

## **Chapter 9: Tax Accounting Considerations**

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### **1. Introduction**

Business restructurings have pervasive impacts on a company's operations, policies and financial position. Such impacts also extend to income taxation, which is directly and often significantly affected by the movement or redeployment of assets and profits that is common to restructurings.

The income tax consequences of business restructurings are typically viewed from a cash tax perspective and for good reason – taxes have a direct impact on the cash available for use in other areas of the business. However, the effect of income taxes on financial reporting is increasingly also becoming a top consideration of the finance function, given the impact on financial results and the increased scrutiny of this area by regulatory bodies, especially in the United States and Europe. For example a company's effective tax rate, which is calculated via income tax accounting, is a key component used to determine earnings per share. As commonly known in the investment community, earnings per share is a key financial

indicator in evaluating a company's performance and therefore attractiveness as an investment opportunity. Earnings per share may also be used internally as a basis on which management bonuses or other types of employee compensation are determined. Needless to say, the effective tax rate is a very important metric for many companies, and effects on the effective tax rate, including those that may arise from business restructurings, are important to understand. Deferred tax accounting – to be explained in more detail throughout this chapter – is another area of importance in income tax accounting. This is not to say that deferred taxes are more important than current taxes, etc. But rather, deferred tax accounting is an area of income tax accounting to be highlighted because for many, this is a relatively new concept and one that can be very complex and result in a significant impact on the financial statements.

It is nearly impossible to assess the income tax consequences – and therefore the income tax accounting consequences – of business restructurings without consideration of transfer pricing. In fact, transfer pricing is a key consideration, if not *the* key consideration, of such assessments, given that intercompany transactions are inherent to most business restructurings. Accordingly, this chapter will focus primarily on “common” transfer pricing issues associated with business restructurings and their related income tax accounting implications. In addition, this chapter will walk through the most significant technical accounting aspects of income tax accounting for business restructurings. Certain important but secondary implications, including interim reporting, financial statement disclosures and accounting for business combinations,<sup>1</sup> are omitted from this chapter for the sake of brevity. Further, one should bear in mind that the income tax accounting considerations discussed in this chapter do not constitute an exhaustive list, but rather a sampling of the most common and significant issues encountered when determining the income tax accounting for business restructurings.

In order to understand the income tax accounting impacts of business restructurings, it is first imperative to understand tax accounting itself and the guiding frameworks and standards. Given the prevalence of accounting under US Generally Accepted Accounting Principles (US GAAP) and the continued global migration to International Financial Reporting Standards (IFRS), the tax accounting discussion in this chapter will primarily address these two

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<sup>1</sup> “Business combination” as defined by IFRS 3/3R and FAS 141/141R.

frameworks, specifically the respective tax accounting standards, Financial Accounting Standard (FAS) 109 and International Accounting Standard (IAS) 12, and related guidance and interpretations as effective at 1 January 2009.<sup>2</sup>

Income tax accounting at its basic level is accounting for income taxes in the context of financial reporting requirements. In contrast to many local (or statutory) GAAPs, the IFRS and US GAAP introduce the concept of accounting for future tax consequences of current and past events, i.e. deferred tax accounting. These frameworks also introduce stringent requirements for recognizing tax benefits in the financial statements as compared to the tax return, particularly related to future tax deductions (or exclusions of income) that may not be realizable, or tax positions taken (or to be taken) on a tax return that may be uncertain. Said another way, the concept of income taxes for financial reporting purposes is often much more than the expected tax liability(ies) on the tax return(s) for a given reporting year. Its impact often extends beyond income tax expense in the income statement, and even beyond income taxes payable and cash on the balance sheet.

Of course to appropriately apply income tax accounting, one must also know the treatment of events and transactions under the relevant tax law as compared to the pre-tax financial accounting treatment of such items. It is, after all, these differences in treatment between financial accounting and tax law that give rise to deferred taxes and effective tax rate impact. A complete discussion of all tax law and pre-tax accounting implications of specific events and transactions associated with business restructurings is far beyond the scope of this discussion; however a brief overview of general tax law considerations is provided later in the chapter, and pre-tax accounting principles are discussed throughout the chapter where appropriate.

## **2. International accounting framework**

### **2.1. General**

For many reasons, an increasing number of enterprises worldwide are required to draw up

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<sup>2</sup> Changes are expected to IAS 12 in the near term, as the IASB intends to issue an exposure draft for a revised IAS 12 during 2009.

their (consolidated) financial statements or to report their figures for group purposes using internationally-recognized accounting standards, typically IFRS or US GAAP. These reasons may include the requirement for many European publicly-traded companies, depending on local country rules, to report financial results in both local GAAP and IFRS, or financial reporting obligations in the United States for foreign private issuers or subsidiaries (or certain other equity investees) of US publicly-traded companies. Whatever the reason, both IFRS and US GAAP provide a comprehensive – and generally similar – set of accounting principles for income taxes.

The number of companies subject to IFRS reporting is expected to continue to increase as an increasing number of countries adopt IFRS as the primary local-country financial reporting framework. This includes the United States, which currently has a draft “roadmap” plan for IFRS adoption over the next several years. The International Accounting Standards Board (IASB), the UK-based body responsible for the development and maintenance of the IFRS framework, and its US / US GAAP equivalent, the Financial Accounting Standards Board (FASB), continue to collaborate with the current ultimate goal of establishing one comprehensive, internationally-recognized and utilized financial accounting framework to be embodied by IFRS. This has been and continues to be accomplished via ongoing convergence projects by the IASB and FASB on a standard-by-standard basis. Needless to say, IFRS is currently viewed as the future of global financial reporting.

## **2.2. Income tax accounting standards**

The IFRS and US GAAP frameworks each encompass a specific standard dedicated to the accounting treatment for income taxes. As noted previously, this standard is IAS 12 for IFRS, and FAS 109 for US GAAP.<sup>3</sup> Using the various sections of these two standards (and related guidance and interpretations), one should be able to handle the principle issue in accounting for income taxes, i.e., how to account for the tax consequences of:

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<sup>3</sup> There is significantly more tax accounting guidance under US GAAP than only FAS 109. Additional guidance includes FASB Interpretations (FIN), FASB Emerging Issues Task Force (EITF) abstracts, AICPA Statement of Positions (SOP), etc. Guidance under IFRS in addition to IAS 12 is two Standing Interpretations Committee (SIC) abstracts, 21 and 25. To fully apply tax accounting under US GAAP and IFRS, however, it is also essential to have sufficient understanding of other relevant accounting standards.

- the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognized in an entity's balance sheet (i.e. deferred taxes); and
- operations, transactions and other events of the current period that are recognized in an entity's financial statements (i.e. current taxes).

For purposes of these standards, income taxes include all domestic and foreign taxes that are based on taxable profits. Income taxes also include taxes that are paid by a subsidiary, associate (equity investee) or joint venture on distributions to the reporting entity, such as withholding taxes.

Most of the basic principles utilized by IAS 12 and FAS 109 are similar. The main principles which have identical meaning within the two standards are notably:

- current tax is the amount of income taxes payable (recoverable) in future periods in respect of the taxable profit (tax loss) for a period;
- deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences;
- deferred tax assets are the amounts of income taxes recoverable in future periods in respect of (1) deductible temporary differences, (2) the carry-forward of unused tax losses and (3) the carry-forward of unused tax credits; and
- temporary differences are differences between the carrying amount of an asset or liability on the balance sheet and its tax base. Temporary differences may be either:
  - taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or the liability is recovered or settled; or
  - deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (loss) of future tax periods when the carrying amount of the asset or liability is recovered or settled.

Although FAS 109 and IAS 12 are similar models, they still contain a number of important differences which could be relevant in practice. Indeed, the devil is often in the details!

As described above, deductible temporary differences and unused tax attributes, including tax losses and tax credits, could give rise to the recognition of a deferred tax asset. This

recognition is not systematic. In this regard, both IAS 12 and FAS 109 provide a “recoverability test” to evaluate whether, and if so, the extent to which deferred tax assets may be recognized on these deductible temporary differences and tax attributes.

In some circumstances, the recognition of a deferred tax asset is particularly complex insofar as the criteria prevailing in this regard are very subjective, and therefore the documentary evidence to support the decision taken by management is key.

To illustrate this, assume a business restructuring within Group XYZ resulted in the transfer of an intangible from Subsidiary A located in Country X to Subsidiary B located in Country Y. Along with the transfer of the intangible asset was the transfer of the associated licence revenue. Assume also that prior to the transfer of the intangible asset, Subsidiary B was historically in a loss position with substantial tax loss carry-forwards for which no deferred tax asset had been previously recognized. However, moving forward, Subsidiary B expects to be in a taxable income position as the result of the licence revenue stream. On this basis, Subsidiary B may be tempted to recognize a deferred tax asset in its financial statements, as there is a greater than 50% likelihood that it will be able to offset its tax losses against taxable profits within the foreseeable future. However, assume now that Subsidiary B is not in a position to provide convincing transfer pricing documentation in respect of the income shifted into its hands as a result of the intangible acquisition. Then, the most reasonable position may be continued non-recognition of the deferred tax asset.

In this regard, guidance provided by IAS 12 and FAS 109, which is expected to assist the management of a business enterprise in its decision, is further explained below.

IAS 12 (paras. 24 and 34 – 36) provides that deferred taxes on deductible temporary differences, unused tax losses and unused tax credits may be recognized to the extent that it is probable that future taxable profit will be available against which said deductible temporary differences, unused tax losses and unused tax credits can be utilized.<sup>4</sup>

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<sup>4</sup> An exception to this general rule is the so-called “initial recognition exception”, where recognition of deferred taxes is prohibited for certain assets and liabilities the book carrying amounts of which differ to their initial tax bases.

Often, the difficulty resides in the assessment of the probability that sufficient taxable profit will be available. IAS 12, para. 36 provides criteria which can be utilized when assessing this probability (“more likely than not” approach)., namely:

- whether the entity has sufficient taxable temporary differences (i.e. deferred tax liabilities) relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the deductible temporary differences, unused tax losses or unused tax credits may be utilized before they expire;
- whether it is probable that the entity will have taxable profits before unused tax losses or unused tax credits expire;
- whether the unused tax losses result from identifiable causes which are unlikely to recur; and
- whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or tax credits can be utilized.

This section of IAS 12 also prescribes that, to the extent that it is not probable that taxable profit will be available against which the unused tax losses and the unused tax credits can be utilized, the deferred tax asset is not recognized. One can regret that while IAS 12 provides guidance with regard to recognition, it is silent as how to measure the amount to be recognized as a deferred tax asset.

When it is more likely than not (i.e. a probability of more than 50%) that deferred tax assets will not be realized, which depends on the existence of future taxable income, the deferred tax assets should be reversed. Such reversal should be based on management’s judgement of the probability considering all available information, both quantitative and qualitative. All available evidence, positive and negative, should be considered, i.e. historical information supplemented by all currently available information about future years.

The framework and criteria for determining the recognizable value of deferred tax assets is very similar between IFRS and US GAAP. In fact, the key difference between the two frameworks is terminology. IAS 12 requires that only the net realizable deferred tax asset be recorded in the financial statements. FAS 109 requires the same, but the net realizable value is achieved through use of a valuation allowance, a contra-asset used to reduce a deferred tax asset to its net realizable value. It is also vital to appropriately compute and understand the valuation allowance under US GAAP, as it is required to be disclosed in the footnotes to the

financial statements.

As to the entities which are required to apply US GAAP, those with fiscal years that begin on or after 15 December 2006 must adopt Financial Accounting Standards Board (FASB) Interpretation 48 (Accounting for Uncertainty in Income Taxes). This interpretation of FAS 109 is intended to provide specific guidance to all business enterprises, not-for-profit organizations, pass-through entities and entities whose tax liability is subject to 100% credit for dividends paid that are potentially subject to income taxes, when they must recognize or measure uncertain tax positions.<sup>5</sup> It applies to all jurisdictions (including therefore non-US parent enterprises) and all tax positions accounted for under FAS 109, regardless of the nature of the enterprise or taxing jurisdiction.

For various reasons, business enterprises can take tax positions which will result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future financial years or a change in the expected realization of deferred tax assets.

The term “tax position” notably includes:

- a decision not to file a return;
- an allocation or a shift of income between jurisdictions;
- the characterization of income or a decision to exclude;
- reporting taxable income in a tax return; and
- a decision to classify a transaction, entity or other position in a tax return as tax-exempt.

Due to the significant implications of accounting for uncertain tax positions in respect of business restructurings, additional discussion of the requirements and application of FIN 48 and its equivalent under IAS 12 are discussed at greater length in 4.1.2. and 4.1.3. of this chapter.

### **3. Tax law considerations**

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<sup>5</sup> As indicated in FASB Staff Position (FSP) 48-3 issued on 30 December 2008, the adoption of FIN 48 by certain non-public companies was deferred. Such companies as defined in the FSP and FAS 109 are not required to adopt FIN 48 until the financial year beginning on or after 15 December 2008.

In its 2008 Discussion Draft on business restructuring<sup>6</sup> (the Discussion Draft), the OECD defines business restructurings as:

the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. It may involve cross-border transfers of valuable intangibles. They primarily consist of internal reallocation of functions, assets and risks within a multinational environment, although relationships with third parties may also be the reason for the restructuring and/or be affected by it.<sup>7</sup>

Business restructuring represents an area of growing attention in the regulatory and tax environments. While the pressure of competition, the savings from economies of scale, the need for specialization, the increase of efficiency and the focus on cost control are all drivers of restructurings, one should not forget that restructurings generally entail a movement of activities and thus a shift of sources of income and expenses from one country to another.

In order to determine the tax considerations, it is essential to clearly identify the restructuring transaction(s) and to understand the resulting changes to the business, both in substance and in form. Areas to consider include pre- and post-reorganization functions; changes to entity and asset rights and obligations; and the manner in which all functions, risks and/or assets were transferred.

Business restructurings come in many shapes and sizes, and identification of all possible tax implications across all industries and tax regimes in one document is nearly impossible. Accordingly, the following tax discussion briefly addresses the most common events and transactions in reorganizations, together with their most important tax considerations.

### **3.1. Plant closures**

Plant closures are typical of reorganizations of manufacturing companies and business segments. The same or similar events and transactions associated with plant closures largely apply also to facilities closures and other operational shut-downs of non-manufacturing

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<sup>6</sup> OECD, Centre for Tax Policy and Administration, “Transfer Pricing Aspects of Business Restructuring: Discussion Draft for Public Comment, 19 September 2008 to 19 February 2009”, a copy of which is available at [www.oecd.org/dataoecd/59/40/41346644.pdf](http://www.oecd.org/dataoecd/59/40/41346644.pdf).

<sup>7</sup> Id. at 6.

companies.

Many reasons may lead to the decision to close a plant, including a company's desire to shed loss-making operations or to relocate operations to another jurisdiction where the cost to manufacture is significantly lower (e.g. due to lower labour and supply costs). No matter the reason, plant closures typically involve termination or relocation of employees, lease terminations, intercompany transfers of assets (tangible and intangible) and/or movement of functions or risks to other members of the group.

Lease termination costs and severance wages associated with employee terminations are generally accrued as part of a restructuring provision for accounting purposes prior to the closure of the plant. As a general rule, such expenses are tax-deductible when paid, and payment may often occur in a later fiscal year than the accrual of the restructuring provision. However, the tax laws of some countries may provide for exceptions to this rule so as to allow partial or full deductibility of the provision in the year accrued if certain criteria are met. Restructuring provisions are often large expenses, and therefore it is important to be aware of the timing of the related tax deductions and to ensure compliance with all applicable criteria should an accelerated deduction be taken.

Also, in such a situation, there will be a transfer of an activity (being the assets and liabilities related to the activity which can be profit- and/or loss-making) with regard to which it should be verified whether a compensation should be paid and if so, what the arm's length price is. This compensation will be taxable within the company transferring its activity. The (stepped-up) price paid for the activity may be depreciated in the company receiving the activity.

Given the fact that the available carried-forward tax losses<sup>8</sup> may be definitively lost when closing down a company, the recorded deferred tax asset may need to be revised in the period in which the decision to close down the company is taken.

Depending on the functions and risks assumed by the plant, it must be verified whether the plant that will be closed down or another group company will have to account for the closing costs.

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<sup>8</sup> The same reasoning may be applied for other carried-over tax attributes.

### 3.2. Migration of intangibles

Intangibles may be transferred as the group has, for example reasons to centralize ownership and management of intangible property.

The first important consideration is to have the intangibles identified and valued. The transfer of the intangibles can be effected by means of a simple sale or a contribution, and should take into account the arm's length principle. Unfortunately, the valuation of intangibles is quite difficult, as they are by definition unique. The valuation is to be seen as a judgement made on the basis of available facts regarding the intangibles and the market in which they are exploited.

In valuing the intangibles, the following three approaches are internationally accepted:

- the cost approach: an estimate of the cost to replace or recreate;
- the market approach: a study of the market to create or discover guidelines; and
- the income approach: the earnings expected from the exploitation of the intangibles are valued.

When selecting the approach to be used to value the intangibles, various factors are to be considered, including the quality and quantity of the available data and the access to the available data.

As a result of the transfer, it might be that contractual rights are given (through licences of manufacturing agreements) to the local company to use the intangible property that it initially owned. Again, the compensation to be paid should be in line with the arm's length criteria in order to avoid the situation where, for example part of the compensation paid, is not tax deductible, leading to economic double taxation (as the company receiving the compensation is also taxed on its revenue).

Special attention should be given when determining the price for transferring intangibles that do not yet have an established value (e.g. new intangibles with a high future profit potential).

The company selling the intangibles will, in principle, be taxed on the realized gains. The

company purchasing the intangibles generally may depreciate the (stepped-up) value of the intangible asset.

When setting up or having an intellectual property (IP) centre in a number of countries, special deductions (additional to the depreciation on the IP) might be available. For example Belgian companies may be allowed a deduction related to patent income (i.e. reduction of 80% of the patent income).

### **3.3. Conversion into limited risk entities**

A conversion into a limited risk entity entails the transfer of risks. This may have both positive and negative consequences. The company transferring the risk will have its potential losses and liabilities also shifted. On the other hand, the potential returns related to the risk will also be shifted. It should therefore be questioned whether some compensation is to be paid when shifting risks and if so, how an arm's length price can be determined.

A central issue is to assess whether the risk – and thus also the transfer of the risk – is economically significant. If the risk is assessed as being insignificant (although this leads one to ask “what is significant?”), its corresponding value is also likely to be low. The transfer of that risk generally will not lead to a substantial decrease of the entity's profits.

The company to which the risk is allocated should manage and/or mitigate the risk and bear the related costs. In addition, the increase of the risk potential should also increase the expected return of the company.

When determining the market price, it should also be verified whether the company to be stripped previously created some intangibles which are part of the transfer and which should also be compensated.

It can be questioned whether the use of a specific transfer pricing method will create a so-called “low-risk environment”. However, the degree of risk which is inherent to the nature of the business, should be the basis for choosing the transfer pricing method – and not the contrary.

#### 4. Specific tax accounting impacts

Naturally, a business restructuring will have a tax accounting impact, particularly in the case of multi-jurisdiction restructurings, to the extent that pre-tax financial accounting results are affected. For example shifting operations – and therefore income and expenses – between jurisdictions with different statutory tax rates may increase or decrease the effective tax rate for the overall enterprise. Similarly, establishing a restructuring reserve for wage and lease expenses related to a manufacturing facility closure may result in the need for deferred taxes. These changes first impact the pre-tax financial accounting results, which then drives the need to determine the tax accounting impact. Equally significant, however, are the tax accounting consequences that result from changes in facts and circumstances arising from a reorganization<sup>9</sup> that are not directly reflected in the pre-tax financial accounting results or that may not otherwise be evident in the financial statements (e.g. as the result of eliminations accounting in a consolidation). These key tax accounting considerations include:

- accounting for uncertainties in income taxes; and
- deferred tax accounting, including (1) accounting for intercompany asset transfers, (2) assessment of the realizability of deferred tax assets and (3) changes to outside basis differences expected to be distributed or “permanently reinvested”.

These considerations can have a significant impact on the values of the tax accounts, including income tax expense, in the financial statements as well as to the related disclosures and financial metrics (e.g. earnings per share). In addition, the impact often extends beyond the tax and finance departments, and requires decisions to be made by company management regarding management’s intended future actions (e.g. the decision to settle or litigate an issue raised by the tax authorities).

The remainder of this chapter will address each of these tax accounting considerations and their pervasive impacts in more depth, and will be followed by a comprehensive example that follows the tax accounting and business impacts of a hypothetical reorganization.

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<sup>9</sup> “Reorganization” and “business restructuring” are used interchangeably throughout this chapter. Both terms are intended to indicate an internal change in business structure/operations that involves only related parties.

Business restructurings generally come hand-in-hand with new transfer pricing arrangements or changes to existing arrangements. As a consequence, all of the uncertainties and risks inherent in transfer pricing come hand-in-hand, as well. These uncertainties and risks must be evaluated not only from a cash tax and compliance perspective, but also from a tax accounting perspective where the potential exposure to the financial position of the company is appropriately and timely accounted for and disclosed in the financial statements.

#### **4.1. Transfer pricing uncertainties**

As discussed in quite some length in previous chapters, business restructurings typically involve the movement of assets (both tangible and intangible), functions and/or risks between related entities and across borders. Such movements are governed by transfer pricing regulations as a means of ensuring that related-party activities are conducted at arm's length pricing, affording each involved tax authority its fair share of the tax base pie. This then begs the question, "Are these related-party activities appropriately conducted at arm's length?"

In practice, the answer is often a range of answers provided by asset valuation reports, benchmark studies, and the like. For example a manufacturing know-how intangible transferred between entities may be valued from EUR 15 million to EUR 18 million. Or an appropriate mark-up for a limited risk distributor may be return-on-sales of 3%, although return-on-sales remuneration for distributors in the same industry with similarly limited risk and performing similar activities may range from 2% to 5%. The difference among the possible correct answers is the underlying estimates, assumptions and varying reasonable (but not always accepted) methodologies used to determine arm's length pricing. Income projections, useful life assumptions and discount rates are among the many moving targets included in transfer pricing calculations, for example in the framework of transfers of intangibles. These factors create the risk that the relevant taxing authorities will arrive at a different answer than the taxpayer – and an answer that is less favourable to the taxpayer.

In fact, the "soft" nature of transfer pricing is increasingly making this area of taxation a prime target for challenge by tax authorities.<sup>10</sup> There are grounds to challenge nearly any

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<sup>10</sup> Nick Raby, *International Transfer Pricing 2008* (PricewaterhouseCoopers, 2008), at 1.

transfer pricing position, and the tax authorities benefit from the possibility that a company will be more inclined to reach an early settlement rather than pursue lengthy, and likely costly, litigation procedures. While accounting for uncertainties in income taxes under IFRS and US GAAP should be based on the technical merits of the tax position rather than the risk that the tax authorities will detect or audit a position (discussed in more detail below), the attention of tax authorities to this area of taxation should motivate companies to carefully consider the tax accounting impact of their transfer pricing positions in order to prevent any surprises in their financial statements resulting from a tax audit. And indeed, it is the soft nature of transfer pricing and the possibility of multiple positions having technical merit that should drive the tax accounting analysis in the first place.

#### **4.1.2. FIN 48: A further overview**

FIN 48 was designed to place much more rigour around companies' evaluations and calculations of tax reserves, and as a result provides an almost step-by-step approach.

The first step is the recognition test. For each potential tax exposure, a company must determine if, based on the technical merits of the tax position, it is *more likely than not* that the tax return position can be sustained.<sup>11</sup> There are three key points to consider here:

- FIN 48 is a tax benefit-oriented approach. The question is whether or not the tax benefit taken (or to be taken) on the tax return can be sustained. This can be somewhat counter-intuitive in cases where the tax benefit results from non-recognition of income rather than an increased tax deduction. For example the tax benefit associated with a lower-than-recommended cost-plus mark-up for the taxpaying entity, is having less pre-tax profits on which to assess tax. There is no deduction that can be pointed to on the tax return to indicate this benefit – it is a function of a lower pre-tax income starting point.
- Determination of the sustainability of a tax return position must be made on technical merits alone and on the basis that the tax authority is aware of all relevant facts, circumstances and information. FIN 48 prohibits consideration of detection risk, the risk that an exposure will be identified by the tax authorities under audit, in the recognition step. Even if a company believes there to be only a remote possibility that

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<sup>11</sup> FIN 48, Para. 5.

an issue will be discovered by the tax authorities, such a belief is not necessarily sufficient to bypass the full FIN 48 analysis and record no reserve.

- The term “more likely than not” refers to a greater-than-50% probability (i.e. 51% – 100%) to have a sustainable tax position.

The determination of whether or not a tax position meets the recognition threshold can be relatively subjective, especially if tax law and related case law are unclear. It is the responsibility of management to analyse the technical basis that supports the position and draw a conclusion regarding its sustainability. In some cases, a “should” or other high level of opinion from tax or accounting advisors may help in management’s final determination. If it is ultimately determined that a tax position is *not* more likely than not to be sustained, a FIN 48 liability in the full amount of the benefit must be provided for in the financial statements and the next step, the measurement step, is bypassed.

The second step of the FIN 48 analysis is measurement. In this step, a company must determine the largest amount of tax benefit that has a cumulatively greater than 50% likelihood of being realized.<sup>12</sup> This entails identifying the potential sustainable tax benefit outcomes and their relative percent likelihood of sustainability for a given tax position. The cumulative amount of tax benefit that has a more than 50% likelihood of being sustained is the tax benefit allowed for financial reporting purposes. To the extent that the tax benefit amount calculated is less than the benefit to be reflected on the tax return for that tax position, a FIN 48 liability is required for the difference between the calculated benefit and the tax return benefit. The following example illustrates this methodology:

#### Example

Company A, a publicly-held kitchen appliance manufacturer, has a foreign subsidiary, Company B, which performs sales and marketing services for Company A in the foreign market. As compensation for these services, Company A ensures that Company B earns an operating margin of 5%. Company A has analysed a benchmark study prepared by its tax advisors regarding this arrangement and determined that while the 5% return-on-sales margin is within an acceptable range, it may be higher than the percentage ultimately

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<sup>12</sup> FIN 48, Para. 8.

accepted by the tax authorities, given the nature of services provided by Company *B* as compared to similar arrangements among other companies in the same industry. At the end of the fiscal year, Company *A* management had not finalized a decision to amend the intercompany agreement with Company *B* to lower the margin, and therefore the 5% rate continued to be used. As part of the year-end tax provision calculation, Company *A* prepared the following FIN 48 measurement analysis for this uncertain tax position, having determined that it met the recognition test:

Assumptions:

- Company *B*'s reimbursable sales for the year were 200,000.
- Company *A* determined that the tax authorities may apply a 2.5%, 3% or 4% mark-up percentage, with individual probabilities of acceptance by the tax authorities of 25%, 30% and 35%, respectively. Company management believed the current 5% mark-up position to have a 10% chance of acceptance.
- Company *A*'s statutory tax rate is 10%.

(Amounts are tax-effected)

Return on sales	Potential benefit	Potential cost	Individual probability	Cumulative probability	
5%	1,000	0	10%	10%	
4%	800	200	35%	45%	
<b>3%</b>	<b>600</b>	<b>400</b>	<b>30%</b>	<b>75%</b>	Probability > 50%
2.5%	500	500	25%	100%	

Benefit to be taken on the tax return =	1,000
(200,000 x 5% mark-up x 10% tax rate)	
Benefit allowed in the financial statements =	600
(200,000 x 3% mark-up x 10% tax rate)	-----
Required FIN 48 liability =	400

Company *A* expects to recognize a 1,000 tax benefit on its tax return, as its total

expenses, and therefore tax deductions, will reflect an intercompany charge at the 5% mark-up percentage related to the remuneration of Company *B*. However, based on the other possible outcomes and the related individual probabilities of those outcomes determined by Company *A*, the amount of benefit that has a greater than 50% likelihood of acceptance by the tax authorities is 600, the tax benefit associated with a cost-plus mark-up of 3%. As a result, a FIN 48 liability of 400 is required. This amount may or may not represent the exact amount of additional tax that Company *A* management expects to ultimately pay to the tax authorities, but it is the amount the Company is obligated to record as a liability in accordance with FIN 48.

It should also be noted that the FIN 48 liability of 400 is more appropriately known as an unrecognized tax benefit. As its name suggests, an unrecognized tax benefit is the amount of benefit taken on the tax return that is not recognized in the financial statements, which is in line with FIN 48's tax benefit-oriented approach. In practice, the terms "unrecognized tax benefit" and "FIN 48 liability" are commonly used interchangeably, as a FIN 48 liability is usually the amount of unrecognized tax benefit for a given tax position. However, an unrecognized tax benefit does not always result in an actual liability recorded on the balance sheet. An unrecognized tax benefit may instead result in a reduction to a deferred tax asset. Said another way, a FIN 48 liability is an unrecognized tax benefit, but an unrecognized tax benefit is not necessarily a FIN 48 liability. The implications of unrecognized tax benefits to deferred tax balance sheet presentation will be discussed in more detail later in this chapter.

The values and percentages included in the example above would have been determined by Company *A* management based on factors such as its knowledge and experience on the subject matter, and its understanding of the involved tax authority's tendencies and prior determinations on related issues. Accordingly, measurement is often an area of considerable subjectivity and an area that should be thoroughly analysed and documented.

The unrecognized tax benefits have been determined. Now what? In some cases, an unrecognized tax benefit may in fact give rise to a future tax benefit elsewhere that should also be determined. For example an unrecognized tax benefit may relate to a temporary difference where a tax deduction is accelerated. There may be some uncertainty as to whether or not all qualifications were met in order to sustain the deduction acceleration. If sufficient

uncertainty exists, a FIN 48 liability should be established for the amount associated with the accelerated deduction that is expected to be disallowed by the tax authorities. However, if the accelerated deduction is in fact disallowed, the deduction will then be allowed, in most cases, in the future tax year in which all criteria for deductibility are met. A deferred tax asset should therefore be recorded in conjunction with the FIN 48 liability to reflect the deduction available in the future year.

### Example

XYZ Company recorded a restructuring reserve of 10 million for severance wages at the end of Year 1. XYZ will pay these expenses in Year 2. Normally, reserves are deductible only when paid; however the tax law allows for a deduction in the year of accrual if certain criteria are met (assuming the years in which the reserve is accrued and paid are different). XYZ intends to fully deduct the reserve on its Year 1 tax return. However, XYZ believes that there is significant risk that some of the criteria required for accelerated deduction have not in fact been satisfied. XYZ performed a FIN 48 analysis and determined that, while the recognition step was met (because the deduction was a temporary difference and would ultimately be allowed), they concluded that the benefit to be allowed in Year 1 based on a cumulative probability analysis was zero. Assuming a statutory tax rate of 30%, XYZ therefore recorded a FIN 48 liability of 3 million in Year 1 for the restructuring reserve as follows:

Restructuring reserve	10 million
Tax rate	30%
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FIN 48 liability	3 million
DR Current tax exp	3 million
CR    FIN 48 liability	3 million

However, should the tax authorities in fact disallow the deduction for the reserve in Year 1, XYZ may take the deduction in Year 2 after the severance wages are paid. As a result, XYZ should also record a deferred tax asset in Year 1 for the future tax benefit of the tax deduction that can then be taken in Year 2 through the following entry:

DR	Deferred tax asset	3 million
CR	Deferred tax exp	3 million

Interest and penalties for underpayment of taxes are also items of consideration that have a direct impact on the financial statements. Typically, interest and penalties are not applicable upon initial establishment of a FIN 48 liability because financial statements for a given taxable year are often prepared prior to the filing of the applicable tax return at which time penalties would be assessed, and the clock begins ticking on interest obligations.<sup>13</sup>

Presentation and disclosure of unrecognized tax benefits as well as any associated deferred tax assets, interest and penalties on the face of the financial statements and within the footnotes are the next items of consideration. FIN 48 provides specific guidelines for balance sheet presentation of FIN 48 liabilities in a classified balance sheet. Namely, a FIN 48 liability should be recorded as a current liability to the extent that payment of cash to the tax authority is expected within one year (or the operating cycle, if longer than one year), or as a non-current liability if cash payment is not anticipated within this time frame. The FIN 48 liability should not be netted with current or non-current deferred tax liabilities except in special cases where the FIN 48 liability arose from an uncertain tax position associated with a deferred tax liability. An expected tax benefit associated with a FIN 48 liability, however, should be classified as a deferred tax asset – assuming the tax benefit is not expected within one year, and there is no legal right of offset against the related FIN 48 liability (e.g. the tax benefit is related to a jurisdiction other than that in which the tax associated with the FIN 48 liability will be assessed, such as federal vs. local, or Country A vs. Country B). If the tax benefit is expected within one year, the benefit should be reflected as a current tax receivable and may be netted against any income tax payable, including any current FIN 48 liability amounts, if legal right of offset exists.

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<sup>13</sup> Consideration should also be made with regard to a company's accounting policy on how to present interest associated with uncertain tax positions in the financial statements (specifically, whether to present interest "above the line" in the income statement as a component of pre-tax book income or "below the line" in income tax expense). Under both FAS 109 / FIN 48 and IAS 12, presentation of interest is an accounting policy to be made by the company and disclosed in the footnotes to the financial statements.

FIN 48 also has specific guidelines regarding disclosure in the footnotes to the financial statements. Perhaps the most significant disclosure requirement introduced by FIN 48 is the tabular roll-forward. This roll-forward must reflect increases and decreases to the unrecognized tax benefits related to current period and prior period tax positions taken, tax authority settlements and statute of limitations expirations. Other items required to be disclosed include:

- total amount of unrecognized tax benefits that would impact the effective tax rate if recognized;
- total amount of interest and penalties recognized in the financial statements;
- the nature and estimated amount of a tax positions expected to change significantly within the next year, and the reason for the expected change; and
- descriptions of open tax years for significant tax jurisdictions.

Careful consideration of disclosure language should be made regarding the nature of uncertain tax positions. In many cases, especially for publicly-held companies, the financial statements are public record and can be viewed by tax authorities in addition to the general public.

It may be evident from this overview that FIN 48 is heavy with definitions and “rules” regarding the recognition and disclosure of uncertainties in income taxes. Such rigour does not yet exist under IAS 12, despite efforts by the IASB and FASB to converge IFRS and US GAAP. While the two standards are not drastically different in the overall approach to accounting for tax uncertainties, notable differences do exist.

#### **4.1.3. IAS 12 versus FIN 48: Overview and key differences**

As alluded to previously, IAS 12 is relatively silent on accounting for tax uncertainties compared to FIN 48. IAS 12 states that current taxes related to prior and current periods which are based on taxable profits and expected to be paid to or received from the tax authorities should be accounted for using enacted or substantively enacted tax rates and laws. There is no defined two-step process (recognition and measurement) as included in FIN 48. However, a recognition and measurement process is implicit in the standard. Some insight on the application of IAS 12 with regard to tax reserves may be drawn from IAS 37, the IFRS standard that governs non-income tax provisions (reserves) and loss contingencies. To be

clear, this standard specifically does not address income tax-related reserves and contingencies, although its footnote disclosure requirements should be followed for such reserves and contingencies. IAS 37 includes a “probable” threshold for recognition of a non-income tax provision, which is also applied to recognition of a tax reserve under IAS 12. “Probable” as defined in IAS 37 is in fact the same as the “more likely than not” threshold in FIN 48 – greater than 50% likelihood.

IAS 37 indicates that the “single best estimate” and “weighted average probability” approaches with regard to measurement, are also the methods used for measurement of tax uncertainties under IAS 12. The single best estimate approach utilizes just that – management’s single best estimate of the amount to be assessed by the tax authority for a given tax position. The weighted average probability method considers all potential assessment outcomes and uses each outcome’s individual probability to determine the weighted-average outcome. These measurement approaches differ to the cumulative probability model used under FIN 48, and can result in materially different outcomes between the two standards.

Consider the measurement table in the previous FIN 48 benchmarking example, modified to include the probability-weighted cost as shown below. The differences among the FIN 48 and IAS 12 measurement approaches become apparent.

Return on sales	Potential benefit	Potential cost	Individual probability	Probability weighted cost	
5%	1,000	0	10%	0	
4%	800	200	35%	70	<- Single best est.
3%	600	400	30%	120	<- Cumulative probability > 50%
2.5%	500	500	25%	125	
Total probability weighted cost				<b>315</b>	

Recall that under FIN 48, the amount of tax uncertainty liability recorded was 400 (using the required cumulative probability approach). Under the weighed-average probability model

used for IAS 12, the amount of liability recorded is 315. Under the single best estimate approach (also currently accepted under IAS 12), the liability amount recorded is only 200 (highest individual probability of occurrence among all potential outcomes, i.e. the most likely outcome determined by management). Due to the potential for significantly varying outcomes, it is crucial to apply the appropriate methodology depending on the applicable standard and in the case of IAS 12, the methodology that is in line with the current accounting policy of the company. Regarding the treatment of tax benefits associated with uncertain tax positions, IAS 12 is again silent, as is IAS 37. There is diversity in practice in this area, and it is perhaps most important to develop a reasonable accounting policy and use it consistently.

Presentation and disclosure requirements of tax reserves under IAS 12 are less stringent and may vary among users of IFRS. IAS 12 does not provide specific requirements with regard to balance sheet presentation of tax reserves, and therefore the guidelines for current and non-current tax liabilities within IAS 12 are generally followed. The current vs. non-current liability balance sheet presentation criterion is similar to that in FIN 48, i.e. the one-year threshold. However, in the event that deferred tax assets arise in connection with a tax uncertainty liability, these deferred tax assets should be reflected as non-current assets on the balance sheet consistent with the current IAS 12 presentation rules for all deferred taxes. In addition, the principle of legal right of offset is also applicable under IAS 12 to determine the netting of tax reserves and related tax assets.

The IFRS standards are otherwise silent regarding offset of tax reserves against deferred tax assets and presentation of deferred tax assets associated with tax reserves on the balances sheet. IAS 12 also does not provide any specific disclosure requirements around uncertain tax positions and related tax reserves, other than to refer to IAS 37. Both IAS 37 and IAS 1 are looked to for more specific guidance. These standards currently require that the nature and estimated financial effect of the uncertain tax position be disclosed, as well as an indication of the uncertainty that exists that gives rise to a potential future payable amount. These requirements do not demand the level of detail that FIN 48 requires. However, the IASB is in the process of finalizing further guidance regarding accounting for tax uncertainties under IAS 12, which is expected to include more specific disclosure requirements. While a full convergence of IAS 12 with FIN 48 in this area is not expected, the guidance under IFRS is expected to require more disclosure than that provided under current practice.

In spite of some quite significant differences between FIN 48 and IAS 12 regarding accounting for and disclosing income tax uncertainties, the overall process of analysing tax risks is currently largely the same, i.e. determining recognition, an amount to be recognized (measurement), other impacts such as interest and penalties, and presentation and disclosure in the financial statements. Similar considerations specific to transfer pricing-related uncertain tax positions will apply under either accounting standard.

#### **4.1.4. Accounting for transfer pricing tax uncertainties: specific considerations**

From a transfer pricing perspective, determination of whether or not to recognize a tax reserve is often the “easy” part. In most cases, a technical basis or principle on which to calculate an arm’s length price, whether a valuation of an asset or a percent-of-sales return, is readily assessable in tax law, regulations, case law and in large part due to the international principles established by the OECD that are followed by many countries. Measurement, however, tends to be a bit trickier as a result of a “range” of potential outcomes. A range of potentially acceptable outcomes may be useful in some circumstances where there are different identifiable points within the range that can be used to build a cumulative probability or weighted-average probability model. Different possible valuations for a buy-in payment, for example may be based on identical calculations except that one input, such as estimated annual profit growth associated with the use of the intellectual property, is adjusted producing different final valuation results. If a probability of outcome can be reasonably associated with each modified calculation, an analysis can be performed to compare the tax return benefit associated with the buy-in payment made and the appropriate buy-in payment that is most likely to be accepted by the tax authorities based on the cumulative or weighted-average probability outcomes, as appropriate.

A range may be more grey where it is used to validate the acceptance of one particular data point. This is common in return-on-sales or cost-plus mark-up scenarios where a subsidiary is compensated for sales or services performed based on a percent margin on sales or mark-up of certain costs, respectively. The margin or mark-up percentage is determined based on factors such as the type of services or activities performed and the level of risk assumed, and can vary across industries and companies as the nature of the underlying determining factors may differ slightly or widely. Often, as part of meeting contemporaneous transfer pricing

documentation requirements, a company will hire a tax firm to perform a benchmark study that benchmarks the company's transfer pricing return-on-sales or cost-plus percentage against those of its competitors, those in the same or similar industry or those with similar functional profiles. Based on the results of the benchmark analysis, a range of acceptable percentages is typically provided, within which the return-on-sales or cost-plus percentage used by the requesting company will preferably fall. If the return-on-sales or cost-plus percentage used does in fact fall within the range, the company may feel "safe" that no further analysis of the tax position is required. However, there in fact could be another even more appropriate value within the range that the company should be using based on the facts and circumstances of the arrangement with the subsidiary. Certain tax authorities may also expect the median to be used or referenced. In this case, a FIN 48 / tax uncertainty liability may still be appropriate. Further analysis of the benchmarking study or tax authority practices should be performed to determine exactly which return-on-sales or cost-plus percentages within the range would be relevant. These percentages – or points within the range – may not be as readily apparent as those in the previous asset valuation example, as the criteria to determine the range of potentially acceptable percentages are potentially more subjective.

As transfer pricing continues to grow as a "hot" global taxation issue and receives more scrutiny by tax authorities, tax assessments in this area are likely to increase in both volume and value. Companies hit with a significant tax assessment may be increasingly inclined to pursue compensating adjustments with the jurisdiction in which the other party to the transfer pricing arrangement sits, i.e. where income is increased or expenses decreased by a transfer pricing adjustment in one jurisdiction, an equal and opposite adjustment should be made in the other jurisdiction in order to avoid double taxation. In the United States, companies may choose to pursue relief via competent authority in this situation if there is an applicable income tax treaty with the other involved jurisdiction. Where competent authority is used, tax authorities from the United States and the other involved jurisdiction will seek to reach an agreement on the adjustments to be made in each jurisdiction such that double taxation is largely avoided.

Similarly, mutual agreement procedures or arbitration may be pursued by European companies, although currently these procedures are not as widely used or available among treaty countries as competent authority is in the United States. The decision to request such proceedings in the event of a tax assessment can have a significant impact on the deferred tax

asset implications of uncertain tax positions, and may require company management to make a written representation as part of the financial statement audit regarding its intent to pursue such proceedings. Management may represent, for example that it would seek mutual agreement procedures or arbitration procedures should a tax assessment be made related to an existing uncertain tax position for which a tax uncertainty liability has been established and the tax assessment exceeds a specified value threshold. If management believes that such proceedings would result in a compensating adjustment and therefore full or partial relief from double taxation, a deferred tax asset may need to be recorded in the amount of the expected relief associated with the tax uncertainty liability established for the uncertain tax position. Due to the potentially significant impact on deferred taxes of such adjustments, these decisions to pursue competent authority or arbitration must be thoroughly documented, and particular attention is often paid to these decisions during a financial statement audit.

## **4.2. Deferred tax accounting**

There are other considerations related to deferred taxes in addition to those that arise from accounting for income tax uncertainties in the context of business restructurings. There are a number of items that originate in the pre-tax accounting that should be analysed from a deferred tax perspective, including intercompany transfers of assets. In addition, particular attention should be paid to realization of deferred tax assets, as well as changes to foreign earnings and company policy regarding repatriation of those earnings.

### **4.2.1. Pre-tax accounting: deferred tax implications**

Business restructurings trigger pre-tax accounting events that may give rise to book-tax basis differences and therefore require deferred taxes to be recognized. Restructuring reserves, as mentioned earlier, may be accrued for employee severance, lease terminations and other exit costs associated with a plant closure, movement of operations and similar restructuring activities. The value of tangible and intangible assets may be written down should impairment criteria be met. Deferred tax assets (or decreases to deferred tax liabilities) often arise related to these events in jurisdictions where the income tax base is calculated largely on a cash basis. Restructuring reserves may not be tax-deductible until cash payment is actually made on the underlying obligations. Similarly, a loss on the impairment of plant assets, for example may not be tax-deductible until the assets are actually scrapped or

otherwise disposed of. Often, the timing of restructuring reserve accruals and asset impairments in the financial statements happen in a different financial reporting / tax year than the actual events that would allow these items to be deducted for tax purposes. In these situations, deferred tax accounting is generally required.

#### **4.2.2. Intercompany asset transfers**

FAS 109 includes specific guidance regarding the treatment of intercompany transfers of tangible and intangible assets, which differs notably from the treatment of such transfers prescribed in IAS 12.

FAS 109, by reference to Accounting Review Bulletin (ARB) 51, prohibits the transferor of the assets from recognizing income taxes for financial reporting purposes that result from a gain on transfer of the assets, even though the transferor may need to report the gain on its tax return and pay tax on the gain in the year of sale. If the transferor in fact does pay income tax on the gain in the year of sale, such tax payment is considered a prepayment of tax and is recorded on the consolidated balance sheet as an asset with a corresponding credit to current tax expense. This credit to current tax expense negates the debit to current tax expense that would have resulted from a higher income tax payable due to the gain recognition on the tax return. Accordingly, income taxes on such gain are “deferred” in this manner for financial reporting purposes until the assets are transferred outside of the group. FAS 109 further prohibits recognition of a deferred tax asset by the transferee for any book-tax basis differences in the transferred assets that result from gain deferral for consolidated financial reporting purposes.

#### **Example**

Assume that Company A located in Country A transfers an R&D IP intangible to Company B, a related party located in Country B, for EUR 1 million. At the time of transfer, the IP is fully expensed/amortized for book and tax purposes, and therefore the basis for both is nil.

In accordance with FAS 109, Company A defers recognition of income tax on the EUR 1 million gain (EUR 1 million sale price less zero basis). However, Company A pays

income tax to the Country A tax authorities on the full amount of the gain in the year of transfer to Company B. Company B's tax basis in the intangible is the EUR 1 million purchase price, and the book basis from a consolidated financial reporting perspective remains zero as a result of the gain deferral via elimination of intercompany transactions. While such temporary book-tax basis differences would typically require a deferred tax asset to be established by Company B, no deferred tax impact is reflected in the US GAAP consolidated financial statements pursuant to FAS 109 / ARB 51. Instead, the tax paid to the tax authority by Company A is treated as a prepaid tax on the consolidated balance sheet until such time that Company B transfers the intangible outside of the group, thus triggering recognition of the gain (or loss) for financial reporting purposes.

Assuming a 34% statutory tax rate in Country A and total group tax expense of EUR 600,000 before consideration of the gain on the intercompany IP transfer, the journal entries to record the income tax accounting impact on Company A's books are as follows (all amounts EUR):

DR	Income tax expense	940,000	
	CR	Income taxes payable / Cash	940,000

To record total income tax payable (or payment) and expense including the tax on the gain from the intercompany IP transfer

DR	Prepaid asset	340,000	
	CR	Income tax expense	340,000

To reclassify the tax expense (and payment) associated with the gain as a prepaid asset

Total group tax expense = 600,000

No entries are required for Company B. As a result, the tax expense impact for the group associated specifically with the IP transfer transaction is nil.

In contrast to FAS 109, IAS 12 prohibits deferral of recognition of the tax impact of the

gain realized by the transferor on an intercompany transfer of assets, and does allow a deferred tax asset to be recorded by the transferee at the transferee's (substantively) enacted tax rate for any initial book-tax basis differences. If Companies *A* and *B* in the above example reported under IFRS, Company *A* would make no prepaid tax entry to defer the income tax impact of the EUR 1 million gain from the asset transfer, and Company *B* would record a deferred tax asset for the EUR 1 million excess tax-over-book basis in the assets transferred. Assuming Country *B*'s tax rate is 20%, the following entries would be made for Company *A* and Company *B*:

*Company A*

DR	Income tax expense	940,000	
	CR	Income taxes payable / Cash	940,000

To record total income tax payable (or payment) and expense including the tax on the gain from the intercompany IP transfer

*Company B*

DR	Deferred tax asset	200,000	
	CR	Income tax expense	200,000

To record the deferred tax asset associated with the step-up in tax basis in the IP transferred to Company *B*

Total group tax expense = 740,000

Note that compared to the treatment under FAS 109, the intercompany IP transfer under IFRS may result in an impact to tax expense to the extent the transferor's and transferee's applicable statutory tax rates differ. In this case, Company *A*'s tax rate was 34% whereas Company *B*'s tax rate was 20%. This tax rate differential resulted in additional group tax expense since the current tax expense paid by Company *A* on the gain was more than the deferred tax benefit associated with the deferred tax asset established by Company *B* for the basis difference. If, for example, the tax rates were reversed such that Company *A*'s tax rate was 20% and Company *B*'s tax rate was 34%, a reduction to group tax expense would be the likely outcome, i.e. Company *A*'s current tax expense is less than Company

*B*'s deferred tax benefit.

As a practical note to intercompany transfers of assets, it is not uncommon in practice for companies to record intangibles and other assets and liabilities of the group “top-side” at the consolidation level, rather than at the appropriate legal entity level. While this way of accounting is often done for expedience, especially given tight financial reporting deadlines, and may provide the correct financial results from a consolidated perspective, companies should take care to track the book and tax treatment of such assets and liabilities, particularly to the extent that multiple taxable entities are involved. If an asset or liability is not assigned to the appropriate legal entity and the jurisdiction-specific or taxable entity-specific tax treatments (e.g. applicable statutory tax rate or “realizability test” for deferred tax assets) are not appropriately considered, financial statement errors in current or deferred tax accounting may arise.

#### **4.2.3. Realizability of deferred tax assets**

Reorganizations often involve shifting of income streams between entities and jurisdictions to the extent that IP or operations (or other business functions) are moved. An entity that once had taxable income due in large part to license revenues on IP, for example may lose that income stream should the IP be moved elsewhere within the group. If such transaction is expected to put the once profitable entity into a taxable loss position following transfer of the IP, any deferred tax assets held on its books should be re-evaluated for realizability.

Under US GAAP, a valuation allowance may be required to reduce the value of total deferred tax assets on the balance sheet in part or in full. Under IFRS, the appropriate net carrying value of total deferred tax assets would need to be determined.<sup>14</sup> It may likewise be the case that a once loss-making entity turns profitable as a result of such a transaction (e.g. the entity purchasing/receiving the IP and future license stream). In this situation, it may be appropriate

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<sup>14</sup> A realizability assessment under US GAAP or IFRS will result in the same or materially similar net deferred tax asset on the balance sheet in most cases. The difference between the two frameworks in this area is primarily terminology – US GAAP requires assessment of the contra-deferred tax asset (i.e. valuation allowance), while IFRS requires assessment of the deferred tax asset itself to arrive at a net realizable value. However, IAS 12R is expected to introduce the valuation allowance terminology into the IFRS framework.

to increase the value of the net realizable deferred tax asset if that value was previously reduced. This increase would be made directly to the net deferred tax asset under IFRS or via a valuation allowance release under US GAAP.

Other restructuring transactions or activities that would similarly impact the profitability of an entity should prompt re-evaluation of that entity's deferred tax position. For example if an entity's status changes from an "entrepreneur" the profits of which are determined on sales revenues less costs of sales and operations (in other words, not on a transfer priced basis) to a distributor that is compensated on an return-on-sales basis, this change to the way in which profits are generated may impact realizability of deferred tax assets. The term "may" is used quite frequently in the examples provided because it is important to assess the impact of such changes in entity status or profitability to deferred taxes on a case-by-case basis within the frameworks provided in IAS 12 and FAS 109. It may very well be the case that a status or profitability change does not ultimately impact the deferred tax position of an entity, given a particular set of facts and circumstances. The important take-away is that an assessment should be made.

An additional consideration with regard to an assessment of deferred tax asset realizability is the timing of such assessment. Generally, business reorganizations are planned and set into motion far before the time that the new structure is in place and final from a legal perspective. Companies that are well down the path of reorganization may be inclined to consider future expected profits that result from the reorganization in their valuation allowance / net deferred tax asset assessment prior to finalization of the reorganization. Both FAS 109 and IAS 12 provide for the use of prudent and feasible tax planning strategies as positive evidence to support recognition of deferred tax assets.

This raises the question of whether or not business reorganizations qualify as a tax planning strategy as defined in these standards. Generally, the answer is that they do not. Business reorganizations are considered to be tax planning "actions" rather than "strategies". The difference between these two definitions can be a fine line in the case of reorganizations depending on the nature of the restructuring. However, the main principle behind a tax planning action is that an action, such as a reorganization, often has a much broader business purpose and operational impact than a tax planning strategy, and would generally not be implemented for the main purpose of realizing deferred tax assets. A tax planning strategy,

on the other hand, would in fact be executed primarily in order to realize deferred tax assets, and its impact on other areas of the company would be minimal. As such, any potential future income from an anticipated tax planning “action” ordinarily would not be included in income projections until the “action” (i.e. reorganization, in this case) is affected because the impacts of the tax planning “action” would not be objectively verifiable. However, in circumstances where effects of the tax planning “action” are objectively verifiable (i.e. no uncertainties or contingencies exist), the anticipated effects of such “action” would be included and incorporated into the overall future income projections.<sup>15</sup>

#### **4.2.4. Outside basis differences**

The same changes to entity profitability described in the previous section may also prompt review of a company’s deferred tax position with regard to reversal of outside basis differences. “Outside basis” is a term often used by tax professionals to indicate a parent’s basis in the stock of its subsidiary, associate or joint venture. This differs to “inside basis”, which denotes the subsidiary’s, associate’s or joint venture’s own basis in its assets and liabilities. An outside basis difference, as discussed under both US GAAP and IFRS, is then the difference between a parent’s book basis in its investment and tax basis in the stock. To the extent that an outside basis difference exists, the parent must account for the deferred tax impact of such difference unless certain criteria are met. There are a number of items that may give rise to outside basis differences. However, this section will focus on a particular type of outside basis difference that is commonly impacted by restructuring activities – unremitted foreign earnings.

Unremitted earnings of foreign subsidiaries is often the cause or one of the causes of outside basis differences. For US GAAP or IFRS purposes, a subsidiary, associate or joint venture, whether foreign or domestic, is accounted for by its parent via the equity method or consolidated accounting<sup>16</sup> (as appropriate based on the percentage ownership), and as a result, the parent’s investment in the entity (i.e. its book outside basis) is adjusted each reporting period to reflect changes in basis due to income or losses in the entity. Financial accounting is generally not concerned with borders or jurisdictions. From a tax perspective,

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<sup>15</sup> *Guide to Accounting for Income Taxes 2007* (PricewaterhouseCoopers, 2007), at 108.

<sup>16</sup> Under certain conditions, partial consolidation also exists under IFRS.

however, the tax jurisdiction in which a subsidiary is located does impact the parent's tax outside basis. Earnings made by a foreign subsidiary may not be immediately distributed to the parent, causing the parent's tax basis in the subsidiary to remain unchanged until the earnings are repatriated and taxed in the parent's jurisdiction. Delays in actual or deemed distributions or remittances of earnings by a foreign subsidiary give rise to outside basis differences between book and tax.

FAS 109 requires a deferred tax liability to be established for the outside basis difference caused by unremitted foreign earnings,<sup>17</sup> to account for the expected tax bill upon repatriation of those foreign earnings. An exception to this rule exists under Accounting Principles Board (APB) Standard 23, which requires no deferred tax liability to be recorded if the company asserts and can support permanent reinvestment of those earnings in the foreign jurisdiction, i.e. there is no intention of repatriating the foreign earnings in the foreseeable future.

IFRS has a similar view that no deferred tax liability need be recorded so long as the parent company has the ability to control the timing of the repatriation, and it is probable that such repatriation will not happen in the foreseeable future. Should a company's foreign operations (as analysed on a taxable entity basis) become profitable or loss-making as the result of restructuring, its deferred tax position relating to such operations should be re-evaluated. For example a goal of restructuring is often to move revenue-generating IP or profitable operations to a low-tax foreign jurisdiction. Profits generated in the low-tax jurisdiction post-restructuring must be reviewed by company management to determine whether such profits are to be repatriated or permanently reinvested as a matter of company policy. Such review is particularly important to the extent that operations in that jurisdiction were generating losses prior to reorganization or no prior presences existed in that jurisdiction before the reorganization. If it is the case that management intends to repatriate the profits, a deferred tax liability is likely required. If no repatriation is intended, management should document this policy and, to the best of its ability, track unremitted earnings moving forward for financial statement disclosure purposes. Both US GAAP and IFRS provide guidance regarding financial statement disclosure of unremitted foreign earnings.

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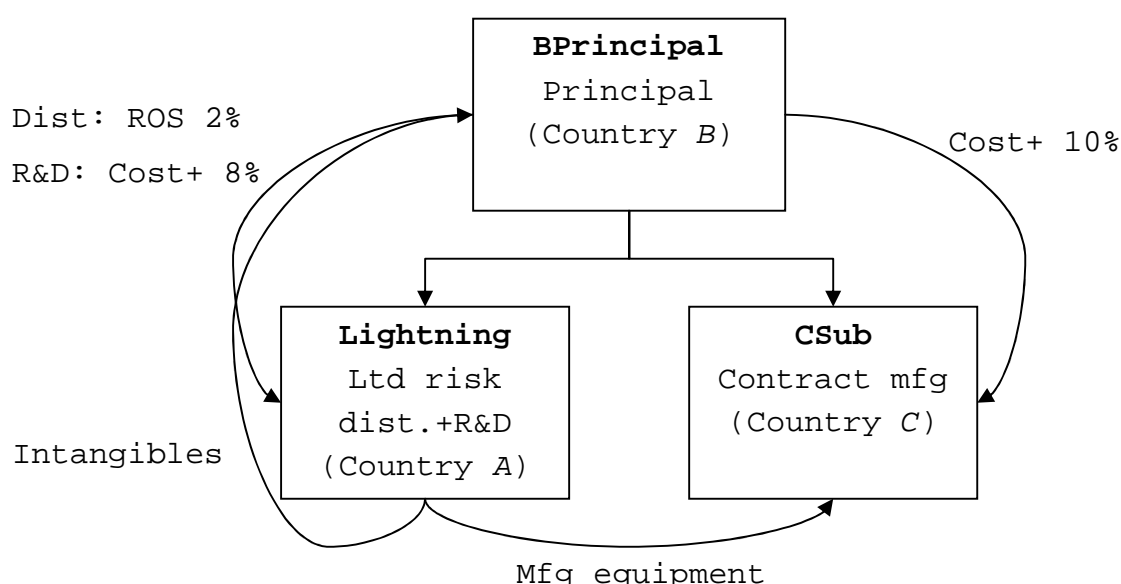
<sup>17</sup> Both standards require deferred tax accounting for all outside basis differences unless certain criteria are met; however, again, only unremitted foreign earnings are addressed in this discussion.

Similarly, if a previously profitable foreign subsidiary became loss-making as the result of a reorganization, the deferred tax liability, if any, associated with those profits that are recorded in the parent may need to be reduced or reversed entirely.

### 4.3. Comprehensive example

Perhaps the best way to illustrate the tax accounting considerations discussed is through an example. The example below is fictitious, but is intended to mirror fact patterns (to some degree of detail) that may be encountered in practice, and the respective tax accounting implications to be considered.

Lightning Semiconductors (Lightning), a publicly-held Country A company, manufactures semiconductors and sells to computer companies throughout Europe. In recent years, Lightning has been profitable, and has been considering reorganizing into a more tax-efficient structure and reducing labour costs. At year-end FY 2007, Lightning formally announced its plans to restructure, and completed the restructuring in 2008. As a result of the reorganization, a Country B principal (BPrincipal) was established to bear the majority of the risk of the operations, and all manufacturing operations were moved to a newly-formed subsidiary (of BPrincipal) in Country C (CSub). Lightning was then converted from a fully-fledged manufacturer and distributor to a limited risk distributor, but also retained the R&D function. The new structure is as follows:



ROS: Return on sales

To effectuate this change, Lightning transferred all technology and manufacturing IP intangibles to BPrincipal. Lightning also shut down its two manufacturing plants in Country A, and transferred certain key manufacturing equipment to CSub. An intercompany agreement was put in place between BPrincipal and Lightning which stipulated that BPrincipal would pay Lightning return-on-sales of 2% for its distribution services and cost-plus 8% for R&D services. CSub was established as a contract manufacturer for BPrincipal and was compensated on a cost-plus 10% basis by BPrincipal per the intercompany agreement. All newly-created technology and manufacturing IP that results from the R&D and manufacturing activities are retained by BPrincipal.

In addition:

- Lightning files consolidated financial statements with the Country A National Bank under IFRS;
- at the end of 2006, Lightning was in a small net deferred tax liability position. Lightning had a large deferred tax liability for fixed assets primarily related to accelerated depreciation for tax purposes. This deferred tax liability exceeded the total deferred tax assets, the most significant of which related to a bad debt provision;
- at the end of 2007, Lightning impaired its fixed assets to the expected recoverable amount,<sup>18</sup> and the resulting net book value was less than the net tax value. Lightning also established a EUR 16 million restructuring provision for severance wages and the costs to cancel the building leases for its two Country A manufacturing facilities;
- plant equipment transferred had net book value of EUR 10 million, a net tax value of EUR 6.5 million and a fair market value of EUR 9.5 million on the transfer date;
- the manufacturing know-how transferred from Lightning to BPrincipal was valued at EUR 14 million based on a valuation prepared by a “Big Four” public accounting firm. As discussed in the report, the EUR 14 million value is the weighted average value of the most likely possible values, which range from EUR 9 million to EUR 17 million. The other possible valuation amounts are the result of different asset life and

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<sup>18</sup> The recoverable amount of an asset or a cash-generating unit is the higher of (1) its fair market value less costs to sell or (2) its value in use (IAS 36, Para. 6).

revenue stream estimates used to value the intangible asset. Similarly, the technology IP transferred from Lightning to BPrincipal was valued at EUR 36 million, which the tax consultants determined to be the most relevant value among possible valuation amounts ranging from EUR 32 million to EUR 38 million;

- the cost-plus and return-on-sales percentages used to determine compensation for manufacturing, R&D and distribution services, as applicable, were all determined to fall within a range of acceptable percentages based on benchmark studies prepared by another “Big Four” public accounting firm. However, the accounting firm discussed with Lightning that the range determined in the study prepared for the limited risk distributorship, although viewed as acceptable, may be argued by the tax authorities to be too low, and the authorities may therefore view the return-on-sales percentage of 2% as too low.; and
- BPrincipal made a one-time “goodwill” payment to Lightning to compensate Lightning for the transfer of its profitable business to BPrincipal upon restructuring.

Based on the information provided, what are key tax accounting considerations for the 2007 and 2008 year-end financial statements? These issues, for 2007 and 2008, are indicated below.

#### *2007*

- (1) Is there any deferred tax accounting for the asset impairments and restructuring provision? Does Lightning intend to deduct the restructuring provision on its 2007 tax return? If so, is there any risk that the deduction may be disallowed by the tax authorities in 2007?
- (2) If Lightning is in a net deferred tax asset position at the end of 2007, are there any factors that might indicate that a reversal of all or part of the deferred tax assets is required?

#### *2008*

- (3) Has Lightning appropriately valued the manufacturing know-how and technology intangibles transferred to BPrincipal? Do these values represent an uncertain tax position?

- (4) What was the book and tax basis in the manufacturing know-how and technology intangibles prior to transfer? Must Lightning recognize any tax gain on the intercompany transfer in the consolidated financial statements? Is there an initial book-tax basis difference that requires deferred tax accounting for BPrincipal?
- (5) Are the cost-plus and return-on-sales percentages between BPrincipal and Lightning as well as CSub appropriate for the activities performed and risks borne by the two subsidiaries? Is the one-time “goodwill” payment from BPrincipal to Lightning adequate to compensate Lightning for the transfer of its profitable business?
- (6) Are there outside basis differences in BPrincipal’s investments in Lightning and CSub at the end of FY08? What is Lightning’s policy for remittance of foreign earnings?

Assume the following additional information:

- Lightning intends to deduct the full restructuring provision amount on its 2007 tax return. A deduction is allowed only if certain criteria are met. Lightning believes that there is some risk that some of the criteria may not have been met in time to allow a full deduction in 2007 from a timing perspective. In addition, Lightning believes that the tax authorities may disallow an amount of the restructuring costs on the basis that one entity should not bear restructuring costs incurred to restructure other entities within the group.
- The book and tax bases in the technology and manufacturing know-how intangibles, which were both internally developed, were zero as the associated costs were expensed and deducted as incurred. The sales price ultimately used for the technology was EUR 32 million – company management reviewed the valuation report and agreed that the EUR 36 million value indicated by the accounting firm was indeed a possible value that the tax authorities would assert. However, Lightning believed that it could reasonably support the use of a lower EUR 32 million value, and therefore priced the transaction accordingly for accounting and tax return purposes. For the manufacturing know-how intangible, Lightning in fact took a more conservative approach and valued the intangible at EUR 17 million. This position is considered to be a certain tax position by Lightning. Lightning’s policy is to litigate tax assessments or proposed settlements (or pursue mutual agreement procedures or arbitration where possible) for additional tax amounts in excess of EUR 1 million.
- Lightning sales were EUR 110 million for 2008, from the date of the reorganization.

- The Country *A* statutory corporate tax rate is 34%.
- The Country *B* statutory corporate tax rate is 16%.

#### Key considerations

- (1) Yes. The impairment of the net book value of fixed assets to the lower fair market values resulted in a change to the deferred tax position in this case, from a deferred tax liability to a deferred tax asset. As Lightning decided to deduct the restructuring provision in the year of accrual, it may seem that there is no difference between the tax and accounting treatment, and therefore no further tax accounting considerations. However, Lightning analysed the criteria that must be met in order to allow for a deduction in 2007, and concluded that there may be grounds for the tax authorities to argue that such criteria were not in fact met until 2008. As a result, Lightning established a tax uncertainty liability of EUR 5,439,840 (EUR 16 million x 34%) to reflect the additional tax liability owed to the tax authorities for 2007 in the event that the deduction taken in 2007 is not allowed until 2008. As the EUR 16 million deduction would ultimately be allowed on the 2008 tax return, however, Lightning also established a deferred tax asset of EUR 5,439,840 to account for this future benefit should the tax uncertainty liability materialize. Once the 2007 tax return is filed, Lightning should also consider accruals for underpayment penalties and interest. After careful consideration, Lightning determined that the issue regarding full deductibility of the restructuring charges in Country *A* was a certain tax position, and therefore no tax uncertainty liability was recorded specifically related to this item.
- (2) Yes. Lightning was in a deferred tax asset position at the end of the year due primarily to the impacts of the asset impairment and restructuring provision. Lightning should assess the realizability of these deferred tax assets. Given that the restructuring is a tax planning “action”, Lightning may not consider any tax consequences of the restructuring to support realizability. If Lightning does not have sufficient future income to support realization of the deferred tax asset, a reversal of the deferred tax asset may be required.
- (3) Lightning valued the technology intangibles at EUR 32 million, which was below the weighed-average value indicated in the valuation report prepared by the Big Four accounting firm. Lightning believes this issue to be an uncertain tax position. While Lightning believes its overall methodology used to arrive at the EUR 32 million

valuation is sustainable on a “probable” basis, Lightning also recognizes that some of the underlying assumptions used may be aggressive and therefore modified by the tax authorities to arrive at a higher valuation amount if audited. Lightning reviewed the following weighted-average valuation table included in the intangible technology valuation report, and also reviewed the factors and assumptions used to arrive at the different possible values of the intangible. Having agreed with the approach used by the accounting firm for each intangible valuation, the table included in the report was used as the basis of the tax uncertainty liability determination (all amounts EUR):

Intangible technology valuation	Potential benefit	Potential cost	Individual probability (%)	Probability weighted cost
32,000,000	2,040,000*	0	25	0
34,500,000	1,190,000	850,000	10	85,000
36,000,000	680,000	1,360,000	50	680,000
38,000,000	0	2,040,000	15	306,000
Total probability weighted cost				<b>1,071,000</b>

\*  $(38,000,000 - 32,000,000) \times 34\%$

Based on this analysis, a tax uncertainty liability of EUR 1,071,000 should be established. In addition, given Lightning’s policy to seek compensating adjustments for tax assessments in excess of EUR 1 million, Lightning intends to seek mutual agreement procedures with the Country A and Country B tax authorities, and believes that this process would result in allowed additional expenses in Country B of 80% of the undervalued amount, or EUR 4.8 million. As a result, a deferred tax asset of EUR 768,000 was also established at the Country B statutory tax rate of 16%.

- (4) Given that the book and tax bases for both the manufacturing know-how and technology intangibles are zero, the transfer of these intangibles to BPrincipal results in gains in the hands of Lightning. These gains will be deferred for pre-tax financial accounting purposes until the intangibles are transferred outside of the consolidated

group However, Lightning must pay tax on the gains in the year of transfer, and IAS 12 requires that the impact of such gains be reflected in income tax expense in the year of transfer (rather than deferred as under FAS 109). In addition, BPrincipal's tax basis in the transferred intangibles is the fair market value (i.e. the price paid to Lightning for the intangibles), and therefore, deferred taxes may need to be accounted for, given that the tax basis was stepped-up to fair market value but the book basis remained unchanged.

- (5) Based on a review of the benchmark studies prepared by the accounting firm and review of the assumptions and data points included in those studies, Lightning concluded that the cost-plus arrangements regarding the manufacturing and R&D activities were conservative, and therefore considered these tax positions to be certain. However, in light of the discussion with the accounting firm regarding the 2% return-on-sales percentage, Lightning analysed the potential expected percentage to be accepted by the tax authorities. This resulted in the following weighted-average probability analysis (all amounts EUR):

Return on sales (%)	Potential benefit	Potential cost	Individual probability	Probability weighted cost
2%	748,000**	0	30%	0
2.5%	561,000	187,000	20%	37,400
4%	0	748,000	50%	374,000
Total probability weighted cost				<b>411,400</b>

\*\*  $[(110,000,000 \times 4\%) - (110,000,000 \times 2\%)] \times 34\%$

Based on the weighted-average probability analysis, a 4% return-on-sales percentage is the most likely percentage to be accepted by the tax authorities. For 2008, this means that Lightning was potentially undercompensated by EUR 2.2 million, or 2% of sales while under the intercompany contract. As a result, a tax uncertainty liability of EUR 411,400 was established to account for this potential assessment.

With regard to the one-time "goodwill" payment, Lightning determined that the

payment received from BPrincipal was a certain tax position based on the multiple-of-earnings calculation used to value the Lightning manufacturing operations and determine the payment. As such, no tax uncertainty liability was recorded related to this issue.

- (6) Yes. Both Lightning and CSub are guaranteed a profit margin, albeit relatively small, for services performed. As a result, both entities will have earnings, which BPrincipal must decide whether or not it will repatriate or reinvest in the local operations. If the decision is made to reinvest and BPrincipal has full ability to do so (e.g. is able to fully control movement or non-movement of cash, does not need the cash to fund its own obligations/activities, etc.), no deferred tax liability would likely be required, as no Country *B* tax liability is expected associated with the unremitted earnings. Conversely, if the decision is made to repatriate the foreign subsidiaries' earnings in the future, a deferred tax liability may be required to account for applicable "participation exemptions" and withholding tax on dividends for Country *B* tax purposes, provided that certain conditions are not met.

## **5. Conclusion**

Income tax accounting in the context of business restructurings, and certainly in general, is an important and often complex area that deserves its fair share of attention. While cash may be king, especially in recent economic times, accounting for income taxes can have a significant impact on the financial statements and therefore influence the way in which a company is evaluated in the financial markets. And again, the devil is often in the detail! It is important to analyse every significant transaction and event of a business restructuring for income tax accounting consequences, and to understand the transactions and events in both substance and form. Communication internally within a company regarding income tax accounting impacts is also crucial, as management may be required to make representations as part of financial statement audits indicating management's intentions regarding such issues as litigation and investment of unremitted foreign earnings. And as IFRS continues to grow as the premier global financial reporting framework, the need to understand the implications of the standard for accounting for income taxes (currently IAS 12) and related guidance will grow, as well.

