Tax Accounting Services

Accounting for Income Taxes: 2014 Year-end Hot Topics

January 2015
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A year in review

Calendar year 2014 has seen considerable activity in the legislative and regulatory landscapes both in the United States and abroad. These developments, combined with an environment of political and economic uncertainty, have added to the existing challenges in accounting for income taxes.

The global tax environment continues to evolve as companies are faced with a rapidly-changing business landscape, increased stakeholder scrutiny, and a heightened enforcement environment. Trends in responsibility and integrated reporting, as well as the use of non-GAAP measures have also gained momentum.

Managing tax risks and addressing a perception that companies may not be paying their “fair share” of tax are in the spotlight as stakeholders have increasingly shown interest in these areas. Tax planning and certain areas of tax accounting have become Boardroom issues.

As in prior years, this publication is focused on topics we believe will be widely relevant to the preparation of 2014 year-end financial statements. Some topics have been discussed in our prior annual publications; however, their continuing importance warrants their inclusion in 2014. For information related to presentation and disclosure, please refer to the separate PwC Tax Accounting Services Income Tax Disclosure publication.

Unless specifically indicated, the discussion and references throughout the publication pertain to US generally accepted accounting principles (US GAAP) and reporting considerations.
Tax law developments

Under US GAAP, Accounting Standards Codification (ASC) 740, *Income Taxes*, requires companies to measure current and deferred income taxes based upon the tax laws that are enacted as of the balance sheet date of the relevant reporting period. As a result, for the measurement of deferred tax assets and liabilities, the applicable tax rate applied to cumulative temporary differences is based upon the enacted law for the period in which the temporary differences are expected to be realized or settled. Thus, even legislation having an effective date in the future will typically cause an immediate financial reporting consequence upon enactment.

Under International Financial Reporting Standards (IFRS), International Accounting Standard (IAS) No. 12, *Income Taxes*, requires companies to measure current and deferred income taxes based on the tax laws that are enacted or substantively enacted as of the balance sheet date of the relevant reporting period. This can mean that for a particular reporting period, the effects of a tax law may be reported under IFRS but not under US GAAP. For additional information, please refer to the PwC Global Tax Accounting Services publication *Around the World: When to account for tax law changes.*

At each reporting date, other tax law developments, such as federal, state, and international court decisions, should also be timely considered for effects on existing uncertain tax positions, or on positions expected to be taken in the future. The existence of controls to proactively monitor, evaluate, and timely consider the accounting implications of such matters is critical.

The following highlights several 2014 tax law changes and developments around the world.

### US and state tax law developments

- **United States federal** – As mentioned in our 2013 *Hot Topics* publication, a number of US tax law provisions expired on December 31, 2013. At the end of 2014 President Obama signed into law the Tax Increase Prevention Act of 2014, providing for a one-year retroactive extension of expired business and individual tax provisions. Key business provisions that were renewed through December 31, 2014 include the research credit, 50-percent bonus depreciation, look-through treatment for controlled foreign corporations (CFCs), and the subpart F exception for active financing income.

- The Internal Revenue Service (IRS) issued final regulations on the IRC Section 174 deduction for research and experimentation expenditures (T.D. 9680) that adopt, with certain modifications, the proposed regulations issued in September 2013.

- The IRS issued final regulations under Section 168 regarding disposals of tangible depreciable property (T.D. 9689), which modify the proposed regulations issued in September 2013.

- The IRS issued final Section 861 regulations (T.D. 9676) regarding the allocation and apportionment of interest expense in calculating the foreign tax credit. These regulations finalized temporary and proposed regulations without substantive change.

- The IRS indicated that final regulations applying to foreign currency translation under Section 987 could be issued by the end of the calendar year.

- **New York** – On March 31, 2014, Governor Andrew Cuomo signed the state’s fiscal year 2014-2015 executive budget legislation. The legislation overhauled the corporate tax regime and made other changes to various tax provisions.

- **Rhode Island** – On June 19, 2014, Governor Lincoln Chafee signed into law the following changes to the business corporation tax: (1) a tax rate reduction from 9% to 7%, (2) mandatory unitary combined reporting, (3) special treatment for entities organized in ‘tax haven’ countries, (4) single sales factor apportionment, and (5) repeal of related party expense add-backs. The new law also repealed the franchise tax for tax years beginning on or after January 1, 2015.

- **Michigan** – On July 14, 2014, the Michigan Supreme Court held that International Business Machines Corporation (IBM) was entitled to use the Multistate Tax Compact’s (MTC) elective three-factor apportionment formula to calculate its 2008 Michigan business tax. The court further held that the modified gross receipts component of the tax fit within the broad definition of an income tax under the MTC, thereby allowing IBM to use the Compact’s elective formula for this portion of the tax base.

Significant changes include: (1) eliminating the bank franchise tax and subjecting all corporations to a revised corporate franchise tax, (2) reducing the corporate tax rate from 7.1% to 6.5%, (3) increasing the MTA surcharge rate from 17% to 25.6%, (4) establishing a 0% tax rate for “qualified New York manufacturers”, (5) phasing out the capital base tax rate to 0% by 2021, (6) implementing a new unitary combined reporting system, (7) revising the net operating loss provisions, and (8) establishing a single receipts factor apportionment formula with customer sourcing provisions.

New York City has yet to conform to these changes; taxpayers will be required to determine their overall state and city liabilities under two different tax regimes.
On September 11, 2014, Governor Rick Snyder signed legislation (S.B. 156) retroactively repealing the Multistate Tax Compact from the state statutes, effective January 1, 2008. The legislation is intended to supersede the Michigan Supreme Court’s decision and potentially relieve the state from paying refund claims to other taxpayers who elected the three-factor apportionment formula.

**International tax law developments**

- **Austria** – In 2014 Austria enacted a number of significant tax measures, including: (a) limitation on utilization of foreign tax losses to 75% of Austrian taxable income; (b) elimination of goodwill amortization; (c) disallowance of deductions for ‘golden handshakes’ (generally, special severance payments).

- **Australia** – The Australian government repealed the carbon tax and minerals resources tax. It also repealed the following measures retroactively: (a) deduction for geothermal energy exploration expenditures (effective from July 1, 2014); (b) immediate deduction for certain depreciable assets held by a small business (effective from January 1, 2014); and (c) loss carry-back rules (effective from July 1, 2013). In addition, amendments were made to thin capitalization rules to reduce the safe harbor debt amount from 75% to 60% of adjusted Australian assets (an effective debt/equity ratio of 1.5:1, replacing the existing 3:1 ratio) and increase the de minimis threshold for allowable debt deductions to $2m. Lastly, the participation exemption for dividends received from foreign companies on shares that qualify as debt interests under the Australian debt/equity rules was removed and an integrity measure with respect to the non-resident capital gains tax provisions was introduced.

- **Chile** – Significant tax reform measures were enacted in Chile that included: (a) creation of two alternative methods of income taxation at the shareholder level (attribution basis and cash basis); (b) gradual corporate income tax rate increase from 20% to 25% (for shareholders on the attribution method)/27% (for shareholders on the cash basis method) in 2018; (c) the thin capitalization debt/equity rules will now be applied to total (foreign and local) indebtedness; (d) a 35% tax on capital gains of foreign shareholders recognized in connection with the sale or other transfer of Chilean shares; (e) limitation on amortization of goodwill; (f) introduction of CFC and general anti-tax-avoidance rules.

- **Hungary** – In 2014 changes to tax loss carry-forward rules were enacted in Hungary. Broadly, tax losses incurred after 2015 will be available for utilization within five years, and losses incurred before 2015 will be available for utilization up to 31 December 2025.

- **Japan** – In 2014 tax reform was enacted in Japan. Key measures of the reform include: (a) the termination of the Restoration Corporation surtax effective from April 1, 2014, (b) extension of the temporary suspension of the tax loss carry-back for another two years (small and medium enterprises excluded); (c) temporary suspension of the taxation of retirement pension funds was extended for another three years.

- **India** – The Indian Budget 2014 included the following corporate tax changes: (a) general anti-avoidance rules which become effective April 1, 2015; (b) capital gain treatment for income arising from transactions in securities (including derivatives) of foreign institutional/portfolio investors; (c) an extension of the concessional 5% withholding tax rate for foreign loan agreements entered into before June 30, 2017; (d) exemption of Indian capital gains tax for the transfer of certain government securities between two non-Indian residents outside India.

- **Luxembourg** – The Luxembourg Parliament approved law 6556, intending to align certain tax provisions with the European Union (EU) law. Taxpayers migrating their statutory seat and place of central administration from Luxembourg to another European Economic Area (EEA) member state (i.e., to an EU member, Iceland, Liechtenstein or Norway) now have an option to defer the exit tax arising on the migration without incurring interest on the outstanding tax liability. In addition, a ‘roll over’ is now available for capital gains realized on the disposal of certain qualifying assets (e.g., immovable property) if the sale proceeds are reinvested in an asset allocated to a permanent establishment of the company in any other EEA member state and certain other conditions are satisfied.

- **Poland** – Stricter thin capitalization rules were introduced in Poland. In particular, the debt/equity ratio is now 1:1. In addition, there are now new CFC provisions which apply to passive income taxed at a rate lower than 14.25%. Subsidiaries in ‘tax havens’ also will be treated as CFCs.

- **Russia** – In 2014, Russia eliminated a 30% tax rate on dividends payable on the shares of Russian issuers recorded through depositary programs and other accounts of foreign intermediaries. This rate previously applied when information about the beneficial owners of dividends was not disclosed in due course to a Russian tax agent. With the change, effective on January 1, 2015, the maximum Russian withholding income tax rate on dividends will be 15%.

- **Spain** – The corporate income tax rate in Spain was reduced from 30% to 28% for 2015 and to 25% for 2016 year (30% rate would continue to apply to financial institutions). In addition, the offset of tax losses is now limited to 70% of taxable income, and impairment losses in relation to tangible assets and investment property are no longer tax deductible.

- **Thailand** – Thailand reduced its corporate income tax rate for the 2015 year from 30% to 20%. Without further action the rate will revert to 30% in 2016.
• **United Kingdom** (UK) – The following budget proposals were enacted: (a) changes to the grouping rules for the UK debt capitalization rules; (b) restrictions on utilization of trading losses due to changes in corporate ownership were relaxed, (c) annual investment allowance (100% capital allowed on plant) was increased to GBP 500,000.

• **Venezuela** - On November 18 2014, a reform of the Venezuelan Income Tax Law was enacted creating a 25% cap (of the tax period’s taxable income) for utilisation of carryforward losses.

**Other developments**

• **Country-by-country reporting** – On September 16, 2014, the Organization for Economic Co-operation and Development (OECD) issued the final template for country-by-country reporting (CBCR template) as part of its first round of deliverables in relation to the Base Erosion and Profit Shifting (BEPS) Action Plan. Using the CBCR template, multinationals would be required to report the following data for all tax jurisdictions in which they are subject to tax: (1) revenues (from both related and unrelated party transactions); (2) profit before income tax; (3) cash income tax paid; (4) current year income tax accrual; (5) stated capital; (6) accumulated earnings; (7) number of employees; and (8) tangible assets (excluding cash and equivalents). The OECD will continue working on implementation and filing issues and report on these matters at the beginning of 2015.

• **State aid** – At the beginning of 2014, the European Commission (EC) announced a new focus on fiscal state aid. Specifically, the EC has initiated several investigations addressing whether a tax benefit obtained via member state rulings, agreements, settlements or targeted incentives constitute unlawful State aid. If a tax benefit is found to be State aid, the EC may require the relevant state to recover the unlawful tax benefit from the taxpayer with compound interest for the ten years prior to the opening of the investigation. In 2014 the EC opened a series of investigations into specific tax rulings and tax regimes. The EC also ordered Spain to recover aid granted through amortization of financial goodwill on indirect shareholdings. However this decision was overruled by the General Court of the EU in December 2014 on the basis that the EC failed to establish that the Spanish regime was selective.

• **Diverted Profits Tax** – In December 2014, the UK government announced a proposal to introduce a 25% tax targeting ‘artificially diverted profits’ (i.e., tax on profits declared overseas that are made from revenues earned in the UK). A similar announcement was also made in Australia.
Throughout 2014, the Financial Accounting Standards Board (FASB) has continued to take steps to clarify or amend existing accounting guidance. In addition, the FASB has introduced several income tax accounting topics as part of its initiative to reduce complexity in accounting standards.

The following Accounting Standards Updates (ASUs) should be considered in the preparation of year-end financial statements and beyond.

**ASU No. 2014-01**

In January 2014, the FASB issued a new standard permitting entities to account for investments in low income housing tax credit (LIHTC) projects using the ‘proportional amortization’ method if certain conditions are met which include 1) it is probable that the tax credits allocable to the investor will be available, 2) the investor does not have the ability to exercise significant influence over the operating and financial policies of the entity, 3) substantially all of the projected benefits are from tax credits and other tax benefits, 4) the investor’s projected yield based solely on the cash flows from the tax credits and other tax benefits is positive, and 5) the investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor’s liability is limited to its capital investment.

Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received. The net investment performance is recognized in the income statement as a component of income taxes. The use of the proportional amortization method is an accounting policy election to be made once and thereafter applied to all eligible investments in LIHTC programs.

For public entities, the new guidance will be effective for fiscal years beginning after December 15, 2014. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2014. Early adoption is permitted.

**ASU No. 2014-02 and 2014-03**

In January 2014, the FASB issued new guidance on two accounting alternatives previously approved by the Private Company Council (PCC).

The new standards provide private companies with: (1) an alternative accounting model for goodwill that permits amortization of goodwill on a straight-line basis over a maximum of ten years, and (2) a simplified hedge accounting approach for qualifying interest rate swaps.

Under the alternative accounting model related to goodwill, goodwill existing as of the balance sheet date would be classified as a finite-lived asset.

For companies assessing the need for a valuation allowance on deferred tax assets, the classification of goodwill as a finite-lived asset may result in taxable temporary differences which support the realization of deferred tax assets. It should be noted that while this alternative accounting model is a departure from the prior guidance, it does not change the prohibition on recording deferred tax for book-over-tax goodwill in a business combination. These standards are effective for fiscal years beginning after December 15, 2014, with early adoption permitted.
ASU No. 2014-09

In May 2014, the FASB issued new guidance that resulted from a joint project with the International Accounting Standards Board (IASB) which clarified the principles for recognizing revenue and developed a common revenue standard for US GAAP and IFRS.

The core principle of the standard is that an entity should recognize revenue which depicts the transfer of promised goods or services to customers in an amount that reflects the consideration that the entity expects to be entitled to in exchange for those goods or services.

While there is no financial reporting impact for this year-end, there is nothing precluding proactive tax planning or the assessment of any potential impacts the new revenue standard may have on (1) existing tax return accounting methods or (2) processes, controls, or data needs that may result to properly compute taxable income and apply the principles of ASC 740.

For public entities that apply US GAAP, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016. For nonpublic entities that apply US GAAP, the amendments are effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption to the public entities’ effective date would be permitted for nonpublic entities.

For IFRS filers, the equivalent standard (IFRS 15) should be applied for annual reporting periods beginning on or after January 1, 2017. Early adoption is permitted.

For more information on the new standard, please refer to the “Tax accounting method changes” section of this publication.

Income tax accounting simplification proposals

In 2014, the FASB gave consideration to several topics related to income taxes which could reduce complexity under their broader simplification initiative. The initiative evolved as a result of feedback from the Financial Accounting Foundation’s (FAF) Post-Implementation Reviews of FAS 109 and FAS 123 (R) which were completed in November of 2013 and August of 2014, respectively. At present, there are two projects that are focused on the simplification of income tax accounting: the income tax project and the stock-based compensation project.

Income Tax Project

In October of 2014, the FASB agreed to issue an exposure draft related to two income tax accounting topics. The draft is expected to be issued in January 2015 with a 120-day comment period.

The first proposed change would require recognition of the current and deferred income tax consequences of an intra-entity asset transfer when the transfer occurs. This would eliminate the current exception which requires both the buyer and seller in a consolidated reporting group to defer the income tax consequences of an intra-entity asset transfer. The second proposed change would require the classification of all deferred tax assets and liabilities as non-current on the balance sheet. This would replace the current guidance which requires deferred taxes for each tax-paying component of an entity to be presented as a net current asset or liability and a net non-current asset or liability.

If adopted, these changes would be effective for financial reporting years beginning after December 15, 2016 for public entities. For nonpublic entities, changes would be effective for the year-end financial statements for financial reporting years beginning after December 15, 2017 and interim periods in the following year. Early adoption to the public entities’ effective date would be permitted for nonpublic entities.

In addition to these two proposed changes, the FASB instructed its staff to research the possibility of entirely eliminating the intraperiod tax allocation rules and to reassess the disclosure requirements relating to unremitted earnings and other outside basis differences in foreign subsidiaries as part of its broader Disclosure Framework Project.

Stock Compensation Project

In October of 2014, the FASB decided to add income tax accounting related to stock-based compensation to its agenda. The Board agreed to address the possible recognition of all windfalls and shortfalls within income tax expense. That proposed treatment would replace the current guidance which allocates tax effects between equity and income tax expense based upon several factors requiring complex tracking and computations. Furthermore, the Board agreed to include the possible elimination of the current requirement to display the gross amount of windfall as an operating outflow and financing inflow in the cash flow statement.

IFRS Interpretations Committee

During 2014, the IFRS Interpretations Committee (IFRIC) considered changes to International Accounting Standard 12 related to the recognition of deferred tax assets for unrealized losses on available-for-sale (AFS) debt securities and the recognition of current income tax on uncertain tax positions. These changes would be another step towards US GAAP and IFRS income tax accounting convergence.

In May, the IFRIC recommenced to the International Accounting Standards Board that the assessment of recognizing a deferred tax asset related to an AFS debt security would be made in combination with the entity’s other deferred tax assets. In addition, the ability and intention to hold the investment until the recovery of its amortized cost basis would not in itself provide a basis for recognizing the deferred tax asset. This recommendation is similar to the guidance expected to be issued by the FASB related to the valuation allowance assessment on the deferred tax asset as part of the Board’s project on financial instruments.
Calendar year 2014 has continued to see a significant number of tax-related comment letters issued by the staff of the Securities and Exchange Commission (SEC). Of the comment letters released to the public between January 1, 2014 and September 30, 2014, almost 500 of the comments related to tax matters. Of those tax-related comments, approximately 80% related to the following areas: indefinite reinvestment of foreign earnings, presentation of the effective tax rate, valuation allowance assessments, and uncertain tax positions.

As presented in the table below, matters of management judgment continue to be an area of focus for the SEC. Emphasis on providing accurate, transparent, and plain language disclosures for significant assertions and estimates should be considered by preparers when assessing their existing and future disclosures.

With respect to deferred tax asset valuation allowance assessments, the SEC seeks to more deeply understand the facts, circumstances, judgments, and decisions made by companies. They are interested in a company’s assessment and weighting of the positive and negative evidence, including in situations where there has been a recent return to profitability.

A notable amount of attention is given to accumulated foreign earnings and the presentation of the effective tax rate, including foreign rate reconciling items. The SEC often requests quantitative and qualitative details to support the amounts included in the ‘foreign rate reconciling items’ line item. Common requests include: (1) a discussion of how the line item was computed by identifying its significant components and (2) a reconciliation detailed by country.

The SEC staff has continued to emphasize that a registrant’s indefinite reinvestment assertion(s) related to foreign earnings should be consistent with its disclosures within: (1) Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A), (2) financial statement footnotes, and (3) other publicly available information. The staff has frequently required additional disclosure in the liquidity section of the MD&A of potential tax effects from repatriating offshore cash and cash equivalents.

SEC comment letters have also reminded preparers of the requirement to disclose an estimate of the unrecorded tax liability relating to unremitted earnings, if practicable to calculate. In some of those cases, the SEC has challenged management’s assertion of impracticability. Preparers asserting impracticability should be prepared to articulate the basis for their view. Disclosure should include the events which could cause a liability to be recorded in the future.

We expect areas of management judgment – particularly in the areas of valuation allowance, foreign tax rates and unremitted earnings – to be a continued area of focus by regulators, investors, and commentators in 2015.

### Table: SEC Comment Letters by Area

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<td>Other</td>
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**Uncertain tax positions**

Refer to:
Chapter 16 of the PwC Guide to Accounting for Income Taxes (the PwC Guide)

The accounting for an uncertain tax position does not end with the initial determination of a position’s sustainability. As of each balance sheet date, uncertain positions must be reassessed with the existence of new information.

**New 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 other developments. Such developments could potentially change the estimate of the amount that is expected to eventually be sustained or cause a position to meet or fail to meet the recognition threshold. While the definition of what can constitute new information is expansive, new or fresh reassessment of the same information does not constitute new information.

**Effective settlement** – For a tax position to be considered effectively settled, all three of the following conditions must be met:

- The taxing authority has completed its expected examination procedures, including appeals and any administrative reviews required.
- The taxpayer does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- It is remote that the taxing authority would examine/re-examine any aspect of the tax position.

If the requirements of effective settlement are met, the resulting tax benefit is required to be reported.

**Jurisdictional netting** – On a jurisdictional basis, ASU No. 2013-11 generally requires an unrecognized tax benefit (UTB) to be presented in the financial statements as a reduction to a deferred tax asset for an NOL carryforward, similar tax loss, or tax credit carryforward. This would be the case except when an NOL carryforward, similar tax loss, or tax credit carryforward is not available under the tax laws of the applicable jurisdiction to settle any additional income taxes resulting from the disallowance of a tax position. In such instances, the UTB should be recorded as a liability and cannot be offset against the deferred tax asset. The assessment as to whether a deferred tax asset is available is based on the UTB and deferred tax asset that exist at the reporting date and should be made assuming disallowance of the tax position at the reporting date.

**Disclosures** – Required disclosures related to income tax uncertainties are often extensive and can be highly sensitive. For more information, please refer to the PwC Tax Accounting Services publication – *Income tax disclosure.*
Valuation allowances

Refer to:
Chapters 5 and 6 of the PwC Guide

The evaluation of the need for, and amount of, a valuation allowance for deferred tax assets is an area that often presents challenges for financial statement preparers. The assessment requires significant judgment and a thorough analysis of the totality of both positive and negative evidence available to determine whether all or a portion of the deferred tax asset is more likely than not to be realized. In this analysis, the accounting standard prescribes that the weight given to each piece of positive or negative evidence be directly related to the extent to which that evidence can be objectively verified. Accordingly, recent financial results are given more weight than future projections.

As preparers perform their assessments, the following reminders may be helpful:

**Level at which assessment is performed** – Where local law within a jurisdiction allows for consolidation, a valuation allowance assessment generally should be performed at the consolidated jurisdictional level. However, where the local tax law does not allow for consolidation, the valuation allowance assessment would typically need to be performed at the separate legal-entity level.

**All available evidence** – The accounting standard requires that all available evidence be considered in determining whether a valuation allowance is needed, including events occurring subsequent to the balance sheet date but before the financial statements are released. However, a valuation allowance assessment should generally not anticipate certain fundamental transactions such as initial public offerings, business combinations, and financing transactions until those transactions are completed.

**Triggering events or changes in circumstances** – There should be clear, explainable reasons for changes in a valuation allowance. In assessing possible changes, it is important to consider again the basis for amounts previously provided and how new information modifies previous judgments. For example, consideration should be given to whether the results for the current year provide additional insights as to the recoverability of deferred tax assets or as to management’s ability to forecast future results. The mere existence of cumulative losses in recent years or for that matter, cumulative income in recent years, is not conclusive in and of itself of whether a valuation allowance is or is not required.

**Deferred tax asset utilization vs. realization** – The realization of deferred tax assets is dependent upon the existence of sufficient taxable income of an appropriate character that would allow for incremental cash tax savings. For example, if tax losses are carried back to prior years, freeing up tax credits (which were originally used to reduce the tax payable) rather than resulting in a refund, a valuation allowance would still be necessary if there are no additional sources of income to support the realization of the freed-up tax credits. Certain tax-planning strategies may provide a source of income for the apparent recognition of deferred tax assets in one jurisdiction, but not provide incremental tax savings to the consolidated entity. In order to avoid a valuation allowance in reliance on a tax-planning strategy, we believe that the tax-planning strategy should provide cash savings to the consolidated entity. In a situation where there is an unlimited carryforward period, we do not believe a tax planning strategy can be utilized for the realization of deferred tax assets. The reason for this is because a tax-planning strategy is intended to be a backup plan for realizing attributes that would otherwise expire.
Outside basis differences – The reversal of an outside basis difference in a foreign subsidiary cannot be viewed as a source of taxable income when the foreign earnings are asserted to be indefinitely reinvested. Taxable temporary differences on equity method investments can be considered as a source of taxable income provided there is an appropriate expectation as to the timing and character of reversal in relation to the deferred tax assets.

Indefinite-lived assets – Taxable temporary differences associated with indefinite-lived assets (e.g., land, goodwill, indefinite-lived intangibles) generally cannot be used as a source of taxable income. Thus, a valuation allowance on deferred tax assets may be necessary even when an enterprise is in an overall net deferred tax liability position. However, in jurisdictions with unlimited carryforward periods for tax attributes (e.g., NOLs, AMT credit carryforwards, and other non-expiring loss or credit carryforwards), deferred tax assets may be supported by the indefinite-lived deferred tax liabilities. To the extent a jurisdiction has annual limitations on carryforward usage, a valuation allowance may need to be considered, despite an unlimited carryforward period.

Disclosures – Due to the significant judgments involved in determining whether a deferred tax asset is realizable, clear and transparent disclosures are crucial. For more information, please refer to the PwC Tax Accounting Services publication – Income tax disclosure.
Indefinite reinvestment assertions

Refer to:
Chapter 11 of the PwC Guide
Tax Accounting Services Thought Leadership, Deferred Taxes on Foreign Earnings – A Road Map

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. The growth in unremitted foreign earnings together with differences in global tax laws has made the application of the indefinite reinvestment assertion a matter of heightened concern for many stakeholders. Companies should consider the following when evaluating their indefinite reinvestment assertion:

• There should be coordination and alignment among multiple business functions within a company’s global organization, such as treasury, legal, operations, and business development. Processes or controls must be in place to ensure that the indefinite reinvestment assertion is consistent with the best information available to the organization and represents the organization’s cohesive view, plans, and expectations.

• A specific documented plan should address the parent’s and subsidiary’s long and short-term projected working capital and other financial needs. Evidence maintained by management should include discussion as to why any excess earnings are not needed by the parent or another operation within the group. In cases where management is considering the expected rate of return on reinvesting foreign earnings as compared with the after-tax return on repatriated funds, that assessment should be included in the company’s documentation.

• Management should consider the consistency of its assertion with the parent and subsidiary’s long and short-term budgets and forecasts, any past dividends, and the tax consequences of a decision to remit or reinvest.

• Management should consider whether any intercompany transactions, such as a loan or a credit support agreement provided by the foreign operations to the US parent, may be relevant in assessing the indefinite reinvestment assertion. Such events should be reviewed to consider whether they result in the need to record a current tax liability or whether there is income tax uncertainty related to the matter. Transactions that present risk of US taxation may suggest that foreign funds or liquidity are needed in the US, potentially contravening an assertion of indefinite reinvestment.

• In many instances, such as in the case of an equity method investment or the impact of a consolidated variable interest entity, it is imperative to understand the parent company’s ability to control distributions or other transactions that would otherwise cause a taxable event to occur. For example, if activities are occurring at the CFC level or below that will cause the recognition of subpart F income by the CFC’s US parent, the underlying facts and circumstances must be examined to determine whether recording deferred taxes can be avoided for the item that may become subject to US tax.

• Management must have the ability and intent to indefinitely postpone taxation. The assertion should be supported by all levels of management who would be expected to have significant decision-making input relative to plans or transactions that could affect the assertion. 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.
• The liquidity and overall financial health of the company must be factored into the assessment of the assertion. If the unremitted earnings could be needed at the parent level to meet existing or anticipated obligations (e.g., to fund a pension obligation), it may be difficult to support an assertion of indefinite reinvestment. The tax profile of the company also should be considered. For example, if unremitted earnings were needed to avoid the expiration of foreign tax credit carryforwards, and the repatriation of earnings would represent a better rate of return on capital than other alternatives, it might be difficult to support an indefinite reinvestment assertion.

• When the outside tax basis exceeds the book basis in a foreign subsidiary, a deferred tax asset with respect to that temporary difference is recognized only when it is apparent that the difference will reverse in the foreseeable future. Recognition of a benefit may, for example, occur when there is a planned disposal of the subsidiary. The expectation of the generation of near-term future subsidiary profits (which would cause the outside basis to shrink), however, would not be a basis for recognizing a deferred tax asset on the outside basis difference.

• In limited circumstances, foreign taxes that are expected to become foreign tax credits in the foreseeable future may be appropriate to recognize as a deferred tax asset prior to the actual repatriation event. Among factors to consider, the company must be committed to making the repatriation that triggers the foreign tax credit benefit in the near term. There may also be limited circumstances in which a tax liability for an anticipated repatriation would be recorded even though there is an overall tax-over-book outside basis difference.

Disclosures - Due to the significant judgments involved in assessing indefinite reinvestment as well as the potential magnitude of the unrecorded deferred tax liability, disclosure must be carefully considered. For more information, please refer to the PwC Tax Accounting Services publication – *Income tax disclosure.*
Various forms of capital financing result in differences between an issuer’s financial reporting basis and the tax basis of financial instruments. These basis differences must be assessed to determine whether a temporary difference exists for which a deferred tax asset or liability should be provided. Often, this will depend on the manner in which the financing is expected to be settled and whether the settlement method is within the company’s control. The following are some tax accounting aspects of this complex area to keep in mind:

**Classification of debt versus equity**– In evaluating whether certain basis differences in financial instruments are considered temporary differences for which deferred taxes should be recognized, it is necessary to have an understanding of the appropriate classification for both financial reporting and tax purposes. Certain financial instruments may be structured in a way that requires debt or liability treatment for financial reporting purposes but equity treatment under the applicable tax law, or vice versa. A basis difference that is created from a financial instrument that, upon reversal, has no corresponding tax impact (e.g., a hybrid financial instrument treated as equity for tax purposes and liability for US GAAP purposes) would not be considered a temporary difference for which deferred taxes would be recognized. Characterization of an instrument as debt or equity for US federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances.

The proper identification of the financial instrument’s classification for both US GAAP and tax purposes is the starting point in evaluating whether any applicable book-tax basis difference will result in the recognition of deferred taxes at issuance and/or throughout the term of the instrument.

**Permanent Items** – Permanent items related to financial instruments may arise due to specific provisions within the tax law. For instance, the applicable high yield debt obligation (AHYDO) rules pursuant to Section 163(e)(5) may result in the permanent disallowance of interest deductions on certain debt instruments.

Companies should assess the potential impact of permanent items at the time of the issuance of the financial instrument and consider the impact on the entity’s effective tax rate.

**Embedded Derivatives** – A convertible debt instrument (i.e., hybrid financial instrument) may require bifurcation of the embedded derivative from the host contract for financial reporting purposes, but remain viewed as one instrument for tax purposes. In situations where the instrument is treated differently for book and tax purposes, a book-tax basis difference may result for which deferred taxes would need to be recognized. Deferred taxes would be considered for both the host contract and the bifurcated embedded derivative. While those deferred tax balances will typically offset at issuance, the temporary differences will not remain equal over time as the bifurcated embedded derivative will be marked to fair value on an ongoing basis while the premium or discount on the host contract will be accounted for under other applicable US GAAP. However, in certain situations (e.g., instrument treated as equity for tax purposes) where there is no future tax effect anticipated with the settlement of the hybrid financial instrument, we would not expect deferred taxes to be recognized.

**Debt Extinguishment** – A debt extinguishment can occur when the issuer reacquires its debt for cash, other assets, or equity. For accounting purposes, an extinguishment gain or loss will be recognized in earnings based on the difference between the reacquisition price and the net carrying amount of the original debt.
The reacquisition price is the amount paid to settle the debt, including any call premium, miscellaneous costs of reacquisition, and the fair value of any assets transferred or equity issued. The net carrying amount includes any unamortized debt issuance costs and any unamortized debt discount or premium related to the extinguished debt.

The related tax effects of a debt extinguishment need to be considered within the context of the applicable tax law. The acquisition or extinguishment of debt at a premium (i.e., paying more than the tax basis) may, in certain cases, result in a current tax benefit for the payment in excess of the tax basis. For instance, the applicable tax law may indicate that if a corporation pays a premium over the adjusted issue price (i.e., tax basis) to repurchase debt, the premium paid, in whole or in part, may be deductible as interest. However, there may be situations in which the premium paid to reacquire debt in excess of its tax basis may be disallowed (e.g., in the case of a convertible debt instrument where the premium paid relates to the conversion feature). The extinguishment of debt for an amount less than the adjusted issue price (i.e., tax basis) typically gives rise to cancellation of debt taxable income.

Debt extinguishment gains or losses are recognized in earnings, and therefore, any related current tax effects from the extinguishment or deferred taxes that are eliminated, or reversed, upon the extinguishment will also be recognized in the income statement through the income tax provision. However, there are certain exceptions under ASC 740 which would provide for the current and deferred tax implications to be recognized in stockholders' equity.
Intercompany transactions

In many instances, there are tax effects when an asset is sold or transferred between affiliated companies that are consolidated for financial statement purposes, but file separate tax returns. The seller’s separate financial statements will generally reflect the profit on the sale and a tax expense on that profit. The buyer’s separate financial statements will reflect the asset at the intra-entity price, which will also be the buyer’s tax basis. However, in consolidation, the seller’s pretax profit will be eliminated, and the asset will be carried at its cost to the seller until sold to an unrelated third party or otherwise recovered (e.g., through amortization or impairment).

In general
Deferral provisions under ASC 810, Consolidation and ASC 740 apply to these intercompany transfers of assets, whereby no immediate tax impact is recognized in the consolidated financial statements. The tax effects to the seller are deferred in consolidation and the buyer is prohibited from recognizing a deferred tax asset for the excess of the buyer’s tax basis over the consolidated carrying amount of the asset. Instead, the tax benefit resulting from any step-up in tax basis is recognized as it is realized each period, via deduction on the tax return.

Exceptions
When the intra-entity transaction is the sale of stock of a subsidiary, it involves the “outside” tax basis. Because the guidance refers to the intra-entity transfer of assets, we do not believe that the exception should be extended to the transfer of stock of a subsidiary (i.e., an outside basis difference). Rather, the guidance related to outside basis differences would be applied.

The general rule is that a deferred tax asset cannot be recognized for an excess tax-over-book outside basis difference unless it is apparent that reversal will occur in the foreseeable future (e.g., the entity is planning to sell the subsidiary in the near future).

Special considerations
In certain cases, determining whether an arrangement is considered an intra-entity transfer of an asset is judgmental and depends on the facts and circumstances. This might be the case, for example, with regard to an intra-entity transfer of intellectual property (IP) related to in-process research & development. In the case of an IP transaction, determining whether the arrangement constitutes a transfer as opposed to a license to use the asset is often judgmental and depends on the individual facts and circumstances. In some cases, the arrangement constitutes an outright sale or an exclusive license for the entire economic life of the IP, and there may be little doubt that an asset has been transferred. In other situations where the IP is being licensed, it may be difficult to determine whether the arrangement constitutes an in-substance sale or merely a temporary license of the IP. Intra-entity arrangements should be reviewed to determine whether they confer ownership rights and burdens and whether the benefits and risks associated with the IP have been transferred. One way to make this determination is to consider whether the new holder of the IP would recognize an asset on its separate balance sheet, if it were to prepare separate company financial statements.

Refer to:
Chapter 2 of the PwC Guide
In making this determination, the legal and contractual rights conveyed in the arrangement are the primary considerations, however, the relevant income tax laws should also be considered. While not necessarily a bright-line indication of the accounting treatment, the characterization of the arrangement and subsequent tax treatment under the relevant income tax laws, as either a license or a sale may provide additional context to assist with the determination.

Other special areas should be given consideration, including, but not limited to accounting for the release of a valuation allowance concurrent with an intra-entity asset transfer, intra-entity transfers as potential tax-planning strategies to support realization of deferred tax assets, the effects of changes in respective uncertain tax positions, and the effects of subsequent law changes or transactions such as a disposal via spinoff or sale of the seller and/or buyer entity.
Foreign currency

Few areas in accounting for income taxes are more difficult to apply than the tax accounting for the effects of fluctuations in foreign currency values.

The following are some aspects to keep in mind:

- Translation adjustments on foreign subsidiary stock typically create a portion of the outside basis temporary difference related to the parent’s investment in the subsidiary. Generally, the cumulative translation adjustment (CTA) reflects the gains and losses associated with the translation of a foreign subsidiary’s books from its functional currency into the reporting currency and is reflected in other comprehensive income (OCI). If the outside basis difference is not indefinitely reinvested, deferred taxes are recorded for the tax estimated to be incurred upon repatriation of the outside basis difference, including the portion attributable to the CTA account.

- When the indefinite reinvestment assertion has been made on unremitting earnings, deferred taxes are not typically provided on translation adjustments. In some cases, financial statement preparers have not provided tax on unremitted earnings because it is expected that their repatriation will result in no additional US tax because of the availability of foreign tax credits. Consideration must still be given to whether a tax provision is required with respect to CTA (or other amounts that comprise the outside basis difference).

- Income that has been (or is expected to be) taxed under the US Subpart F provisions but not repatriated is commonly referred to as previously taxed income (PTI). PTI can generally be repatriated without further taxation other than potential withholding taxes and any tax consequences resulting from changes in foreign currency rates. Whether taxes should be provided on the unrealized foreign currency gains or losses associated with PTI depends upon whether the company has the ability and intent to indefinitely reinvest the amounts that correspond to PTI.

- Similarly, if the owner of a foreign branch has the ability and intention to postpone remittance indefinitely, and the respective branch-related CTA will only become taxed upon remittance, an accounting policy may be applied to allow an indefinite reinvestment assertion to be considered for the CTA of a foreign branch.

- If a company changes its indefinite reinvestment assertion, the tax impact of current-year movement in the CTA account should generally be recorded in 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.

- When subsequent adjustments to deferred taxes are not recorded in CTA, tax effects lodged therein will not necessarily equal the respective deferred taxes reflected in the balance sheet for the temporary differences related to the gains or losses in CTA. Recognition of those lodged tax effects in net income would generally occur only upon the sale of a foreign operation or actions that result in a complete liquidation.
• 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 such a hedge are recognized in the CTA account. Because the tax consequences will be triggered upon settlement of the hedge with no possibility for deferral even if the indefinite reversal exception applies, deferred taxes should be recorded (in CTA) for temporary differences resulting from the hedging transaction.

• When the functional currency of a foreign business is the same as the reporting currency, deferred taxes on non-monetary assets and liabilities should be computed in the local foreign currency by comparing the historical book and historical tax bases in the local foreign currency. The local foreign currency deferred tax is then remeasured into the reporting currency using the current exchange rate consistent with the requirement that all deferred taxes are translated at the current rate. Any additional tax depreciation in the foreign tax returns is treated as a permanent difference as there is no corresponding amount in pre-tax income.

• When the functional currency of a foreign operation differs from the reporting currency, the reserve for foreign uncertain tax positions, like other balances, are subject to translation adjustments each reporting period. Translation must be applied even if the uncertain tax position reserves (or other accounts attributable to the foreign business) are maintained by the parent company.

• Intercompany loans between parent companies and foreign subsidiaries should be reviewed carefully to determine the accounting impact of foreign currency movements. Differences in the functional currencies, the denomination of the loan, local country taxation of foreign exchange and whether the loan is considered a long-term advance (permanent capital) can affect the accounting for foreign currency translation adjustments.
The accounting for business combinations can be challenging due to the unique nature of each transaction, need for cross-functional knowledge, and constraints on the availability of timely information.

**Acquisition-related events**

Business combinations typically involve a considerable amount of business, legal, and tax planning. Determining whether the tax effects of elections or transactions occurring after an acquisition should be included in acquisition accounting is often judgmental.

We believe the following factors should generally be considered in making that assessment:

- Whether the election or transaction is available and contemplated as of the acquisition date or within the ‘measurement period’ and is based on information and facts that existed at the acquisition date.
- Whether the election or transaction is primarily within the acquirer’s control with no significant complexities or uncertainties as to whether the transaction will ultimately be completed.
- Whether the acquirer is required to make a payment (separate from consideration exchanged for the business) or forgo tax attributes to obtain the tax benefits. Whether other significant costs will be incurred to implement the transaction.

**Bargain purchases**

Bargain purchase refers to a transaction in which the fair value of the net assets acquired exceeds the fair value of consideration transferred. Such excess is often referred to as ‘negative goodwill’ and if it is determined to exist, will lead to recognition of a bargain purchase gain for financial statement purposes.

The tax rules for each separate jurisdiction may require a different treatment for bargain purchases. Tax rules often require the allocation of negative goodwill to certain assets through the use of a residual method, resulting in decreased tax bases. The recognition of the resulting deferred tax liabilities then leads to a reduction in the bargain purchase gain for financial reporting and may result in the recognition of goodwill.

**Acquirer’s deferred tax balances**

The impact on the acquiring company’s deferred tax assets and liabilities, including changes in a valuation allowance assessment caused by an acquisition, is recorded in the acquiring company’s financial statements outside of acquisition accounting (i.e., not as a component of acquisition accounting). Additionally, deferred tax assets/liabilities of the acquiring company may need to be adjusted due to changes in applicable tax rates post-acquisition (e.g., related to changes to the state apportionment factors). Deferred tax liabilities recorded in acquisition accounting may be a source of taxable income to support recognition of deferred tax assets of the acquired company as well as the acquirer. Where some but not all of the combined deferred tax assets are supported by deferred tax liabilities recorded in acquisition accounting, the acquirer will need to apply an accounting policy to determine which assets are being recognized. Additionally, the acquiring entity should consider any necessary changes to the company’s indefinite reinvestment assertion upon consummation of the acquisition.

**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 deferred taxes) in earnings. 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 deferred tax liability 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 deferred tax liability (or a
portion thereof) related to the outside
basis difference on the previously held
investment must be retained under a
special accounting rule.

Transactions with non-controlling
shareholders
A non-controlling interest (NCI) is the
portion of equity (net assets) in a
subsidiary not attributable, directly or
indirectly, to the parent.
• In a transaction that results in a
change in the parent’s ownership
interest while the parent retains its
controlling financial interest, any
difference between the fair value of
the consideration received or paid
and the amount by which the NCI is
adjusted is recognized in equity
attributable to the parent.
• When analyzing the accounting for
non-controlling interests, it is
important to distinguish between
direct and indirect tax effects.
• The direct tax effect, net of any
related valuation allowance, of a
transaction with non-controlling
shareholders that does not cause a
change in control is generally
recorded in equity. Subsequent
release of any related valuation
allowance would also be recorded
in equity.
• However, a parent company may be
able to release its own valuation
allowance as a result of acquiring an
additional interest in a controlled
subsidiary and having the ability to
file a consolidated return. Since this
change is an indirect effect of
acquiring the additional interest, it
will generally be recorded in
earnings.
Assets held for sale
A ‘disposal group’ represents assets and directly related liabilities to be disposed of together in a single transaction. Whether deferred tax assets and liabilities should be included in the disposal group depends on whether the buyer will be seen as buying stock or assets. Depending upon the outcome, the buyer can be viewed as acquiring tax benefits (assets) or assuming tax liabilities.

- If a sale is structured as a sale of stock, deferred taxes associated with any existing book-tax basis differences in the assets and liabilities of the disposal group will usually be assumed by the buyer and should therefore be included in the carrying amount of the disposal group because the deferred taxes meet the definition of assets to be disposed of or liabilities to be transferred.

- A decision to sell the shares of a subsidiary could require the recognition of additional deferred taxes associated with the previously unrecognized difference between the seller’s carrying amount of the subsidiary’s net assets in the financial statements and its tax basis in the shares of the subsidiary (the outside basis difference). This tax consequence to the seller should not be included in the held-for-sale asset group.

- If a sale is structured as an asset sale, the seller will usually recover the deferred tax assets and liabilities (i.e., any inside basis differences will reverse in the period of sale and become currently deductible by or taxable to the seller) and maintain any remaining carryforwards. Therefore, in an asset sale, deferred taxes should usually not be included in the carrying amount of the assets and liabilities that are held for sale because they will not be transferred to the buyer.
Tax accounting method changes

Refer to:
• Chapter 7 of the PwC Guide
• New FASB, IASB revenue recognition rules could have significant US tax implications

On May 28, 2014, the FASB and IASB issued their long-awaited converged standard on revenue recognition titled Revenue from Contracts with Customers (Topic 606 and IFRS 15). The new standard could affect the revenue recognition practices of many companies that have contracts with customers to provide goods, services, or non-financial assets, with a corresponding impact on cash taxes (generally in situations involving advance payments), book-tax differences, and deferred tax positions.

Tax accounting considerations
Because tax law generally prescribes special rules for recognition of revenue for tax purposes, most changes introduced by the new revenue recognition standard will likely affect computation of book-to-tax differences and the related deferred taxes. Nonetheless, the new standard could change the manner in which revenue is recognized for book purposes and complicate the determination of book-tax differences.

For example, the tax law requires recognition of revenue from the sale of goods when the ‘benefits and burdens of ownership’ of the property are transferred to the customer, which generally is more consistent with the current US GAAP ‘risks and rewards’ model. As a result, the new ‘transfer of control’ model could result in new book-tax differences.

Similar complexities could arise if the transfer of control model changes the timing of the recognition of services, long-term contract, or licensing revenue for financial accounting purposes but not tax purposes. To the extent the timing of an item of income changes, companies would need the capability to track book-tax differences.

Companies may wish to file an Application for Change in Accounting Method, Form 3115, to change the existing method of recognizing revenue for federal income tax purposes to better align the existing tax reporting methods to the new revenue recognition requirements.

When a request for a change in accounting method is reflected in a company’s financial statements depends on whether or not a company is changing from a proper or improper accounting method and whether or not the change qualifies as an automatic or non-automatic change. We believe that the change of the accounting method under the above circumstances would qualify as a change from a proper accounting method.

In our view, automatic changes (i.e., those enumerated in the applicable Internal Revenue guidance) from one permissible accounting method to another should be reflected in the financial statements when management has concluded that it is qualified, and has the intent and ability, to file an automatic change in accounting method. Multinational companies should also consider the impact of the new standard that can vary by country.
As companies seek to incentivize high performance among employees, the popularity of share-based compensation and equity incentive plans continues to increase. Mobility of workforces and evolving global tax and regulatory compliance requirements raise significant challenges in administering equity incentive plans which are often global in nature. In addition, tax accounting for equity incentive plans remains a complex area for many companies due to the uniqueness of the accounting principles coupled with diverse tax laws.

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

**Uncertain tax positions and “backwards tracing”**

While there is generally a prohibition in the income tax accounting standard against “backwards tracing”, there is an exception for certain equity items (e.g., recognition of windfalls and shortfalls included in equity). We believe this would include both favorable and unfavorable adjustments resulting from a change in the assessment of an uncertain tax position. Accordingly, to the extent a 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 an uncertain tax position associated with the windfall benefit.

**Accounting for windfall benefits**

Under the general rule for ordering tax benefits, items included in continuing operations generally are considered to enter into tax computations before items included in other components. The current guidance in ASC 718, Stock Compensation, provides that the tax benefit and related credit to APIC for a windfall tax benefit should not be recorded until the deduction reduces income taxes payable. If a company has windfall tax benefits and NOLs or other carryforwards from earlier years, there are two acceptable methods to determine the order in which tax attributes should be considered: (1) the with-and-without approach or (2) tax law ordering approach.

Under the with-and-without approach, windfall tax benefits would be used last, whereas under tax law ordering approach, the provisions in the applicable tax law would determine the sequence in which windfall tax benefits are used. An entity should treat its decision to adopt either approach as an accounting policy decision and follow the approach consistently. A policy decision to account for utilization of windfall tax benefits based on tax law ordering will often be less complex to administer as compared with the with-and-without approach. In addition, following the tax law ordering approach should reduce the need to track differences between the treatment of carryforwards for book purposes as compared with the treatment of the carryforwards for tax return purposes.

**Underwater options**

Declines in stock prices may suggest that some stock-based compensation awards for which deferred tax assets 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 deferred tax asset, even if there is no expectation that the award will be exercised. The deferred tax asset should be reversed only when the award has lapsed or been forfeited. However, consideration should be given to providing disclosure that may help users assess the expected impact to the company.

**Permanent differences**

Generally a difference between the book compensation charge and the tax deduction related to an equity award results in temporary differences. However, a difference that is not due to a change in fair value between the respective book and tax measurement dates could result in a permanent difference to be recorded through the income statement. This may arise, for example, if a restricted stock award...
includes features that impact the
grant date fair value for financial reporting
purposes but do not impact the fair value
used for tax purposes.
Permanent differences could also arise
from awards being subject to excessive
compensation limitations under IRC
162(m).
Entities may also use a profits interest as
an incentive for its employees. When an
employee is granted a profits interest,
there may be an opportunity under tax
laws to take the interests into income on
the grant date when the value is typically
zero for the employee. This treatment
effectively eliminates any future tax
deduction for the entity. In situations such
as these, a permanent difference would
result when the book expense is
recognized.
Taxes not based on income

Refer to:
- Chapter 1 of the PwC Guide
- Chapter 16 of the PwC Guide

The principles of the income tax accounting standard are applicable to taxes based on income. Although the literature does not clearly define this term, we believe that a tax based on income is predicated on a concept of income less allowable expenses incurred to generate and earn that income.

Examples of taxes which would generally not be based on income include:
- Payroll taxes
- Excise taxes
- Sales and use taxes
- Gross receipt taxes (depending on the jurisdiction’s definition of taxable gross receipts)
- Withholding taxes (those withheld for the benefit of others)
- Property taxes
- Value-added taxes (VAT)
- Customs duties

Some state or foreign taxes (or their portion) may also not be considered as taxes based on income. For example, certain states and jurisdictions impose franchise taxes that are computed as the higher of a tax based on income or a tax based on capital.

Only the portion of the tax which is based on income and which exceeds the tax based on capital is subject to ASC 740.

For example, if a tax based on income is $100 and a tax based on capital is $80, then only a portion of the tax based on income, i.e., $20 that exceeds the tax based on capital ($100-$80), would be subject to ASC 740. In a reverse situation, where a tax based on income is $80 and a tax based on capital is $100, no portion of income tax will be accounted for under ASC 740.

This scenario also raises questions as to how ASC 740 would be applied in determining the applicable tax rate that is used to compute deferred tax assets and liabilities. In computing the deferred tax provision, an entity should base the applicable tax rate on the incremental expected tax rate for the year(s) in which the temporary difference is expected to reverse. Another acceptable approach would be to use the applicable rate that the statute prescribes for the income-based computations. In this case companies may need to perform additional analysis to determine whether a valuation allowance is required against the resulting deferred tax assets.

Taxes that do not meet the criteria in the income tax accounting standard should not be recognized, measured, presented, classified or otherwise treated as an income tax. Thus, for example, deferred tax accounting and the provisions of uncertain tax positions would not be applicable to taxes outside the scope. Companies would instead apply the guidance set forth in ASC 450, Contingencies, or other applicable literature regarding the recognition of non-income based tax exposures. When applying such guidance to situations of uncertainty involving non-income based tax exposures, we believe assessments should be performed assuming the taxing authority is fully aware of relevant facts (i.e., without considering the risk of detection).


**Intraperiod tax allocation**

Refer to:
Chapter 12 of the PwC Guide

Allocating income tax expense (or benefit) to the various components of the financial statements (e.g., continuing operations, discontinued operations, and OCI) is a complex area of tax accounting. Key points to consider include:

- Income tax expense (or benefit) is generally allocated to the financial statement category where the related pre-tax item was recorded.
- Subsequent changes (e.g., tax rate changes and valuation allowance changes) are often recognized in continuing operations and not necessarily the financial statement component for which an item may have arisen.

**The basic model** – While ASC 740 does not explicitly state the level of application of the intraperiod allocation rules, implicitly those allocation rules should be applied at the jurisdictional level when only one return is filed within a jurisdiction, and at the tax-return level when more than one tax return is filed within a jurisdiction (e.g., where a consolidated return is not filed).

The basic approach for intraperiod allocation (often referred to as the “with-and-without” or “incremental” approach) can be summarized in the following steps:

1. Compute the total tax expense or benefit (current and deferred) from all financial statement components for the period.
2. Compute the tax attributable to continuing operations.
3. The portion of total tax (step 1) that remains after the allocation of tax to continuing operations (step 2) is then allocated among the other remaining financial statement components.

**Exceptions to the with-and-without model** – An exception to the use of the with-and-without approach occurs when there is a pre-tax loss from continuing operations and pre-tax income from other categories of income. Application of the 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 under the with and without approach.

**Changes in valuation allowance** – Under the intraperiod tax allocation rules, the allocation of a tax benefit from a loss or deduction depends on:

- Whether the benefit of the loss or deduction is recognized or realized in the year in which it is generated
- Whether the income that allows for the realization of the loss relates to the current year or future years

The rules can be summarized as follows:

- When the tax benefit of a loss in the current year is recognized, it is allocated to the component that generated the loss.
- When there is an increase or decrease in the valuation allowance resulting from changes in the valuation allowance, the resulting benefit is allocated to the component of income that allowed for recognition (with continuing operations having priority).

However, exceptions apply to these general rules as it relates to the initial recognition of tax benefits for certain items that are required to be “backwards traced”. The initial recognition of tax benefits for these items (e.g., increases or decreases in contributed capital) should be allocated directly to the related component of shareholders’ equity, regardless of the source of income that allows for their realization.

**Tax effects lodged in OCI** – Under the incremental approach, subsequent adjustments to deferred taxes originally charged or credited to OCI are not necessarily reflected in OCI. As a result, the tax effect lodged in OCI may not necessarily be proportionate to the pre-tax items recorded in OCI. ASC 740 is silent as to the disposition of a disproportionate tax effect lodged in OCI. General practice (as confirmed by the FASB staff) eliminates the disproportionate tax effect when the circumstances upon which it is premised cease to exist.
## Contacts

For more information, please reach out to your local PwC partner or the following PwC Tax Accounting Services Market Leaders:

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