Tax Accounting Services

Accounting for Income Taxes: 2012 Year-end Hot Topics

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A year in review

Refer to:

- Tax Accounting Services NewsAlert, Key tax accounting considerations of the United Kingdom’s Finance Act 2012
- Tax Accounting Services NewsAlert, Key tax accounting considerations of France’s second Amended Finance Act for 2012
- PwC WNTS myStateTaxOffice, Pennsylvania enacts single sales factor, extends RAR reporting deadline to six months, authorizes the Department to engage contractors on a contingent fee basis, and imposes other tax changes (July 13, 2012)
- PwC WNTS myStateTaxOffice, Tennessee issues guidance on intangible expense add-back and deduction (October 11, 2012)
- PwC WNTS Insight, IRS formally delays effective date of the temporary repairs regulations (December 14, 2012)
- PwC WNTS myStateTaxOffice, California Proposition 39: Single sales factor for most taxpayers and market-based sourcing for all taxpayers (December 3, 2012)
- Chapter 7 of PwC’s Guide to Accounting for Income Taxes (the Guide)

Calendar year 2012 has seen considerable activity across the global legislative and regulatory landscapes. In addition to one-off changes to tax laws in several key territories, certain legislative trends have had a significant impact on income tax accounting. These developments, combined with the continued economic uncertainty, have added to the complexity and judgment involved in accounting for income taxes.

As in prior years, this publication is focused on the topics we believe will be most relevant to the preparation of 2012 year-end financial statements. Some topics have been discussed in our prior annual publications, however their continuing importance warranted including them again in 2012. Where relevant, PwC publications which may go into more depth or provide greater insight into a topical area have also been referenced. Unless specifically indicated, the discussion and references all pertain to accounting standards and related reporting considerations based upon US GAAP.

The topics covered in this 2012 publication are as follows:

- Tax law developments
- SEC comment letter trends
- Uncertain tax positions
- Valuation allowances
- Indefinite reinvestment assertions
- Foreign currency
- Business combinations and disposals
- Tax accounting method changes
- Stock-based compensation
- Taxes not based on income
- Effective tax rate reconciliation
- Presentation and disclosure
- IFRS status update


**Tax law developments**

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

While the following is not a comprehensive list, we have highlighted several key tax law changes and developments in selected jurisdictions.

**US and State Tax Law Developments**

- **US** - Following the issuance in December 2011 of new temporary and proposed regulations for tangible property repair costs, Revenue Procedures were issued in March 2012 with respect to method changes, specifically addressing audit protection for prior years. A directive to field agents was also issued in March 2012 to discontinue current exam activity with respect to matters addressed by the new regulations.

- **California** - On November 6, 2012 California voters passed proposition 39 which requires single sales factor apportionment for California business taxpayers, unless specifically exempted, for tax years beginning on or after January 1, 2013. This initiative also mandates the use of market-based sourcing for sales other than sales of tangible personal property for all business taxpayers, irrespective of the apportionment methodology used. Taxpayers which derive more than 50% of their gross business receipts from one or more qualified business activities (agricultural, extractive, savings and loan, and banking or financial business activities) will continue to apportion their business income to California by multiplying such income by the equally-weighted three-factor formula. Under current law taxpayers have the option to utilize a standard double-weighted sales apportionment formula based on property, payroll and sales factors or make an irrevocable annual election to use the single sales factor apportionment formula.

- **Pennsylvania** - On July 2, 2012 H.B. 761 was enacted which requires all business income to be apportioned based on a single sales factor for tax years beginning on or after January 1, 2013. Under current law Pennsylvania’s apportionment formula is based upon 90% of sales and 5% of property and payroll.

- **Tennessee** - On April 27, 2012 H.B. 2372 was enacted changing Tennessee’s intangible expense deduction provisions by requiring, in most cases, pre-approval from the Department of Revenue to claim the deduction. In order to receive approval, taxpayers must demonstrate that such expense, or portion thereof, does not have as its principal purpose the avoidance of tax.

**International Tax Law Developments**

- **Ireland** - Amendments to the capital gains regime, including an increase in the applicable tax rate from 25% to 30%, were enacted on March 31, 2012. Also enacted on this date were changes to the start-up company, research and development, dividends-received and group relief regimes and the rules providing relief for foreign tax incurred on royalties and interest.

- **Spain** - Various changes to the Spanish tax regime were enacted on March 31, 2012 including a new interest capping rule. The rule applies to both related and third party debt in certain situations and limits tax relief for net interest expense to 30% of the taxpayer’s adjusted earnings before interest, tax, depreciation and amortization. There is also a reduction in the tax credit utilization limitation from 35% to 25% of that year’s tax liability and an extension of the carry-forward period for tax credits to 15 years (18 years for research and development and technology credits). Further updates were also enacted on July 13, 2012, primarily relating to tax loss limitation rules and the scope of the interest-capping rule.

- **India** - A number of changes to Indian corporate tax law were enacted on May 28, 2012 including retroactive legislation to tax certain capital gains. This taxation of capital gains applies to the transfer of shares or interest in a company or entity registered or incorporated outside of India, substantially all of whose value is derived, directly or indirectly, from assets located in India.

- **Peru** - Several changes to the Peruvian tax regime were enacted in July 2012, including the introduction of controlled foreign company (CFC) legislation and various anti-avoidance provisions.

- **Netherlands** - Legislation was enacted on July 10, 2012 to restrict tax relief for interest on ‘excessive’ debt used to finance subsidiaries.

- **France** - On August 18, 2012, France enacted a surtax of 3% on certain dividends and branch profits, restrictions on a company’s ability to use losses in the event of certain reorganizations or changes in activity and changes to the capital loss rules.

- **United Kingdom** - Reductions in the main corporate tax rate to 24% from April 1, 2012 and 23% from April 1, 2013 were enacted on July 17, 2012 along with various changes to the CFC and foreign branch taxation regimes. Additionally, a 10% “patent box” regime was introduced along with various other changes to the corporate tax law.
Belgium - Thin capitalization rules were enacted on March 29, 2012 introducing a general 5:1 debt-to-equity ratio along with an anti-abuse rule aimed at the involvement of third parties. Amendments to the original legislation were enacted on June 22, 2012 to take into account the specific characteristics of coordination centers, cash pooling arrangements and financing companies.

Chile - On September 27, 2012, Chile enacted an increase in the corporate tax rate to 20% effective January 1, 2013, a 35% tax on capital gains on indirect sales and various other changes applicable to domestic and foreign operations.

**Legislative Trends**

- **Loss limitations** - New rules restricting the use of carry-forward tax losses were introduced or proposed during the year in several foreign territories. Generally, these rules seek to limit the use of carry-forward income tax losses to a fixed percentage of taxable income in any future period. This can significantly impact the realizability of deferred tax assets in respect of such losses.

- **Interest restrictions** - A number of territories have introduced or proposed new rules in 2012 to restrict the tax benefit of interest expense.
SEC comment letter trends

Calendar year 2012 has continued to see an increase in the number of tax-related comment letters issued by the staff of the Securities and Exchange Commission (SEC). Of the letters originally issued to companies after December 31, 2011 and released to the public between January 1, 2012 and September 30, 2012, approximately 250 of the comments identified related to tax matters. Of those tax-related comments, 80% of the comments related to the following areas: indefinite reinvestment of foreign earnings, presentation of the effective tax rate, valuation allowance assessments and uncertain tax positions.

Clearly, matters of judgment continue to be an area of focus for the SEC. We have continued to see an increased emphasis on providing more accurate, transparent and plain language disclosures of significant assertions and estimates. There has been a significant amount of attention given to accumulated foreign earnings and the presentation of the foreign effective tax rate. We have noted a continued emphasis that disclosures within Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and financial statement footnotes around liquidity and capital resources be consistent with the registrants’ indefinite reinvestment assertions related to foreign earnings. Further, recent SEC comment letters have reminded companies of the requirement to disclose the amount of the temporary basis difference and the unrecorded tax liability if practicable to calculate, or to explain why the calculation of the unrecorded liability is not practicable.

We expect these topics to be continued areas of focus by regulators (including the SEC and the Public Company Accounting Oversight Board (PCAOB)), investors and commentators in 2013.
**Uncertain tax positions (UTPs)**

*Refer to:*

- Chapter 16 the Guide

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 positions must be reassessed based upon new information. The accounting standard 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** - 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.

In assessing uncertain tax positions, an organization is required to recognize the benefit of a tax position in the first interim period that one of the following conditions is met:

- The more-likely-than-not recognition threshold is met.
- 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.

**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 examination procedures, including appeals and administrative reviews required. The current policy of the IRS indicates that an examination is closed when the examining agent presents written verification of either: (1) adjustments to the organization’s tax liability, or (2) acceptance of the organization’s tax return without changes.

- 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.

In jurisdictions like the US where the taxing authority can re-examine tax positions that gave rise to a net operating loss or other carry-forwards in the year those carry-forwards are claimed, the judgment as to whether effective settlement has occurred becomes more complex. To the extent that the requirements of effective settlement are met, the resulting tax benefit is required to be reported (application of effective settlement criterion is not elective).

**Special examination procedures** - Taxing authorities may have special examination procedures available to reduce or eliminate uncertainty either prior to or during an examination.

In determining whether the recognition threshold has been met, management may consider pursuing such options as a Private Letter Ruling (PLR), Competent Authority resolution, pre-filing agreement, or Advance Pricing Agreement (APA). These rulings and agreements, if issued to the taxpayer by the taxing authority, typically form the basis for meeting the recognition threshold.

The IRS Compliance Assurance Process (CAP) program for large corporate taxpayers is an additional consideration. Under CAP, participating taxpayers work with an IRS team to identify and resolve potential tax matters before the income tax return is filed each year. These pre-filing communications with the IRS may be viewed as new information by an organization in support of a re-evaluation of a position’s measured benefit.
Valuation allowances

Refer to:

- Chapter 5 of the Guide
- Chapter 6 of the Guide
- The quarter close - December 2012
- Dataline 2012-20: 2012 year-end accounting and reporting considerations (December 2012)
- PwC Tax Accounting Services Thought Leadership, The impact of transfer pricing in financial reporting (September 2011)

The evaluation of the need for, and amount of, a valuation allowance for deferred tax assets (DTAs) is 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 is likely to be realized. Likelihood in this context is determined based upon a prescribed weighting of evidence in accordance with its objective verifiability. Accordingly, recent results are given more weight than future projections.

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

**Jurisdictional assessment** - The valuation allowance assessment is generally performed on a jurisdiction-by-jurisdiction basis which is in contrast to other areas of accounting such as goodwill impairment testing and may differ from how a company views its business. For example, a company may be highly profitable at the segment and reporting unit level, but may be in a cumulative loss position within a particular jurisdiction. Further, where the local tax law does not allow for consolidation, the valuation allowance assessment may be at the separate legal entity level as opposed to the jurisdictional 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 year-end but before the financial statements are released. However, a valuation allowance assessment should not consider transactions over 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 the transactions are completed.

**Triggering events or changes in circumstances** - In assessing potential changes to a valuation allowance (i.e., either establishing or releasing), it is important to consider what has actually changed from the prior assessment and whether a change in assessment is warranted. Based on the short time period between the issuance of an entity’s year-end financial statements and release of its first-quarter Form 10-Q, changes in judgment during this period would be expected to be relatively uncommon and generally would result from a specific event or change in circumstances that could not have been foreseen.

An entity should consider the appropriate timing to release the valuation allowance when circumstances change. Cumulative income is not a prerequisite to releasing a valuation allowance. An entity must consider the totality of all positive and negative evidence when considering whether to establish or release a valuation allowance. In jurisdictions that allow for unlimited carryforward of certain tax attributes, a lower level of sustained profitability may be sufficient evidence to support realization of the deferred tax assets as compared to jurisdictions in which attributes are subject to expiration.

**Intra-entity transfers** - An intra-entity transfer of assets may trigger the release of a valuation allowance. Before applying the deferral of the recognition of tax expense generated as part of an intra-entity sale of assets, a company should first determine whether the transaction results in the realization of its existing tax attributes. If tax benefits from attributes are realizable, the intra-entity deferral provision should not apply to the valuation allowance release and the recognition of that income tax benefit.
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. In effect, the tax-rate differential is effectively regarded as a cost associated with implementing the strategy.

**Character of DTAs** - 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 carry-forward period and must create 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 sources of income which allow for the realization of the tax credits. In other words, utilization does not always mean realization. The substitution of one DTA for a future DTA, without a source of income for the future DTA’s realization, does not represent realization.

**Limitations on NOL utilization** - 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, recent legislation in certain European countries has limited the amount of taxable income that can be offset by NOLs in a given tax year. In a situation where a company is 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 may need to be increased) to reflect the shifting of loss utilization as a result of the limitation into later years.

**Outside basis differences** - When a taxable temporary difference related to the outside basis in a foreign subsidiary (e.g., related to undistributed foreign earnings) is viewed as a source of taxable income to support recovery of DTAs, a company’s plan with respect to the timing of reversal of the difference should be considered. Taxable temporary differences on equity method investments may also 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 DTAs.

**Deferred tax liabilities** - 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 DTAs may be necessary even when an enterprise is in an overall net deferred tax liability (DTL) position.

In jurisdictions with unlimited carryforward periods for tax attributes (e.g., net operating losses, AMT credit carryforwards and other non-expiring loss or credit carryforwards), the related DTAs can be supported by the indefinite-lived DTLs, assuming they are within the same jurisdiction and the relevant tax law would allow for the offset of the carry-forward against the accrued liability.

**Disclosures** - The SEC staff continues to focus on the judgments and disclosures relating to valuation allowance assessments. They have regularly required that disclosures include a discussion of the evidence considered, including reference to negative evidence such as recent losses, how the evidence was weighted, 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 questioning of the establishment 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); and

- The assessment of the adequacy and consistency of estimates used in the valuation allowance assessment when compared with other estimates involving assumptions about the future used in the preparation of the financial statements and in other filing disclosures.
Indefinite reinvestment assertions

Refer to:
- Chapter 11 of the Guide
- PwC 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 and ongoing uncertainty within the global economy has made the application of the assertion more challenging.

When evaluating this assertion, companies should consider the following:

- 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-term and short-term projected working capital and other financial needs in locations where the earnings are generated. Evidence maintained by management should include documented reasons why any excess earnings are not needed by the parent or another operation in the group. Management should consider the consistency of its assertion with the parent and subsidiary’s long-term and short-term budgets and forecasts, any past dividends, and the tax consequences of a decision to remit or reinvest.

- Management should consider any transactions, such as loans or credit support provided by the foreign operations to the US parent, which may be relevant in assessing whether the assertion can be made. Transactions which present risk of US taxation may suggest that foreign funds or liquidity are needed in the US thereby possibly preventing an assertion of indefinite reinvestment.

- Management must have the ability, intent, and control to indefinitely postpone home country taxation. The assertion needs to be supported by all levels of management who would be expected to have significant decision-making input relative to the plans or transactions which 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 obligations and keep the business afloat, it may be difficult to support an assertion of indefinite reinvestment.

- The effect of the expiration of Internal Revenue Code subpart F provisions (the look-through treatment of payments between related controlled foreign corporations and exceptions for certain active financing income) which had enabled US tax deferral should be considered. The expiration of these provisions increases the importance of evaluating the indefinite reinvestment assertion at lower levels of a company’s organizational structure due to the increased potential for subpart F to arise from cross-border dividend (or certain other) payments.

- 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 generation of future subsidiary profits, however, would not provide a basis for recognizing a deferred tax asset on the outside basis difference. Deferred tax assets on outside basis differences must also be assessed for realizability (i.e., to determine whether a valuation allowance is required).
We believe there are limited circumstances in which foreign taxes that are expected to become foreign tax credits in the foreseeable future would be recognized as a benefit prior to the actual repatriation event. Among other factors to consider, the company must be committed to making the repatriation that triggers the foreign tax credit benefit in the near-term.

The SEC is continuing to encourage more robust disclosures around the indefinite reinvestment assertion. Companies are required to disclose the amount of the temporary basis difference and, if practicable, an estimate of the unrecorded tax liability. Recent SEC comment letters have asked registrants to explain why the calculation of the unrecorded liability is not practicable. The SEC also continues to issue comments with regard to liquidity discussions and the financial statement impact of repatriating cash where a company is asserting indefinite reinvestment.
Foreign currency

Refer to:
- Chapter 11 of the Guide
- PwC Tax Accounting Services Thought Leadership, Foreign Currency Tax Accounting

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 key aspects of this complex area to keep in mind:

- Translation adjustments for foreign subsidiaries 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. 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 unremitted 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 reflected in the outside basis difference).

- Income that has been (or is expected to be) taxed under the 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.

- Subsequent adjustments to deferred taxes originally charged or credited to CTA are not always allocated to CTA, but instead must often be reported in continuing operations. Depending upon a company’s accounting policy, adjustments due to changes in uncertain tax positions may be recorded either in CTA or as part of income tax from continuing operations.

- When subsequent adjustments to deferred taxes are not recorded in CTA, tax effects lodged therein will not necessarily equal the respective deferred taxes recognized 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 of a foreign operation.

- 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.

- If the owner of a foreign branch has the ability and intention to postpone remittance, 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 the branch.

- 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 tax bases in the local foreign currency after the respective depreciation. 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 UTPs are subject to translation adjustments each reporting period. Translation must be applied even if the UTP 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 and whether the loan is considered a long-term advance (permanent capital) can affect the accounting for foreign currency translation adjustments.
**Business combinations and disposals**

**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*

The accounting for business combinations is an area of challenge for many organizations due to its technical complexity, the involvement of cross-functional teams, as well as constraints on the availability of timely information.

**Acquisition-related events**
Business combinations often involve a considerable amount of business, legal and tax planning. There is no direct guidance that addresses whether the tax effects of elections or post-acquisition transactions should be included in acquisition accounting. Practice in this area is evolving.

We believe the following factors should generally be considered in the assessment of whether the tax effects of such events should be included in acquisition accounting:

- 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. In this regard, the mere realization, or settlement of an acquired deferred tax liability is not considered a separate payment.
- Whether other significant costs will be incurred to implement the transaction, also keeping in mind whether such pre-tax costs will or will not be included in acquisition accounting.

**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 sometimes referred to as “negative goodwill.”

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 valuation allowance**
The impact on the acquiring company’s deferred tax assets and liabilities, including any 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).

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, the acquirer’s, or both. 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. We believe there are two acceptable accounting policies. One policy is to consider the recoverability of deferred tax assets acquired in the acquisition before considering the recoverability of the acquirer’s existing deferred tax assets. An alternative policy is to recognize deferred tax assets based upon which assets will be realized first under the tax law.
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.

- 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 the related valuation allowance would also be recorded in equity.

- When analyzing the accounting for non-controlling interests, it is important to distinguish between direct and indirect tax effects. For example, 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 in management assessment is an indirect effect of acquiring the additional interest, it will generally be recorded in earnings.

Business combinations achieved in stages
For a business combination achieved in stages, the acquirer should remeasure 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. 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 any 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. Where the acquired company is a partnership, consistent with the treatment for corporate entities, staged acquisitions result in the remeasurement of a previously held equity interest at fair value. Consideration of the deferred tax effects resulting from the acquisition of control of the partnership can vary depending upon the circumstances.

Worthless stock deductions
The tax effects of an excess tax-over-book basis in the stock of a subsidiary should be recognized when it becomes apparent that the temporary difference will reverse in the foreseeable future. In the context of a worthless stock deduction, this requirement would generally be met in the earliest period in which the investment is considered “worthless” for income tax purposes.

- In the US, there are various measures used to make this determination. Certain identifying events that confirm stock worthlessness include bankruptcy, a court-appointed receiver and liquidation. As a result, if such an identifiable event is required in order to recognize a tax benefit, the ability of the company to control the occurrence of that event must be considered.

- The tax effect of a worthless stock deduction should be accounted for discretely in the interim reporting period when it becomes apparent that the temporary difference will reverse in the foreseeable future.

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. The determination impacts both the buyer’s acquired tax attributes and the tax bases of assets and liabilities. 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 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.
Stock-based compensation

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 for “backwards tracing”, there is an exception for certain equity items. We believe this 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 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 a UTP associated with the windfall benefit.

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 providing disclosure that may help users assess the economic exposure 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.

Repurchase of an award - The accounting for the repurchase of an award is affected by several factors, including whether the award is vested or unvested and the probability of vesting. From a US federal tax perspective, the amount of the cash settlement is generally deductible by the employer to the extent the entity has not previously taken a tax deduction for the award. When there is a repurchase of an award for cash, any remaining deferred tax asset (in excess of the tax benefit resulting from the repurchase, if any) related to the awards generally would be reversed as a shortfall. A cash settlement of incentive stock options (ISOs) will create a tax benefit reported in earnings (to the extent of book compensation) similar to a disqualifying disposition.

Clawback of an award - Entities may include a “clawback” provision in stock-based compensation awards. These features are becoming more prevalent, particularly due to certain legislation such as the Dodd-Frank Act, and typically provide a company the right to recover previously earned awards from an executive as the result of some triggering event, such as a financial restatement or the executive’s breach of an employment policy. The income tax accounting for a clawback that has been triggered depends on the status of the award at the time of the clawback and whether the entity has previously taken the tax benefit from the stock-based compensation award. If the clawback occurs prior to the exercise of a stock option (or the vesting of restricted stock for tax purposes) and no tax deduction has been taken for the clawed-back awards, the related deferred tax asset would be reversed through income tax expense and not considered a shortfall. If an entity has taken a deduction for a stock-based compensation award that is being clawed-back, taxable income resulting from the clawback would be allocated to the various components of the financial statements in accordance with intraperiod allocation guidance.
Taxes not based on income

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

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).
Presentation and disclosure

Refer to:
- Chapter 15 of the Guide

In light of the focus by investors and regulators on income tax-related disclosures, companies may wish to enhance their procedures around the identification and development of income tax disclosures.

Key reminders to consider as part of the year-end process include:

- Tax-related disclosures should be consistent with other disclosures within MD&A.

- Consideration should be given to early warning disclosures related to significant estimates and judgments related to income taxes. Examples include disclosure of possible near-term recognition or release of a valuation allowance or a material change in an uncertain tax position.

- Companies should also consider early warning disclosures related to deferred taxes and the impact of potential tax rate changes that are in various stages of legislative processes. For example, it is expected that corporate tax rates in the US could be lowered in the near-to-mid term, which could result in an adjustment of deferred taxes. MD&A requires disclosure of known uncertainties if it is reasonably likely that the uncertainty will come to fruition and it is reasonably likely to have a material impact on financial condition or results of operations.

- When the US dollar is the functional currency of a foreign subsidiary, revaluations of local currency foreign deferred tax balances are reported as transaction gains and losses, or as deferred tax benefit or expense, depending on the accounting policy.

- 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 or approach applied by the company should be considered.

- Current deferred tax assets and liabilities within a single tax jurisdiction should be offset and presented as a single amount in the balance sheet. Similarly, noncurrent deferred tax assets and liabilities within a single tax jurisdiction should be offset and presented as a single amount.

- Consideration should be given to whether the tax accounts from different jurisdictions (where the right of offset does not exist) should be reported separately 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.

- Financial statement amounts reported in the consolidated income tax provision and net income attributable to NCI can differ based on whether the subsidiary is a C-corporation or a partnership.

- Consideration should be given to disclosing the nature and effect of significant items affecting the comparability of the tax accounts and effective tax rate for all periods presented.

- Disclosure of tax attribute carryforwards should be based upon the accounting recognition and measurement criteria. A company may wish to consider disclosure of both the amounts claimed in tax returns and the respective amounts benefitted in the financial statements.

- 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 required footnote disclosures for UTPs 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. This includes 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.

- Companies are required to disclose the amount of government grants to the extent such grants are recognized as a reduction of income tax expense.

- 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 to better understand the tax position of the company.
**IFRS status update**

*Refer to:*
- Chapter 18 of the Guide

**United Kingdom** - Until proposals were published by the UK Accounting Standards Board (ASB) in February 2012, it was expected that some form of IFRS would be required to be adopted for the accounts of all UK companies from January 1, 2015. However, the February proposals confirmed that the intention is now to provide companies with a choice, subject to certain criteria, of EU endorsed IFRS or a new Financial Reporting Standard (FRS) for UK GAAP reporters. Both options are permitted with or without reduced disclosures. Adoption of one of the options will be mandatory from January 1, 2015, with early adoption permitted from as early as 2013.

Although the FRS is based on the principles of the IFRS for SMEs (small and medium-sized entities) standard, its legal form will be a UK standard rather than an international standard. It is also currently proposed that the tax accounting rules will be broadly based on the ‘timing differences’ or ‘income statement’ approach currently included under UK GAAP. There will therefore continue to be significant differences between accounting for income tax under this new UK standard and IFRS or US GAAP.

**United States** - In the US, the staff of the SEC’s Office of the Chief Accountant ("the staff") published its report in July 2012 on its Work Plan aimed at helping the SEC evaluate the implications of incorporating IFRS into the US financial reporting system. While the staff report was not intended to, and does not, provide an answer to the question of whether it is in the best interests of the US capital markets and investors for a transition to IFRS to take place in the US, it does outline areas where the staff believe improvements can be made to IFRS. The potential improvements include the accounting for certain industry specific issues, the consistency of global application, the interpretative process and the enforcement and co-ordination activities of international regulators. The report also states that adoption of IFRS as authoritative guidance in the US is not supported by the vast majority of participants in the capital markets and recommends that additional analysis be undertaken before any decision is made about incorporating IFRS into the US financial reporting system.
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# Tax accounting services market leaders

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