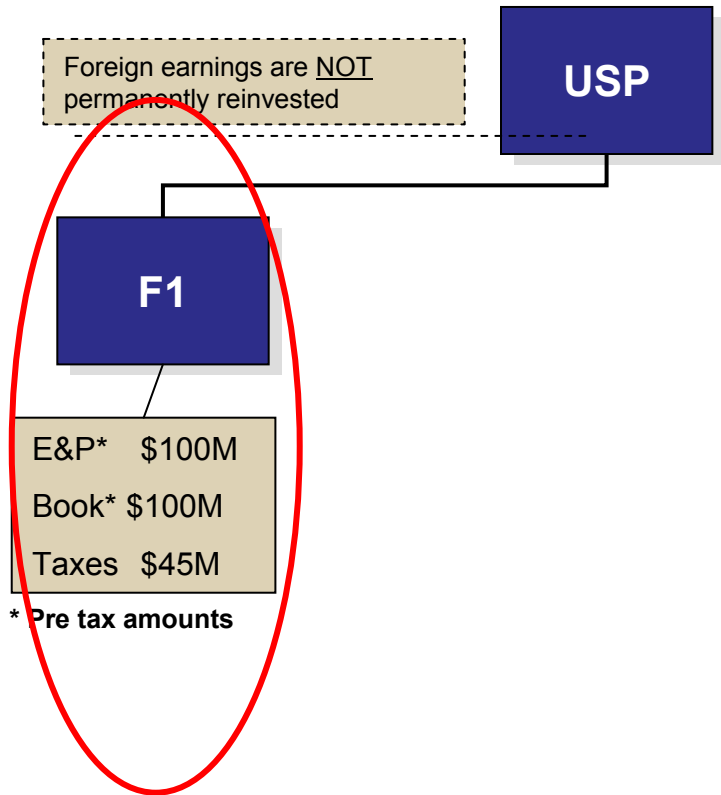
# APB 23 (ASC 740-30)



- Book basis > tax basis by 70 for each sub (unremitted earnings)
- Assume 30% local tax rate; 35% US tax rate
- What if E&P ≠ current year book earnings
  - What if reduced E&P / increased tax basis in shares is attributable to stock option compensation deductions?

	Book Approach	E&P Approach	Another Approach
Dividend	50	50	50
x Tax Rate	35%	35%	35%
DTL	(18)	(18)	(18)
FTC	30	30	30
Effect of Gross Up	(11)	(11)	(11)
Net FTC (DTA)	20	20	20
Stock Basis DTL	-	-	-
<b>Net DTA?</b>	<b>2</b>	<b>2</b>	<b>2</b>
Basis Diff	50	50	50
E&P	50	50	50
%	100%		100%
Tax Pool	30	30	30
FTC	30	30	30

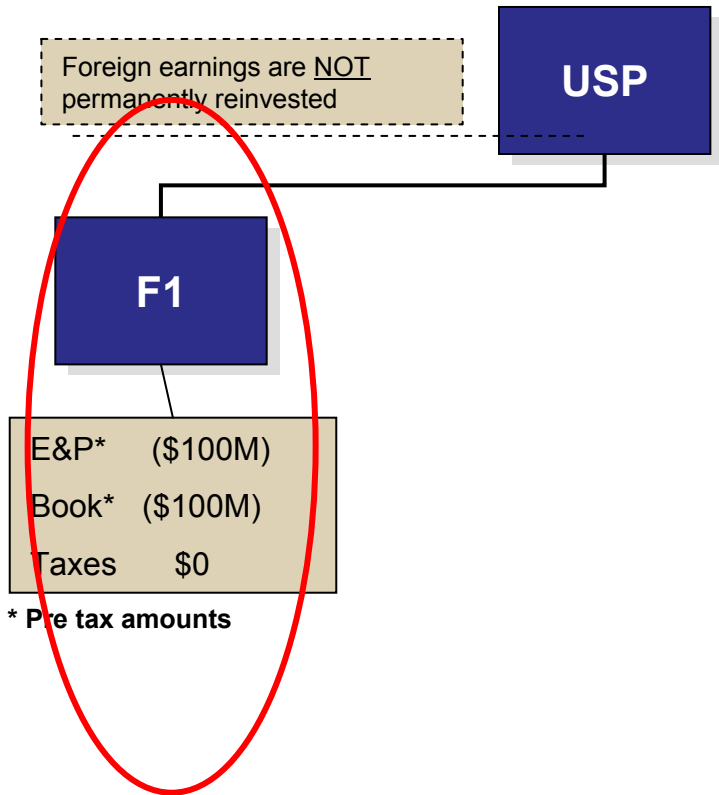
# APB 23 (ASC 740-30)



- Book basis > tax basis by 55 for sub (unremitted earnings)
- Assume 45% local tax rate; 35% US tax rate
  - Application of FAS 109, paragraph 34?

DTL Calculation	
Dividend	55
x Tax Rate	35%
DTL	(19)
FTC	45
Effect of Gross Up	(16)
Net FTC (DTA)	29
<b>Net DTA?</b>	<b>10</b>
Basis Diff	55
E&P	55
%	100%
Tax Pool	45
FTC	45

# APB 23 (ASC 740-30)



- Book basis < tax basis by 100 for sub (unremitted earnings (deficit))
- Application of FAS 109, paragraph 34?

DTL Calculation	
Basis Diff	(100)
x Tax Rate	35%
DTL	-
FTC	-
Effect of Gross Up	-
Net FTC (DTA)	-
<b>Net DTL?</b>	<b>-</b>
Basis Diff	-100
E&P	0
%	
Tax Pool	0
FTC	-

**FAS 109 Para.34  
(ASC 740-30-25)**

# Tax accounting in a downturn

November 2009

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BDO LLP

# Valuation Allowance

- Economic downturn may result in more companies reviewing the need for valuation allowance, and on a more frequent basis
- Negative and positive evidence
  - Significant considerations include
    - “Three Year Rule”
    - Projections of Future Taxable Income

# Valuation Allowance

- “Three year rule”
  - Book Income adjusted for permanent differences
  - Does not include Cumulative Effect of Accounting Method Changes
  - Generally includes discontinued operations, extraordinary items, restructuring charges and impairments
  - Three years vs. 12 quarters

# Valuation Allowance - Three year rule: Sample Disclosures

- **Entertainment Software Company (Q2 2009, From 10-Q)**

*In accordance with FAS No. 109, "Accounting for Income Taxes" (FAS 109), we evaluate our deferred tax assets, including net operating losses and tax credits, to determine if a valuation allowance is required. FAS 109 requires that companies assess whether a valuation allowance should be established based on the consideration of all available evidence using a "more likely than not" standard. In making such judgments, significant weight is given to evidence that can be objectively verified. FAS 109 provides that a cumulative loss in recent years is significant negative evidence in considering whether deferred tax assets are realizable and also restricts the amount of reliance on projections of future taxable income to support the recovery of deferred tax assets. We have had three years of cumulative U.S. tax losses and no longer can rely on common tax planning strategies to use U.S. tax losses. Therefore, during the second quarter of fiscal 2009, we recorded a valuation allowance of \$71.6 million against our deferred tax assets. At September 30, 2008 and March 31, 2008, we had net deferred tax assets of \$87.4 million and \$40.8 million, respectively, offset by a valuation allowance of \$79.9 million and \$8.4 million, respectively. The ultimate realization of our net deferred asset of \$7.5 million at September 30, 2008 is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Changes in existing tax laws could also affect actual tax results and the valuation of deferred tax assets over time. The deferred tax assets for which valuation allowances were not established relate to foreign jurisdictions where we expect to realize these assets through guaranteed profit percentages recorded at our foreign distributors. The accounting for deferred taxes is based upon an estimate of future results. Differences between the anticipated and actual outcomes of these future tax consequences could have a material impact on our consolidated results of operations or financial position.*

# Valuation Allowance - Three year rule: Sample Disclosures

- **Electronics Testing Equipment Manufacturer (Q2 2009 – Press Release)**

*Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, (SFAS No. 109), requires that companies assess whether a valuation allowance should be recorded against their deferred tax assets (DTAs) based on the consideration of all available evidence, using a "more likely than not" realization standard. In making such assessment, significant weight is to be given to evidence that can be objectively verified. In accordance with SFAS No. 109, COMPANY has evaluated its DTAs each reporting period, including an assessment of its cumulative income over the prior three-year period and future periods, to determine if a valuation allowance was required.*

*SFAS No. 109 requires that a valuation allowance be established after an evaluation of all positive and negative evidence. A significant negative factor was the possibility that COMPANY may be in a three-year historical cumulative loss as of the end of the fourth quarter of fiscal 2009, as highly profitable quarters in the second half of 2006 are removed from the rolling three-year calculation. This, combined with uncertain near-term market and economic conditions, reduced our ability to rely on projections of future taxable income in assessing the realization of our DTAs.*

*"The Q2 increase in the valuation allowance does not have any impact on our cash, nor does such an allowance preclude us from using our tax losses, tax credits or other deferred tax assets in the future," .... "The increase in the valuation allowance is not the result of a change in our view of the company's near or long-term outlook."*

# Valuation Allowance - Three year rule: Sample Disclosures

- **Automobile Manufacturer (Q3 2007, from 10-Q)**

*In the third quarter of 2007, we recorded a charge of \$39 billion related to establishing full valuation allowances against our deferred tax assets in the U.S., Canada and Germany. In accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS No. 109), we evaluate our deferred income taxes quarterly to determine if valuation allowances are required. SFAS No. 109 requires that companies assess whether valuation allowances should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In making such judgments, significant weight is given to evidence that can be objectively verified. As previously disclosed in our 2006 Form 10-K, we had determined in prior periods that valuation allowances were not necessary for our deferred tax assets in the U.S., Canada and Germany based on several factors including: (1) the degree to which our three-year historical cumulative losses were attributable to unusual items or charges, several of which were incurred as a result of actions to improve future profitability; (2) the long duration of our deferred tax assets; and (3) the expectation of continued strong earnings at COMPANY SUBSIDIARY 1 and improved earnings in COMPANY SUBSIDIARY 2.*

*We believe that a valuation allowance is now required due to events and developments that occurred during the third quarter of 2007. In conducting our third quarter 2007 analysis, we utilized a consistent approach which considers our three-year historical cumulative income (loss) including an assessment of the degree to which any losses were driven by items that are unusual in nature and incurred in order to improve future profitability. In addition, we reviewed changes in near-term market conditions and any other factors arising during the period which may impact our future operating results. We consider both positive and negative evidence in our analysis. Our analysis for*

# Valuation Allowance - Three year rule: Sample Disclosures

## **Automobile Manufacturer (cont'd)**

*the third quarter of 2007 showed that we have a three-year historical cumulative loss in the U.S., Canada and Germany. This loss continued to exist even after adjusting our results to remove unusual items and charges, which is considered a significant factor in our analysis as it is objectively verifiable and therefore, significant negative evidence. This was coupled with other significant factors which all occurred in the third quarter of 2007... The ongoing weakness at COMPANY SUBSIDIARY 1 related to its COMPANY DIVISION 1 mortgage business resulting in substantial U.S. losses incurred in the third quarter of 2007. Further, the outlook for COMPANY DIVISION 1 and the mortgage industry in general became highly uncertain, with significantly reduced near-term forecast profitability. In addition, in both the U.S. and Germany near-term automotive market conditions were more challenging than we believed in the second quarter of 2007. This, when combined with the pressures of the residential mortgage business, resulted in lower projected earnings in the near-term than we previously anticipated. We also noted that in the near-term a greater percentage of our deferred tax assets were going to be subject to expiration (e.g. 20 years) than in prior periods primarily due to changes associated with the Retiree MOU, which accelerates our tax deductions for OPEB liabilities when compared to our previously expected timing for these deductions. Accordingly, based on a three year historical cumulative loss, combined with significant and inherent uncertainty as to the timing of when we would be able to generate the necessary level of earnings to recover our deferred tax assets in the U.S., Canada and Germany, we concluded that a full valuation allowance was required.*

# Valuation Allowance

- Projections of Future Taxable Income
  - Book Income adjusted for permanent differences
  - Originating temporary differences and their reversal
  - By legal entity/jurisdiction
  - New product lines or businesses
  - History of accurate projections
  - Projections which are inconsistent with other assertions
    - Street guidance
    - MD&A
    - Projections for impairment testing under FAS 142 (ASC 350) and FAS 144 (ASC 360)
    - APB 23 (ASC 740-30) assertions

# Valuation Allowance

## **Other issues**

- Impact of acquisitions
- Release: All or nothing?
- Tax planning strategies
- Excess future tax credits

# Intraperiod Allocation

Gain or income outside of continuing operations may have impact on ETR

- Generally, the amount of tax expense or benefit from continuing operations is determined without regard to other items not a part of continuing operations
  - Exception
    - Impact of gain or income from other items in determining benefit from loss from continuing operations (FAS 109 ¶140; ASC 740-20-45-7)

# Intraperiod Allocation

- Increase in value of marketable security leads to deferred tax benefit credited to continuing ops

	Total Comprehensive Income "With"	Continuing Operations "Without" and Allocation	Exception: Allocation under ASC 740-20-45-7 (FAS 109 ¶140)
<u>Continuing Operations</u>			
Income	1,000,000	1,000,000	1,000,000
Expense	(1,600,000)	(1,600,000)	(1,600,000)
Pre-Tax Income (Loss)	(600,000)	(600,000)	(600,000)
Income Tax Benefit (Expense)	-	-	160,000 *
	(600,000)		(440,000)
<u>Other Comprehensive Income</u>			
Gain from Marketable Securities	400,000	400,000	400,000
Income Tax Benefit (Expense) - OCI	-	-	(160,000)
	400,000		240,000
<u>Total Comprehensive Income</u>			
Comprehensive Income (Loss)	(200,000)	(200,000)	(200,000)
Tax Benefit (Expense) on Comp. Inc.	-	-	-
	(200,000)	(200,000)	(200,000)

\* Benefit limited to that attributable to current year loss

# Intraperiod Allocation

- In characterizing the tax benefits from NOL carryforwards (e.g., from subsequent release of V.A.) generally FAS 109 ¶37(ASC 740-20-45-3) prohibits “backward tracing”
- Exceptions for initial recognition of tax benefits:
  - Acquired tax benefits and pre-reorganization tax benefits under “fresh start” accounting (Topic 805-740-45-2)
    - Consider changes under FAS 141(R)
  - Certain equity items
- But remember substitution rule (FAS 109 ¶243; ASU 740-10-55-37)

# Intraperiod Allocation

- Initial recognition exception

Computation of taxable income:	Year 20x1 Activity
Pre-Tax Book Income	1,000
Taxable income	1,000
NOL utilized	(1,000)
Taxable income	-
Tax Rate....	40%
Tax	-

Deferred Tax Rollforward:	Balance 1/1/20x1	Year 20x1 Activity	Balance 1/1/20x2
Pre-bankruptcy NOL	400	(400)	-
Valuation allowance	(400)	400	-
Net deferred tax asset (liability)	-	-	-

Tax Entries for Year 20x1:	Dr.	Cr.
Income tax expense	400	
Valuation Allowance	400	
Deferred Tax Asset - NOL		400
Post-reorganization assets (ordering rules)		400

Example:

- Beginning of the year DTA due to pre-bankruptcy NOL's.
- Company generates \$1,000 of book and taxable income
- Net operating loss is utilized to offset the \$1,000 of taxable income

Result:

- Under limited backwards tracing exception applicable to initial recognition of tax benefits from certain items, the tax benefit associated with the utilization of the NOL is credited to reduce value Post-reorganization assets.
- Company records a \$400 tax expense to continuing operations associated with the \$1,000 of book income from continuing operations.

# Intraperiod Allocation

- Substitution

Computation of taxable income:	Year 20x1 Activity
Pre-Tax Book Income	-
Reserve (originating TD)	1,000
Taxable income	1,000
NOL utilized	(1,000)
Taxable income	-
Tax Rate....	40%
Tax	-

Deferred Tax Rollforward:	Balance 1/1/20x1	Year 20x1 Activity	Balance 1/1/20x2
Pre-bankruptcy NOL	400	(400)	-
Reserve (originating TD)		400	400
Valuation allowance	(400)		(400)
Net deferred tax asset (liability)	-	-	-

Tax Entries for Year 20x1:	Dr.	Cr.
Income tax expense	-	
Deferred Tax Asset - Reserve	400	
Deferred Tax Asset - NOL		400
Post-reorganization assets (ordering rules)		-

Example:

- Beginning of the year DTA due to pre-bankruptcy NOL's.
- Company generates \$0 of book income, but \$1,000 of taxable income due to a non-deductible reserve.
- Net operating loss is utilized to offset the \$1,000 of taxable income

Result:

- Utilization of NOL is essentially replaced or substituted by an originating deductible temporary difference.
- Company does not record a credit to reduce the value of Post-reorganization assets.
- Company records \$0 tax expense to continuing operations associated with the \$0 of book income from continuing operations.

# Intercompany Transactions - Debt

**May be a more prevalent issue because of deterioration and lack of consistent strength in global markets**

- Difficulties in cash flow may cause balances to increase due to intercompany transactions, including:
  - Cost plus provision of services
  - Commission arrangements
  - Purchases and sales of goods
  - Cost share
  - Working capital

# Intercompany Transactions - Debt

- Section 956
  - If affiliate is claiming APB 23 (ASC 740-30) exception, generally results in an increase in ETR
- Interest on intercompany obligations
  - Imputed interest
  - Accrual of withholding taxes
- Section 267
- Thin capitalization
  - Potential for classic whipsaw due to inconsistent characterization between jurisdictions

# Intercompany Transactions – Debt and Equity

- Viability of intercompany obligations and operations
  - Worthless debt deduction
  - Worthless stock deduction under 165(g)(3)
  - Consideration of local country tax impact

# Intercompany Transactions – Transfer Pricing

- Impact of diminished margins expressed in third party (arm's length) transactions
  - Impact on income tax expense
  - Timing

# Interim Tax Computations

Fast-Moving changes in outlook may require mid-stream adjustments to computations of tax rate

- FIN 18 (ASC 740-270) principles
  - General principles
  - Ordinary income
  - Extraordinary items and discontinued operations
  - Operations taxable in multiple jurisdictions
    - Practical difficulties
  - Ordinary loss jurisdictions

# Interim Tax Computations

- Other
  - Impact of tax law changes
  - Changes in valuation allowance
  - Discrete vs. Annual rate

# Tax Accounting and Reporting Update – ASC 805 [FAS 141(R)]

November 2009

Rich Johnson, Tax Partner  
PricewaterhouseCoopers

# Tax Accounting and Reporting Update – ASC 805 (FAS 141(R)) Agenda

- Overview
- Measurement Period Adjustments
- Acquisition Related Tax Uncertainties
- Transaction Costs
- In-Process Research and Development
- Valuation Allowances
- Contingent Consideration
- Share Based Awards
- Bargain Purchase Transactions

# Overview – ASC 805 (FAS 141(R))

- Fundamental underlying principle is that the acquired business should be recorded at fair value
- Greater convergence with international reporting (IFRS)
- Effective for years beginning after December 15, 2008
  - Early adoption prohibited
  - Prospective transition (retroactive application is prohibited)
  - Immediate application to tax provisions upon adoption
    - Change in Valuation Allowance
    - Acquisition Related Tax Uncertainties

# Effects on Financial Reporting

- Greater volatility/unpredictability of effective tax rate
- Introduces unpredictability in estimating the ultimate purchase price (stock deals, contingent consideration)
- Unpredictability of the effect on ratios/performance measures
- More emphasis on due diligence

# Measurement Period Adjustments

## New Accounting

- Measurement period ends when “the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.”
- Measurement period, however, not to exceed one year.
- Any changes in acquisition accounting affecting accounts retroactively to the closing date.

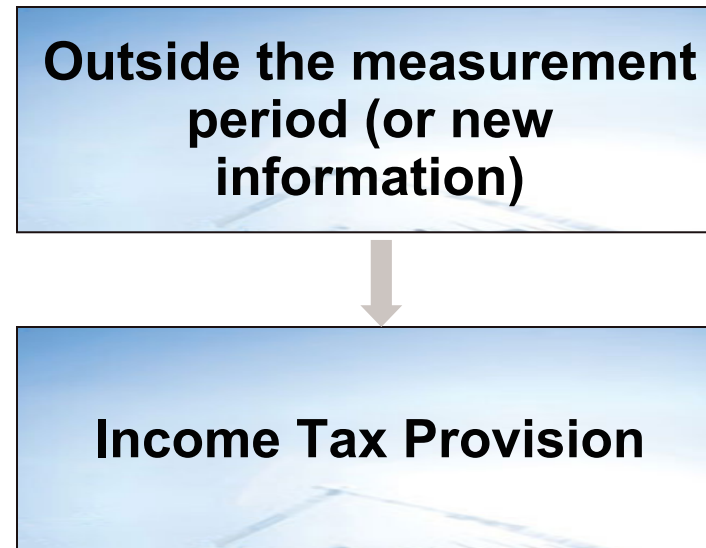
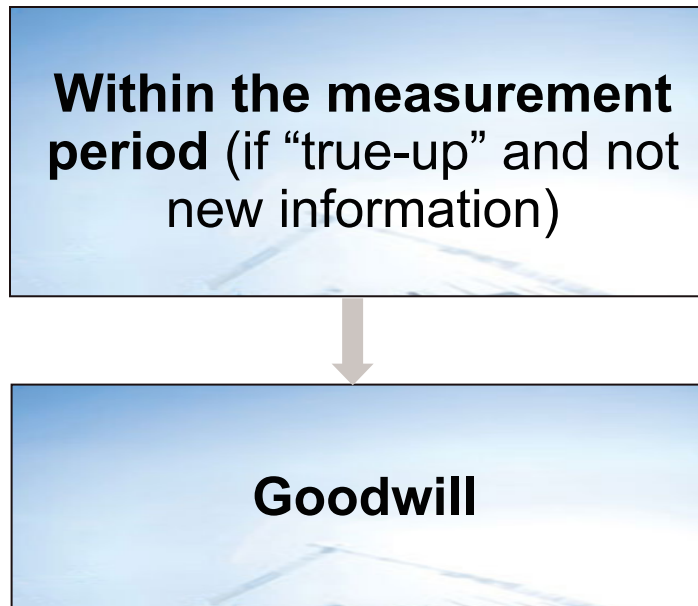
## Previous Accounting

- Allocation period not to exceed one year with changes in acquisition accounting generally prospectively.




## Impact of Accounting

- Greater need to focus on acquisition accounting and required information (e.g., valuation of intangibles) during due diligence.
- Recast prior periods presented in prospective filings.
- Might require the amendment of already filed financial statements (e.g., for new registration statements).

# Measurement Period Accounting



# Measurement Period Examples

Measurement Period Adjustment?	Yes	No
<p>Acquiring Company posts adjustment to Transfer Pricing UTP of Target Company 5 months after the acquisition date based on the final information that it was seeking in connection with the acquisition.</p>		
<p>Acquiring Company posts adjustment to R&amp;D UTP of Target Company 18 months after the acquisition date based on the final information that it was seeking in connection with the acquisition.</p>		
<p>Three months post acquisition, the Acquiring Company determines additional “hot interest” should be accrued on Target Company’s UTP based on the discovery of an IRS assessment that occurred before the acquisition date.</p>		

# Measurement Period Examples

Measurement Period Adjustment?	Yes	No
A valuation allowance on Target Company investments recorded in acquisition accounting is released due to an increase in fair value of investments six months after acquisition date.		✓
Acquiring Company decides it will amend Target Company's prior tax returns to deduct foreign taxes rather than claim them as a credit after completing an analysis of projected foreign source income to avoid having FTC carryforwards expire unused. <i>(it depends)</i>	✓	✓

# Acquisition Related Tax Uncertainties

## New Accounting

- Aside from “true-ups” during the measurement period, any subsequent adjustments based on “new information” are recognized in the income statement.
- Applicable to ALL acquisitions (even if the respective transaction was before the effective date of ASC 805 (FAS 141(R))).

## Previous Accounting

- EITF 93-7; Subsequent changes in the amount of the uncertainty are reflected in purchase accounting regardless of when that tax uncertainty is resolved. The change would first reduce goodwill, then noncurrent intangibles, then impact the income statement.

## Impact of Accounting

- More adjustments to acquired uncertain tax positions will affect income tax provision and create effective tax rate volatility.

# Transaction Costs

## New Accounting

- In a business combination, transaction costs are expensed and not included as part of the consideration transferred.

## Previous Accounting

- Transaction costs are generally a component of the consideration transferred to acquire the group of assets in an asset acquisition, and are capitalized as a component of the cost of the assets acquired.

## Impact of Accounting

- Results in lower income (primarily pre-combination) and less goodwill.
- Puts the “spotlight” on these costs from a management accountability/ service provider perspective.
- As the costs are expensed as incurred, recognition of expense and timing of deal announcement may not coincide (e.g., disclosure issue).

# Transaction Costs

## Impact of Accounting

- Tax implications of expensing transaction costs:
  - Need to potentially account for tax consequence before the transaction has been consummated (i.e., in a pre-combination period)
  - Transaction structure (i.e., asset vs. stock) and tax law treatment may determine whether a tax benefit is recognizable
  - Disproportionate ETR impact (“permanent difference”) would be expected if related amounts are embedded in the stock price for tax

# Transaction Costs

## Accounting Policy Election Decision

- Companies will want to consider which alternative is preferable before making this election.

## Alternative 1

- Don't assume the business combination will be completed.
- Record a DTA if the transaction costs would result in a future tax deduction assuming the business combination is not consummated.

## Alternative 2

- Account for transaction costs based on the tax treatment that is ultimately expected.
- Record a DTA only if the costs are ultimately expected to be included in a tax-deductible asset (e.g., tax-deductible goodwill) or otherwise deductible.

# Transaction Costs Example – Alternative 1

Company A incurred deal costs of \$1M in 2010 and \$3M in 2011 for a nontaxable stock acquisition that closed in 2011. The deal costs will be added to the tax basis of the stock of the entity and Company A is not recording deferred taxes for its investment in the stock of the subsidiary. Company A elects a policy to not anticipate the closing of the transaction and records a DTA for the deal costs as they are incurred. When the transaction closes, the DTA is written off, because Company A is not recording deferred taxes for its investment in the stock of the subsidiary.

## 2010 Impact ('000s)

	Pre-tax	Tax effect	ETR
Income	\$10,000	\$(4,000)	40%
Transaction Costs	(1,000)	400	
	\$9,000	\$(3,600)	40%

## 2011 Impact ('000s)

	Pre-tax	Tax effect	ETR
Income	\$10,000	\$(4,000)	40%
Transaction Costs	(3,000)	--	
DTA Write Off	--	(400)	
	\$7,000	\$(4,400)	63%

# Transaction Costs Example – Alternative 2

Assume the same facts as Alternative 1 except that: Company A elects a policy to determine deferred taxes for deal costs based on its expectations of how the transaction will close. For this transaction, Company A expects that the transaction will close as a nontaxable transaction and therefore does not record a DTA for the deal costs as they are incurred.

## 2010 Impact ('000s)

	Pre-tax	Tax effect	ETR
Income	\$10,000	\$(4,000)	40%
Transaction Costs	(1,000)	--	
	\$9,000	\$(3,600)	44%

## 2011 Impact ('000s)

	Pre-tax	Tax effect	ETR
Income	\$10,000	\$(4,000)	40%
Transaction Costs	(3,000)	--	
	\$7,000	\$(4,000)	57%

# In-Process R&D

## New Accounting

- Capitalized IPR&D considered indefinite-lived intangible (at purchase date) resulting in a taxable temporary difference (DTL) in a nontaxable acquisition.

## Previous Accounting

- EITF 96-7 required IPR&D write-off to be recorded on a gross basis (i.e., before measuring deferred taxes in a business combination).

## Impact of Accounting

- In nontaxable deals, no longer have a large permanent tax expense in acquisition year's income statement.
- Consider "naked credit" exposure when assessing valuation allowance needs during development-stage period and until project completion (IPR&D is amortized or written-off upon project completion).

# Example of In-Process Research & Development in a Business Combination

Acquirer determines fair value for In-process R&D efforts is \$30M in a non-taxable transaction. Book/tax income before acquisition effects is \$100M, with an applicable tax rate of 40%.

	<b>New Accounting</b>	<b>Previous Accounting</b>
IPR&D	\$30M	-
DTL	(\$12)M	
Net Assets	\$18M	
Goodwill	\$12M	-
Expensed IPR&D	-	\$30M
Pretax income	\$100M	\$70M
Tax expense	\$40M	\$40M
ETR	40%	57.1%

# Changes in Acquirer's Valuation Allowance

## New Accounting

- Changes in the acquirer's pre-existing tax balances (e.g., by reversal of an existing valuation allowance) are reflected in income.

## Previous Accounting

- Recognize changes in acquirer's valuation allowance at the date of acquisition as part of purchase accounting.
- Other "synergistic" tax impacts on acquirer (e.g., change in state apportionment rates) are also often recognized in the purchase accounting.

## Impact of Accounting

- Increased earnings volatility may occur in conjunction with the consummation of business combinations as changes in an acquirer's valuation allowance will now affect income tax provision when acquirer and target can file consolidated tax returns.

# Subsequent Decreases in Acquired Enterprise's Valuation Allowance

## New Accounting

- Decreases in valuation allowance related to target's net DTA
  - Within Measurement Period → Goodwill (generally)
  - Outside Measurement Period → Income Tax Provision (generally)
  - Applicable to ALL acquisitions

## Previous Accounting

- Subsequent decreases in valuation allowance (i.e., initial recognition of acquired tax benefits) reduce goodwill, then noncurrent intangibles, then impact the income statement.

## Impact of Accounting

- More valuation allowance releases recorded in the income tax provision, which will affect companies' effective tax rates.
- Simplifies accounting as no longer need to track attributes.

# Contingencies and Contingent Consideration

## New Accounting

- Contingent consideration will be fair valued at the time of the acquisition and then marked to market until settled.
- Tax implications predicated on the nature of the transaction.
- Nontaxable transaction
  - Generally no DTA, as amounts will be in outside stock basis
  - Any “Day 2” adjustment results in permanent difference
- Taxable transaction
  - Day 1: Included in determination of component-1 vs. component-2 goodwill
  - Day 2: Subsequent adjustments constitute temporary differences

## Previous Accounting

- Contingencies are typically measured in accordance with ASC 450-20-25-2 (FAS 5) on the acquisition date and in subsequent periods.

# Contingencies and Contingent Consideration

## Impact of Accounting

- In nontaxable deals, fair valuing contingent consideration (and adjusting contingent assets / liabilities) will create tax rate volatility.
- More contingencies will be recognized and measured at fair value on the acquisition date.
- As the acquirer cannot recognize a value greater than the acquisition-date fair value of a contingent asset or less than the acquisition-date fair value of a contingent liability until settled/ collected, the recognition of a gain is more likely upon the collection or settlement of a contingency.

# Contingent Consideration Example

Company A acquired the stock of a company in 2009 and recorded a liability of \$5M for contingent consideration. In 2010, Company A adjusted the fair value of the contingent consideration liability from \$5M to \$7M. In 2011, Company A settled the liability for \$6M. Company A is not recording deferred taxes for its investment in the stock of the acquired entity.

## 2010 Impact ('000s)

	Pre-tax	Tax effect	ETR
Income	\$10,000	\$(4,000)	40%
Contingent consideration	(2,000)	--	
	\$8,000	\$(4,000)	50%

## 2011 Impact ('000s)

	Pre-tax	Tax effect	ETR
Income	\$10,000	\$(4,000)	40%
Contingent consideration	1,000	--	
	\$11,000	\$(4,000)	36%

# Share Based Awards

## New Accounting

- For replacement awards attributable to pre-combination services, a DTA is recorded against goodwill for share-based replacement awards that ordinarily result in a tax deduction (e.g., “non-quals”, SARs).
  - Windfalls and shortfalls on replacement awards are generally recorded in APIC and impact the “windfall pool”
  - Write-off recorded in earnings once “windfall pool” has been used-up

## Previous Accounting

- No DTA is recorded; instead, the tax benefit is recognized against goodwill when the award is exercised with any excess recorded in APIC (if tax deduction is  $>$  Day 1 fair value of award).

## Impact of Accounting

- More DTAs recorded (with an offset to goodwill) in acquisition accounting for replacement awards with the potential to reverse to P&L if no windfall pool remains.
- Simplifies accounting as awards no longer need to be tracked separately.

# Bargain Purchase Transaction (“negative goodwill”)

- Fair value of acquired net assets > fair value of consideration transferred
- A bargain purchase gain may result
- The allocation of negative goodwill via the residual method may result in decreased tax bases
  - If book bases > tax bases then deferred tax liabilities should be recognized
- The recognition of deferred tax liabilities results in a reduction in the bargain purchase gain for financial reporting purposes (i.e., net of tax presentation)

# Example: Bargain Purchase (“negative goodwill”)

## Background / Facts

- Company A acquires Company B in a taxable acquisition
- Total consideration = \$230 million
- Acquired fair value of net assets = \$290 million
- The resulting allocation is as follows:

	Fair Value	Tax Basis
Class I - Cash	\$ 50	\$ 50
Class III - A/R	60	60
Class V - Tangible Property	180	120
	<b>\$ 290</b>	<b>\$ 230</b>

## Question

(1) What is the recognized deferred tax liability? (2) What is the bargain purchase gain, and (3) How are the items presented?

# Example: Bargain Purchase (“negative goodwill”)

(Continued)

## Analysis / Conclusion

- (1) The difference between the book and tax bases of acquired net assets results in the recognition of a \$24 DTL  $((180-120)*40\%)$
- Therefore, the total amount of net assets recorded in acquisition accounting is \$266 million  $(\$290-\$24)$
- (2) The bargain purchase gain is computed as follows:

Fair value of net assets acquired	\$	266
Less: Consideration transferred		(230)
Bargain purchase gain	\$	<u>36</u>

- (3) The bargain purchase gain of \$36 is reflected in earnings, net-of-tax. That is, gross bargain purchase gain is \$60  $(290-230)$  and recognized DTL is \$24  $((290-230)*40\%)$ .

# Income Tax Accounting Tidbits

November 2009

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# FIN48 – Applying the Theory

Initial recognition and measurement

Administrative practice exception

Units of account

Aggregation of positions

Subsequent changes in management's best judgment

- Recognition and “effectively settled” standard
- De-recognition
- Measurement

# FIN48 – Changes in Judgment

## Subsequent Recognition

- Change of facts related to MLTN tech'l merits
- SOL expiration
- Effectively settled – *remember, only for NMLTN positions*
  - All exam procedures complete
  - No taxpayer appeal or litigation intention *with respect to position*
  - Reexamination of position remote, *assuming full knowledge of all relevant information by tax authority*
  - Position need not be specifically examined; Effectively settled is assessed on a position by position basis

## Subsequent De-recognition - MLTN merits

Re-measurement – new “evidence” impacting probability assessment

# FIN48 Effectively Settled – Practical Issues

Effectively settled when position not explicitly examined – how to apply “full knowledge of all facts” assumption?

- Example – 870 Issued; Assessing Rev Proc 2005-32 standards for reopening cases (e.g., “administrative omission”)
- Example – Foreign jurisdiction where no formal audit closure notice is issued
- Example – NMLTN position; IRS IDR’s cover info necessary to assess issue; Issue not raised specifically; Other issues go to Appeals
- Example – position not examined embedded in carryforward

Should not be applied to the extreme (i.e., defaulting to a SOL expiration practice)

# FIN48 Re-measurement – Practical Issues

Re-measurement – what constitutes “new evidence” or “new information”?

- Weight of verbal communications (particularly in non-US jurisdictions with no formal closure notices)

Audit passed to Appeals when position not specifically examined or unchallenged

- “Full knowledge of all facts” interpretation
- Assessment of probability of Appeals raising new issue

Remember, re-measurement has lower standard than change in judgment regarding recognition

# FIN48 and Xilinx

For 9<sup>th</sup> Circuit taxpayers, would reserve addition be result of de-recognition or re-measurement?

- Remember “court of last resort” assumption for MLTN assessment

Does it matter?

What happens if en banc review is granted (and prior decision is vacated)?

What about taxpayers outside 9<sup>th</sup> Circuit?

# FIN48 Disclosures

Section 21(d) disclosure on “reasonably possible” changes in UTBs during next 12 months

## Tabular rollforward of UTBs

- “Settlement” line intended to be cash paid or refund foregone
- Difference between UTB and outcome reported in “incr/decr in prior year tax positions” line
- Example – refund claim \$100, benefit recorded of \$30, UTB of \$70; ultimately receive \$50
  - Disclose \$50 settlement benefit, \$20 decrease in p/y tax position

# EITF 08-1 and 09-3 – Bundled Hardware / Software Products

EITF 09-3 - Excludes from software accounting (SOP 97-2) tangible products with both software and hardware combining to provide “essential functionality”

Subject to EITF 08-1 – Use of Estimated Selling Price (ESP) in absence of VSOE or Third Party Evidence (TPE)

If “undelivered elements”, now can separate multiple element arrangements; effect could be to accelerate book income that would have been deferred under SOP 97-2

For FYs after 6/15/2010, but early adoption allowed

- Prospective or retrospective application allowed
- Many companies will want to restate for comparability

# EITF 08-1 and 09-3 Example

## Assumptions:

Hardware Product X contains embedded software that is not more than incidental and has no VSOE or TPE but has ESP of \$100

Software Product Y is considered essential to the hardware product's functionality and has no VSOE or TPE but has ESP of \$60

Service Z (relates to both hardware and software) has no VSOE or TPE but has ESP of \$20

Total arrangement consideration is \$160

At period end, Product X and Y is delivered and Service Z is undelivered

## At period end, revenue recognizable would be:

**\$0 under current GAAP**—Under EITF 00-21 and SOP 97-2 arrangement would constitute single unit of accounting because no VSOE or TPE of undelivered services

**\$142 under new GAAP**—All deliverables would be within the scope of EITF 08-1 and revenue would be recognized for delivered items using relative selling price method  
[ $(\$160/180)*\$160$ ]

# Tax Implications of EITF 09-3 “New GAAP”

Potential cash tax impact if historical tax deferral of associated income under Rev. Proc. 2004-34

- Form 3115 tax accounting method change?

Transfer pricing – implications on formulas based on GAAP operating income

If restating for retrospective treatment, how to handle restated quarterly FIN18 computations? Full re-computations with “backward looking” forecasts? Application of previous FIN18 rate? Apply recomputed full year rate? Or some hybrid approach?

If attributable to foreign earnings, impact on APB23 reinvestment representation – particularly if restating for retrospective treatment

# Convertible Debt – Tax Accounting Considerations

## Contingently Convertible Debt (conversion only in shares)

- Non-contingent bond method under 1.1275-4(b) might apply to yield tax deduction comparable to nonconvertible fixed-rate bond
- Excess OID tax deductions can create taxable temporary difference in basis of debt, which might never fully reverse if converted (conversion outside control of issuer)
- Nevertheless, generally record DTL; If conversion, any residual DTL typically goes to APIC

# Convertible Debt Potentially Settled in Cash – FSP 14-1

FSP 14-1 – new GAAP requires bifurcation into liability and equity components – liability portion based on debt value without conversion feature

- Debt discount amortized into interest expense
  - Effectively reflects interest expense comparable to nonconvertible debt
  - Similar to tax OID interest under 1.1275-4(b), but nuanced differences

Book bifurcation can give rise to taxable temporary difference (tax basis debt > book) at time of issuance

- DTL required through APIC, reversal of DTL through current/deferred tax expense
- DTL can be source of taxable income for VA assessment

If tax OID under 1.1275-4, book/tax interest will be similar; majority of DTL for tax interest recapture potential

If issuer also enters into an integrated call option hedge under 1.1275-6, DTA for tax OID effectively nets against DTL

# Convertible Debt with Beneficial Conversion Feature (BCF)

BCF – when effectively in-the-money conversion feature

EITF 05-08 – bifurcate debt into liability and equity components; lower debt book basis than tax, yielding taxable temporary difference

Deferred tax liability recorded to APIC (any VA reduction also through APIC)

DTL released through deferred tax benefit, current tax expense (additional book interest expense not deductible for tax)

Often combined with detachable warrants – generally no deferred tax, but may be book MTM – permanent difference considerations

# Other Tidbits

California Single Sales Factor

China Business Trust – income tax or above the line?

APB23 representations

Others?

Questions ?