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# ***Tax Accounting Services***

## Accounting for income taxes 2011 year-end hot topics

*December 13, 2011*



## A year in review

Accounting for income taxes continues to be one of the more complex and judgmental areas within a company's financial statements. Adding further complexity is the impact of the uncertain economic environment as well as the unpredictability of tax legislation throughout the world, demonstrated by some of the following events that occurred during 2011:

### Refer to:

- [\*Tax Accounting Services NewsAlert, Key Tax Accounting Considerations of the United Kingdom's Main Corporate Tax Rate Reduction\*](#)
  - [\*Tax Accounting Services NewsAlert, Key Tax Accounting Considerations of the French Tax Law Change on Tax Losses and Capital Gains on Shares\*](#)
  - [\*Tax Accounting Services NewsAlert, Key Tax Accounting Considerations of the Illinois Corporate Tax Rate Increase and NOL Suspension\*](#)
  - [\*Tax Accounting Services NewsAlert, Key Tax Accounting Considerations of the Michigan Corporate Income Tax Legislation and the Repeal of the Michigan Business Tax\*](#)
- A number of tax law changes were enacted during 2011 including:
    - United Kingdom - Reduction to 26% effective from April 1, 2011 to March 31, 2012 and further reduction to 25% effective April 1, 2012. Both tax law changes were formally enacted for purposes of US GAAP as of July 19, 2011.
    - France - New tax law provisions now limit the amount of tax losses a company may use in a specific year, but do not impact the unlimited carryforward period. The tax law change is effective for all tax losses as of September 21, 2011 and is considered enacted for US GAAP purposes as of that date.
    - Japan - Introduction of a 10% surcharge on Japanese corporate tax lasting three years for fiscal years starting between April 1, 2012 and March 31, 2015. In addition, a 4.5% reduction in the Japanese corporate income tax rate and changes to the net operating loss (NOL) rules effective for fiscal years starting on or after April 1, 2012. The tax law changes were enacted for US GAAP purposes on November 30, 2011.
    - Illinois - Rate increase to 9.5% for tax years beginning January 1, 2011 through December 31, 2014; 7.75% for tax years beginning January 1, 2015 through December 31, 2024; and 7.3% for tax years beginning on January 1, 2025, with a date of enactment under US GAAP of January 13, 2011. In addition, changes were made to NOL utilization.
    - Michigan - Repeal of the two-prong Michigan business tax and implementation of a corporate income tax, effective January 1, 2012, with an enactment date under US GAAP of May 25, 2011.
    - Internal Revenue Code (IRC) Section 901(m) was enacted on August 10, 2010 and was effective for transactions that occurred after December 31, 2010. The provision reduces the potential tax benefits of a covered asset acquisition (e.g., a Section 338(g) or Section 754 election) by denying a foreign tax credit (FTC) for the "disqualified portion" of foreign income taxes paid or accrued in connection with a covered asset acquisition. For companies providing taxes on their foreign earnings (as opposed to asserting indefinite reinvestment) or providing taxes on a branch's earnings, this provision would result in reduced FTCs available to offset any foreign taxes required to be recorded in a non-reinvestment or branch setting.

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- IFRS Update - A number of countries outside of the United States are requiring adoption, permitting adoption, or in the process of transitioning to IFRS. The United Kingdom is actively moving forward with replacing UK GAAP with IFRS for statutory reporting beginning in 2013. India has announced a plan to transition to IFRS starting in April 2011 through 2014. Brazilian GAAP was converged with IFRS during 2010. In the United States, the SEC continues to move forward with its workplan to analyze the impact of IFRS on US issuers and released a paper early in 2011 considering an endorsement approach that would incorporate IFRS standards into the US financial reporting system over a longer period of time. In November, the SEC released two additional papers, one looking at differences between the two frameworks and one discussing the application of IFRS around the world.

Given the aforementioned events of the past year, combined with the inherent complexities of accounting for income taxes, this publication focuses on the areas we expect to be most relevant for companies as they prepare their annual financial statements. While some of these topics were addressed in our 2010 NewsAlert, we have included them again due to their continued relevance. In addition, we have added new topics for issues seen in the market over the past year that we believe are relevant to many companies. For each area, we reference PwC publications that can be reviewed to gain a deeper understanding of the topics.

- Uncertain tax positions
- Valuation allowances
- Indefinite reinvestment assertions
- Business combinations
- Goodwill impairment
- Intraproduct allocation
- Share-based compensation
- Presentation and disclosure

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## Uncertain tax positions (UTPs)

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### Refer to:

- Chapter 16 of PwC's *Guide to Accounting for Income Taxes* (the Guide)
- Washington National Tax Services Insight dedicated to the codification of economic substance, released March 29, 2011
- Tax Accounting Services NewsAlert, *Accounting implications of recent IRS guidance on success-based fees*
- Tax Accounting Services publication, *The impact of transfer pricing in financial reporting*

Many calendar year-end companies included US Federal Income Tax Form 1120 Schedule UTP in their tax filings during 2010, which, in most cases, was a cumbersome exercise. As companies head into year-end, they should consider the Schedule UTP reporting requirements while preparing their 2011 financial reporting information for UTPs. This information can be leveraged when the time comes to prepare the 2011 Schedule UTP. As tax reserve documentation is being updated, companies should ensure they analyze and document the following core principles:

- Unit of account
- More-likely-than-not recognition threshold
- Cumulative probability approach
- Impact of the codification of economic substance (COES)

**New information** - The assessment of an uncertain tax position is a continuous process, which does not end with the initial determination of a position's sustainability. As of each balance sheet date, unresolved uncertain positions must be reassessed. Guidance requires that changes in the expected outcome of an uncertain tax position be based on new information, and not on a mere re-evaluation of existing information. New information can relate to developments in case law, changes in tax law, new regulations issued by taxing authorities, interactions with the taxing authorities, or some other development. The potential impact of Internal Revenue Service (IRS) Revenue Procedure 2011-29<sup>1</sup> is an example of new information that should be considered in the assessment of a company's UTP associated with success-based fees. Such developments could potentially change the estimate of the amount that is expected to eventually be sustained or to cause a position to overcome the recognition threshold (i.e., the position's sustainability becomes more-likely-than-not or the position ceases to meet the recognition threshold).

**Multiple conditions** - Situations may arise whereby more than one criterion needs to be met in order for a company to consider a tax position to be settled. In such situations, a company should evaluate criterion individually in assessing recognition with settlement of such a position not occurring until all criterion meets the more-likely-than-not requirement.

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<sup>1</sup> Revenue Procedure 2011-29 provides a safe-harbor election for allocating success-based fees paid in business acquisitions or reorganizations described in Regulation Section 1.263(a)-5(e)(3).

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**Settlement** - In assessing its tax positions, a company is required to recognize the benefit of a tax position in the first interim period that one of the following conditions are met:

- The more-likely-than-not recognition threshold is met by the reporting date
- The tax position is effectively settled through examination, negotiation, or litigation
- The statute of limitations for the relevant taxing authority to examine and challenge the tax has expired

In determining whether a tax position is effectively settled, all three of the following conditions must be met:

- Taxing authority has completed examination procedures, including appeals and administrative reviews required (ASC 740-10-25-10a), inclusive of NOL and tax credit carryforwards, which may require unique consideration if the taxing authority can re-examine the positions in a future year when assessing whether a benefit from the utilization of those items should be allowed
- Taxpayer does not intend to appeal or litigate any aspect of the tax position included in the completed examination (ASC 740-10-25-10b)
- It is remote that the taxing authority would examine/re-examine any aspect of a tax position (ASC 740-10-25-10c)

To the extent that a company meets the requirements of effective settlement, it is not optional accounting. As noted above, the guidance requires tax positions to be recognized in the earliest interim period where one of the three conditions is met. From a disclosure perspective, changes in UTPs resulting from effective settlement or new information should be presented in the tabular rollforward as a “result of tax positions taken during a prior period.”

**Intra-entity transactions (ASC 740-10-25-3(e))** - In some cases, uncertain tax positions arising from intercompany transactions may require assessment to determine whether the recognition threshold under ASC 740 is met. The scope of the deferral of tax effects attributable to an intra-entity transfer of assets includes all taxes realized by the seller, including any potential UTPs. For example, assume a company transfers US developed intellectual property (IP) to a foreign subsidiary in exchange for a lump sum payment and determines there were no uncertainties associated with the tax position and therefore no UTP was recorded. In the consolidated financial statements, the IP transfer is accounted for as a sale of assets, with the tax effects deferred and amortized over the economic life of the IP. In Year 2, the tax authorities challenge the economics of the transfer and propose a higher valuation for the IP. The reserve recorded as a result of the company’s current assessment of the UTP would be offset with an increase to the deferred charge in the company’s balance sheet.

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**Translation of reserves for UTPs** - Some US parent companies record the reserves for UTPs of their foreign businesses on the parent's books or in consolidation. When the functional currency of the foreign operation is not the financial statement reporting currency, the parent should treat the accounts as having been pushed down to the books of the foreign business. As a result, the UTP reserve would typically be denominated in the foreign currency and therefore be subject to ongoing translation adjustments. This push-down principle would also apply to the maintenance by the parent of foreign deferred taxes.

Refer to:

- *Chapter 5 of the Guide*

## *Valuation allowances*

Our experience indicates that the evaluation of the need for and amount of a valuation allowance for deferred tax assets (DTAs) continues to be an area of challenge for organizations. The assessment requires significant judgment and thorough analysis of all positive and negative evidence available to determine whether all or a portion of the DTAs will be realized. As companies perform their assessments, the following reminders may be helpful:

- ASC 740 requires all available evidence be considered in determining whether a valuation allowance for DTAs is needed, including events occurring subsequent to an entity's year-end but before the financial statements are released that provide additional evidence. However, a valuation allowance assessment should not consider transactions for which the company does not have control until such transactions are complete. For example, initial public offerings, business combinations, and financing transactions are generally not considered as part of a valuation allowance assessment until complete.
- Consideration of tax-planning strategies is not elective and must be considered before a company records a valuation allowance. Therefore, a reasonable effort should be undertaken by management to find tax-planning strategies that are "prudent and feasible," meaning the strategy must provide cash savings to the reporting group and be primarily within the control of management.
  - Tax-planning strategies are not applicable for companies with operations in jurisdictions in which NOLs and carryforwards do not expire. However, the impact of objectively verifiable tax-planning "actions" on future income projections should be considered.

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- The tax benefit recognized for tax-planning strategies is recorded net of any cost or expense incurred in implementing the strategy. Tax-planning strategies that involve an intra-entity asset transfer from a higher tax-rate jurisdiction where the entity currently does not pay taxes (as a result of losses) to a lower tax-rate jurisdiction (where the entity does pay taxes) result in the tax benefit of the tax-planning strategy being measured at the lower tax rate. The tax-rate differential effectively is a cost associated with implementing the strategy.
  - When an economic tax-planning strategy involving an intra-entity asset transfer uses a NOL or tax credit that the company has previously maintained a valuation allowance on, the release of the valuation allowance would not be considered a tax consequence of the intra-entity transfer. Therefore, the intra-entity balance sheet deferral required under ASC 7401-10-25-3(e) would not apply to the valuation allowance release and an income tax benefit must be recognized.
  - Some of the recent tax law changes may have an impact on a company's assessment of the realizability of its deferred tax assets. For example, the recent French legislation limited the amount of taxable income that can be offset by NOLs in a given tax year. In a situation where a company is in a cumulative loss position and relying upon reversing temporary differences to support the recovery of all or a portion of an NOL DTA, a valuation allowance may be required (or need to be adjusted) to reflect the shift of loss utilization into later years.
  - The realization of DTAs is dependent upon the existence of sufficient taxable income of the appropriate character (e.g., ordinary or capital) within the carryback or carryforward period and must represent incremental cash tax savings. For example, if tax losses are carried back to prior years and free up tax credits (which were originally used to reduce the tax payable), rather than resulting in a refund, a valuation allowance would be necessary if there is no source of income to realize the freed-up tax credits. In other words, the substitution of a future DTA does not necessarily support realization of an existing DTA absent future taxable income from other sources.
  - Future reversals of existing taxable temporary differences—as well as liabilities for unrecognized tax benefits—are sources of taxable income for purposes of assessing realization of DTAs. Consideration must be given to whether the expected timing of such reversals would support realization.

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- “Naked credits” are taxable temporary differences associated with indefinite-lived assets (e.g., land, goodwill, indefinite-lived intangibles) and generally cannot be used as a source of taxable income. Thus, a valuation allowance on DTAs may be necessary even when an enterprise is in an overall net deferred tax liability (DTL) position. However, DTAs for tax attributes with an unlimited carryforward period (e.g., AMT credit carryforwards and other non-expiring loss or credit carryforwards) can be supported by naked credits, assuming that they are within the same jurisdiction.
    - While detailed scheduling is not always required -- it is required when the realization of deferred tax assets is dependent upon future reversals of existing taxable temporary differences.
    - The specific facts and circumstances will determine the extent to which detailed scheduling is necessary. However, at a minimum, an inventory should gather all DTAs and DTLs by jurisdiction to ensure where DTLs are being relied upon they will in fact reverse in the appropriate periods and are not restricted in some way that would prevent realization.
  - The importance of disclosure regarding valuation allowance assessments cannot be overemphasized. The SEC staff (the staff) continues to focus on the judgments and disclosures and has regularly been requiring that disclosures include a discussion of the evidence considered, including reference to negative evidence such as recent losses, the basis for the conclusion as to whether a valuation allowance is or is not required, and the possibility for near-term changes. Other areas of focus by the staff include:
    - The provision or retention of a valuation allowance when it appears to be overly conservative and when it may suggest earnings management (i.e., selecting the period in which to release the valuation allowance)
    - Adequacy and consistency of estimates used in the valuation allowance assessment with other estimates involving assumptions about the future used in the preparation of the financial statements and in other filing disclosures
    - “Early warning” disclosures when it's reasonably possible that a material adjustment of the valuation allowance will occur in the near-term

Refer to:

- Chapter 11 of the Guide
- PwC Tax Accounting Services Thought Leadership, *Deferred Taxes on Foreign Earnings - A Road Map*
- Tax Accounting Services NewsAlert, *Tax Accounting Considerations Related to Lapsing Subpart F Provisions*

## *Indefinite reinvestment assertions*

The assertion of indefinite reinvestment of foreign subsidiary earnings continues to be one of the more complex and judgmental areas of accounting for income taxes, and the ongoing uncertainty within the global economy has only made the assertion more challenging. When evaluating these assertions, companies should consider the following:

- The assertion needs to be considered at every level of an organization's legal entity structure, and coordination and alignment among multiple business functions within a company's global organization is imperative. A specific documented plan should lay out items such as the parent and subsidiary's long-/short-term projected working capital and other capital needs in locations where the earnings are generated, as well as reasons why any excess earnings are not needed by the parent or another subsidiary elsewhere in the chain. Some of the other items to be considered in the documented plan are parent and subsidiary long-/short-term budgets and forecasts, past dividends, and the tax consequences of a decision to remit or reinvest.
- Management must have the ability, intent, and control to indefinitely prevent the outside basis difference of a subsidiary from reversing with a tax consequence. Where controlling or shared ownership is present, the assertions must be aligned with the expectations of owners who may have governance or decision-making influence.
- An indefinite reinvestment assertion applies only to the outside basis difference in foreign subsidiaries, not to subsidiaries in the same country as the investor. (Whether a DTL is required for an outside basis difference in a domestic subsidiary depends upon whether the tax law provides a means for tax-free recovery of such basis and whether the company expects to avail itself of those means.)
- The liquidity and overall financial health of the company must be factored into the indefinite reinvestment assertion. If the unremitted earnings are needed to meet existing obligations and keep the business afloat, this lends itself to a presumption that the assertion cannot be made.
- Multinational companies should consider the effect the scheduled expiration of two favorable Subpart F provisions (look-through treatment of payments between related controlled foreign corporations and exceptions for certain active financing income) may have currently on the measurement of deferred taxes and indefinite reinvestment assertions. The expiration of these provisions increases the importance of evaluating the indefinite reinvestment assertion at lower levels of a company's organization structure due to the increased potential for Subpart F to arise on cross-border dividend payments.

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- In general, a deferred tax asset should not be recognized for FTCs that currently do not exist, but will be generated by the reversal of a taxable temporary difference (often referred to as “unborn FTCs”). However, an exception to this concept may exist if all of the conditions, except for the actual repatriation of cash, have been met to create the credits. Even in this situation, the company must be committed to making the repatriation in the near term. Note that these unborn FTCs can reduce the DTL required on the outside basis differences in a foreign subsidiary.
  - When the indefinite reversal assertion has been made on unremitted earnings, deferred taxes are not typically provided on translation adjustments. However, if deferred taxes are not provided on unremitted earnings because it is expected that their repatriation will result in no additional US tax because of foreign tax credits, it may still be necessary to provide deferred taxes on the translation adjustments themselves if the indefinite reversal criteria are not met and if the realization would not constitute foreign-source income or would not generate foreign tax credits. Additionally, keep in mind that if a company changes its indefinite reinvestment assertion, the impact of current-year movement in the cumulative translation adjustments (CTA) account on the expected tax liability for the repatriation should generally be recorded through other comprehensive income (OCI). However, because the beginning-of-year CTA account balance arose in prior years, the tax effects associated with the beginning-of-year balance should be recorded to continuing operations and not “backwards traced” to OCI.
  - A parent company may enter into a transaction that qualifies as a hedge of its net investment in a foreign subsidiary. Any gains or losses associated with this hedge are recognized in the CTA account. Additionally, since the tax consequences will be triggered upon settlement of the hedge and there is no way to defer the consequences, even if the indefinite reversal exception applies, the parent should provide for the tax effects (through CTA) of any temporary differences resulting from the hedging transaction.

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- With regard to branch operations, an entity should have two sets of temporary differences that give rise to deferred taxes, one for the foreign jurisdiction in which the branch operates and one for the entity's home jurisdiction. In addition, the entity should record deferred taxes in its home country for the tax effects of foreign deferred taxes because each would be expected to constitute a temporary difference in the home country deferred tax computation. A company may or may not apply an indefinite reversal assertion to the CTA of the foreign branch, depending on the application of the accounting literature and the company's facts and circumstances. If a company chooses to apply the indefinite reversal assertion to the CTA on their branch operations and the assertion later changes, the deferred taxes attributable to current-year CTA movement are recorded to OCI and deferred taxes for the beginning-of-year CTA balance are recorded to continuing operations (pursuant to ASC 740-20-45-11(b)).
  - When multinational companies award their foreign subsidiary employees with stock compensation, consideration should be given to the potential impact of those awards on the outside basis in the foreign subsidiaries. To the extent the local country provides a tax deduction for the stock compensation, the foreign subsidiary's earnings and profits for US tax purposes may be impacted, thereby reducing the potential amount of US taxes paid when cash is distributed from the foreign subsidiary.
  - The SEC is continuing to encourage more robust disclosures around indefinite reinvestment. Companies are required to disclose the amount of the temporary difference and the unrecorded liability if practicable. A number of SEC comments have inquired as to why a company is unable to calculate the related DTL. Additionally, SEC comments with regard to liquidity and the financial statement impact of repatriating cash where a company otherwise is asserting indefinite reinvestment have significantly increased in the past 12 - 18 months. As companies review their indefinite reinvestment disclosures for year-end, they should be cognizant of the SEC's focus and also ensure that they provide the necessary early warning disclosures if they are looking to make significant changes.

Refer to:

- Chapter 8 of the Guide
- Chapter 10 of the Guide
- PwC's *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests*
- Tax Accounting Services publication, *Tax indemnification arrangements: Navigating the financial reporting*

## Business combinations

The accounting under ASC 805, *Business Combinations*, continues to be an area of focus and technical challenge. The following are some key considerations for companies to have in mind related to business combinations.

- The general principles of business combinations include:
  - From a financial reporting perspective, assets acquired and liabilities assumed are recorded at fair value under the concept of "market participants."
  - However, market participant is not necessarily from the buyer's point of view. While the buyer may be a market participant, the expectation is that buyer specific actions are not the sole driver of fair value.
- ASC 805 further provides that income taxes should be measured under ASC 740. DTAs and DTLs are recognized for the tax effects of the difference between the assigned value under ASC 805 and the tax basis of each asset acquired and liability assumed as of the acquisition date.
- Consideration should be given to tax-planning, elections, and restructurings, which may occur in conjunction with a business combination, to determine whether the effects should be included in or outside of acquisition accounting. A transaction is likely to be recognized and accounted for separately from a business combination if it is entered into by or on behalf of the acquirer, and is primarily for the benefit of the acquirer or the combined entity rather than that of the acquiree or its former owners. ASC 805 provides three factors, which are neither mutually exclusive nor individually conclusive, to consider in making this determination, which requires a high degree of judgment and analysis: (1) the reason for the transaction, (2) who initiated the transaction, and (3) the timing of the transaction. A few examples are as follows:
  - If an acquiree's DTAs would no longer be realizable as a result of a planned restructuring, the acquirer may need to consider whether a valuation allowance would be established in or outside of acquisition accounting.
  - In general, a voluntary change in tax status of an acquired entity following an acquisition should be accounted for outside of acquisition accounting. However, we believe it would be appropriate in some circumstances to account for such change within acquisition accounting. Specifically, 1) as of the acquisition date, the entity qualifies for and intends to make the election; 2) the election is effective at the acquisition date; and 3) there is no consideration paid to the tax authority to effect the change.

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- Adjustments within the measurement period are generally recorded through acquisition accounting (i.e., goodwill) as long as they are based on information available as of the opening balance sheet date, with adjustments made after the measurement period generally reflected in earnings.
  - **Business combinations achieved in stages** - For a business combination achieved in stages, the acquirer should re-measure its previously held equity interest in the target as of the acquisition-date and recognize the resulting holding gain or loss (including the associated impact of the incremental deferred taxes) in earnings. Furthermore, if upon obtaining control of a domestic subsidiary the parent has the intent and ability under the tax law to recover its investment in a tax-free manner, then the entire DTL related to the outside basis difference on the previously held investment is reversed through the acquirer's income statement outside of acquisition accounting. If the subsidiary is foreign, then generally the DTL (or a portion of that DTL) related to the outside basis difference on the previously held investment must be retained.
  - **Post-acquisition changes** - Acquired enterprises' post-acquisition changes related to valuation allowances and uncertain tax positions are reported in earnings, unless they qualify as measurement period adjustments. Additionally, interest on pre-acquisition liabilities that accrue after the acquisition date should be included in income from continuing operations.
  - **In addition to the highlights above, keep in mind that the following are also important with respect to business combinations:**
    - Tax indemnifications
    - Contingent consideration
    - Acquisition-related costs
    - Treatment of tax uncertainties
    - In process research and development (IPR&D)

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## Goodwill impairment

*Refer to:*

- Chapter 10 of the Guide
- Tax Accounting Services publication, *Goodwill impairment testing: Tax considerations*

As companies test their goodwill to determine whether it has been impaired, they should include income tax considerations in the analysis because they may have a significant impact on whether there is an impairment of the goodwill as well as the amount of impairment.

On September 15, 2011, the FASB issued Accounting Standards Update No. 2011-08, **Testing Goodwill for Impairment**, which was intended to reduce the cost and complexity of the annual goodwill impairment test by providing the option (“step zero”) of performing a “qualitative” assessment to determine whether further impairment testing is necessary ( i.e., step one of the two-step annual goodwill impairment test). An entity is now required to perform step one only if it concludes that it is more-likely-than-not that a reporting unit’s fair value is less than its carrying amount. The revised guidance provides examples of events and circumstances that an entity should consider when performing the qualitative assessment, such as the entity’s overall financial performance, macroeconomic conditions, and events affecting a reporting unit, all of which can be impacted by a company’s tax position.

For companies working through the goodwill impairment process, they should consider that the qualitative assessment under step zero will be impacted by the company’s tax profile (i.e., its cash tax position, forecasted effective tax rate, tax legislative environment). If a company concludes that it did not pass step zero, it would move to step one and step two (when applicable) of the impairment testing process to determine any impairment results. Refer to the PwC publications below for additional tax considerations when working through step one and step two of the impairment testing process.

*Refer to:*

- Chapter 12 of the Guide

## *Intraperiod allocation*

Allocating income tax expense (or benefit) to the various components of comprehensive income and equity is another complex area of accounting. Key points to consider include:

- In general, income tax expense (or benefit) is allocated to the financial statement category where the pre-tax item was recorded. This basic approach is often referred to as the “with-and-without” or “incremental” approach.
- Subsequent changes (e.g., tax rate changes and valuation allowance changes) are recognized in continuing operations, except in limited circumstances (i.e., backwards tracing is generally prohibited).

An exception to the with-and-without approach is that all items (e.g., extraordinary items, discontinued operations, and items recorded in OCI) should be considered in determining the amount of tax benefit that results from a loss from continuing operations. Application of this exception makes it appropriate to consider, for example, a gain in OCI in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. This would be the case even if the loss from continuing operations would have attracted no tax benefit on a with-and-without basis.

**In addition to the highlights above, keep in mind that the following are also important with respect to intra-period allocations:**

- Allocation if there are two or more components other than continuing operations
- Exceptions to backwards tracing
- Retrospectively adjusted prior-year financial statements
- Treatment of valuation allowance releases
- Presentation of tax-effects of the sale of stock of a subsidiary
- Complexities in accounting for windfall benefits under ASC 718

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## Share-based compensation

When evaluating tax accounting for stock-based compensation, the following issues should be kept in mind:

Refer to:

- Chapter 18 of the Guide

- **IRC Section 162(m) limitations:** When a company enters into an employment contract with a “covered employee,” as defined under IRC Section 162(m), which includes both cash and stock-based compensation, the question arises as to whether a deferred tax asset should be recognized for the stock-based compensation that may be subject to the IRC Section 162(m) limitation. The FASB’s FAS 123(R) Resource Group determined that three approaches were acceptable (as an accounting policy election) for determining whether a deferred tax asset should be recorded for stock-based compensation that may be subject to Section 162(m). First, the impact of future cash compensation takes priority over stock-based compensation awards. Second, the impact of the stock-based compensation takes priority over future cash compensation. Third, prorate the anticipated benefit between the cash compensation and stock-based compensation and reflect the deferred tax asset for the stock-based compensation award based on a blended tax rate that considers the anticipated future limitation in the year such temporary difference is expected to reverse, which we believe is the preferable method because it minimizes the disproportionate effects on the reported tax provision.
- **Uncertain tax positions and “backwards tracing”:** ASC 740-20-45-3 generally prohibits “backwards tracing.” However, an exception exists that requires backwards tracing for the initial recognition of the tax effects of certain equity items listed in ASC 740-20-45-11 para. (c) - (f), which we believe would include both favorable and unfavorable adjustments resulting from a change in the assessment of an uncertain tax position as it relates to those equity items. To the extent the company has a sufficient pool of windfall benefits, it should “backwards trace” to additional paid in capital (APIC) the tax effect of increases and decreases to the liability for a UTP associated with the windfall benefit.
- **Loss or credit carryforwards:** When the settlement of a stock-based compensation award results in or increases an NOL or other carryforward, any excess (“windfall”) tax benefit should not be recorded until the deduction reduces income taxes payable. In effect, additional equity (APIC) is recorded only when the related deduction reduces cash outlays for tax. However, to the extent a portion of the NOL corresponds to the book compensation cost, a deferred tax asset subject to normal valuation allowance considerations would be recorded.

- **Valuation allowance:** When an award is settled and the award's related deferred tax asset has a valuation allowance recorded against it, the shortfall, if any, results in no effect on the financial statements because any effect from reversing the deferred tax asset is directly offset by the reversal of the corresponding valuation allowance.
- **Underwater options:** Declines in stock prices may suggest that some stock-based compensation awards for which DTAs have been recorded are unlikely to be exercised. In these cases, absent negative evidence about future taxable income, companies should neither record a valuation allowance nor reverse the DTA, even if there is no expectation that the award will be exercised. The DTA should be reversed only when the award has lapsed or been forfeited. However, consideration should be given to disclosure that may help users assess the economic exposure to the company.

## *Presentation and disclosure*

### *Refer to:*

- Chapter 15 of the Guide

In light of recent heightened regulatory focus on income-tax-related disclosures, organizations may want to consider enhanced or more robust procedures around the identification and development of income tax disclosures. Key points to

Tax-related disclosures should be consistent with other disclosures within Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

- Consideration should be given to “early warning” disclosures related to income taxes. For example, disclosure of possible near-term recognition or release of a valuation allowance, or a material change in an uncertain tax position.
- Where more than one accounting methodology may be reasonably applied to a company's transactions or its approach to recognition, measurement or classification of tax accounts, disclosure of the policy/approach applied by the company should be considered.
- Consideration should be given to jurisdictional netting to ensure deferred taxes are appropriately classified on the balance sheet.
- The valuation allowance for a particular tax jurisdiction should be allocated between current and non-current DTAs for that tax jurisdiction on a pro rata basis. Additionally, S-X Rule 5-04 requires that valuation allowance details be provided on Schedule II. If the information required by Schedule II is provided in the financial statements or notes, the schedule can be omitted.
- Financial statement amounts reported in the consolidated income tax provision and net income attributable to non-controlling interest differ based on whether the subsidiary is a C-corporation or a partnership.

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- Consideration should be given to disclosure of the nature and effect of significant items affecting the comparability of the tax accounts and effective tax rate for all periods presented.
  - Rule 4-08(h) of Regulation S-X requires disclosure of individual reconciling items that are more than 5% of the amount computed by multiplying pre-tax income by the statutory tax rate. Care should be taken to ensure that items are not aggregated nor disaggregated when assessing the need for disclosure. Additionally, groupings should be consistent from year to year.
  - Disclosure of tax attribute carryforwards should be based upon the ASC 740 recognition and measurement criteria. A company may wish to consider disclosure of both the amounts claimed in tax returns and the respective amounts benefitted under ASC 740.
  - Unrecognized tax benefits disclosure includes positions expected to be taken in amended tax returns (or refund claims) as well as positions presented directly to a taxing authority during the course of an examination.
  - The footnote disclosure requirements for UTPs indicate that all of the disclosures should be provided for each of the periods presented in the financial statements.
  - Companies must disclose the nature of uncertain positions and related events if it is reasonably possible that the positions and events could change the associated recognized tax benefits within the next 12 months (including previously unrecognized tax benefits that are expected to be recognized upon the expiration of a statute of limitations within the next year).
  - Companies that have been granted a tax holiday from income taxes by a foreign jurisdiction must disclose the aggregate dollar and per-share effects of the tax holiday as well as the date the tax holiday will terminate.
  - Consideration should be given to the disclosures of non-public entities; as such entities are exempt from certain disclosure requirements, including numerically reconciling the ETR.
  - Companies should ensure disclosures are transparent and helpful to the users. For example, disclosures should apply the appropriate statutory rate and provide clarity with respect to rate effects attributable to domestic versus foreign income.

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