Accounting For Income Tax: Beyond the Basics of ASC 740
Mastering the Complexities of Tax Provision Valuations and Schedules

TUESDAY, JULY 28, 2015, 1:00-2:50 pm Eastern

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Accounting For Income Tax

July 28, 2015

Catherine Fox-Simpson
Corner Office
cfox@thecornerofficeltd.com

Yung Ling
Burr Pilger Mayer
yling@bpmcpa.com
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Accounting for Income Taxes: Beyond the Basics of ASC 740

Key Challenges to Income Tax Accounting

Catherine Fox-Simpson, CPA
cfox@thecornerofficeltd.com
Key Challenges

◆ Complex technical matters
  ◆ Proposed simplifications
◆ Judgments and decisions needed
  ◆ Challenging economic landscape
◆ Historical Data
◆ Material weakness, significant deficiency, or the dreaded restatement.
◆ International monetary climate
Key Challenges

- Internal controls
- Business combinations
- Forecasting/budgeting
ASC 740-270 – Interim Periods

July 28, 2015

Yung Ling
yling@bpmcpa.com
Guidance – Interim Periods

– APB Opinion 28 {ASC 740-270} is based on a view that each interim period is primarily an integral part of the annual period
– Tax expense for interim periods is measured using an estimated annual effective tax rate (or “AETR”) for the annual period
– The Board’s asset and liability approach to accounting for income taxes for annual periods is a discrete approach that requires all tax accounts to be re-measured each annual reporting date
– APB Opinion 28 as amended by SFAS 109 / ASC 740-270 rejects the discrete approach to interim reporting whereby the results of operations for each interim period would be determined as if the interim period were an annual period
Annual Effective Tax Rate ("AETR") – Rules

• Step 1

• Contrary to the balance sheet approach required for annual provisions, the use of an annual effective tax rate (or "AETR") is required at interim periods (ASC 740-270-25-1).

\[
AETR = \frac{\text{Estimated annual tax}}{\text{Estimated annual PBT}} = \frac{\text{(expected tax on ordinary income)}}{\text{(ordinary income)}}
\]
Annual Effective Tax Rate ("AETR") – Rules

• Step 2

• At the end of each interim period, the company makes its best estimate of the AETR for the full year. This AETR includes tax credits, foreign tax rates, capital gain rates, and tax planning (par. 19 of APB 28 / ASC 740-270-30-6 & 30-8).
Step 3.

The estimated AETR is applied to YTD “ordinary” income (or loss) to compute the YTD tax provision. The interim provision is the difference between this computation and the prior YTD provision (par. 9 of FIN 18 / ASC 740-270-30-5).

\[ \text{YTD tax provision} = \text{YTD ordinary income} \times \text{AETR} \]

\[ \text{Interim Provision} = \text{YTD Provision} - \text{Prior interim period YTD provision} \]
Annual Effective Tax Rate ("AETR") – Rules

• Step 4.

• The tax (or benefit) related to all other items are individually computed and recognized when the items occur Paragraph 740-270-25-2.
Example #1 – No Discrete Items

Facts

• Assume no discrete items and the following quarterly information:

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected full-year</td>
<td>40%</td>
<td>35%</td>
<td>37%</td>
<td>35%</td>
</tr>
<tr>
<td>AETR</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarterly book income</td>
<td>$400</td>
<td>$100</td>
<td>$(200)</td>
<td>$700</td>
</tr>
<tr>
<td>YTD book income</td>
<td>$400</td>
<td>$500</td>
<td>$300</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Activity

a. Calculate the year-to-date tax provision

b. Calculate the quarterly tax provision

c. Calculate the quarter effective tax rate
## Example #1 – No Discrete Items

Calculate the quarterly tax provision and the ETR for the quarter.

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected full-year AETR</td>
<td>40%</td>
<td>35%</td>
<td>37%</td>
<td>35%</td>
</tr>
<tr>
<td>Quarterly book income</td>
<td>400</td>
<td>100</td>
<td>(200)</td>
<td>700</td>
</tr>
<tr>
<td>YTD book income</td>
<td>400</td>
<td>500</td>
<td>300</td>
<td>1,000</td>
</tr>
<tr>
<td>YTD Tax Provision</td>
<td>160</td>
<td>175</td>
<td>111</td>
<td>350</td>
</tr>
<tr>
<td>Quarterly tax provision</td>
<td>160</td>
<td>15</td>
<td>(64)</td>
<td>239</td>
</tr>
<tr>
<td>Quarter effective tax rate</td>
<td>40%</td>
<td>3%</td>
<td>-21%</td>
<td>24%</td>
</tr>
</tbody>
</table>
To What Balance Sheet Account is Provision Recorded?

• No guidance – No specific requirement
• Preferable to attempt to split between current and deferred, but not required

• Possible approaches
  • Book YTD current and plug deferred
  • Book YTD deferred and plug current
  • Book YTD material deferred taxes and plug current
  • Develop “split” AETR (current and deferred component) and book to new YTD current and YTD deferred. Update component rates each interim period.
Items Accounted for Separately From the Estimated AETR

- Certain items/events are specifically excluded from the estimated AETR and as such the related tax effects are recognized discretely from the AETR:
  - Tax effect is excluded from the numerator
  - Underlying book income/expense (if any) is excluded from the denominator

- Items/events excluded from the AETR calculation may include:
  - Significant unusual or infrequently occurring items
  - Out of period adjustments
  - Certain loss jurisdictions
  - Unpredictable income/loss
  - Certain perm items and credit (when not sufficiently estimable)

- Items/events partially excluded from the AETR may include:
  - Changes in valuation allowance
  - Changes in tax laws/rates
  - Changes in permanently reinvested assertion for outside basis deferreds
## Rate vs. Discrete – UTB and Other

<table>
<thead>
<tr>
<th>Discrete</th>
<th>Accrual to return adjustment to the tax accounts for the prior year return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>Adjustment to the current period rate related to information learned from filing prior year return</td>
</tr>
<tr>
<td>Discrete</td>
<td>Adjustment to UTB reserve specific to prior tax years</td>
</tr>
<tr>
<td>Rate</td>
<td>Accrual of UTB related to current year items</td>
</tr>
<tr>
<td>Discrete</td>
<td>Accrual of interest related to prior year tax contingencies if classified as a component of tax expense. Interest should be recognized over time as incurred.</td>
</tr>
<tr>
<td>Discrete</td>
<td>Accrual of penalty for prior year tax contingency</td>
</tr>
<tr>
<td>Discrete / Rate</td>
<td>Adjustment of current year rate to incorporate changes in law or rate – discrete to period that includes enactment, accrued by application of new ETR to year-to-date pre-tax income</td>
</tr>
</tbody>
</table>
## Rate vs. Discrete – Tax Law/Rate and Indefinite Reinvestment

<table>
<thead>
<tr>
<th>Rate</th>
<th>Impact of tax law/rate changes on current taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discrete</td>
<td>Impact of tax law changes on beginning of the year deferred tax assets/liabilities recognized discretely in period of tax law/rate change</td>
</tr>
<tr>
<td>Rate</td>
<td>Impact of tax law changes on deferred tax assets/liabilities arising in the current year</td>
</tr>
<tr>
<td>Discrete</td>
<td>Any change in judgment for the establishment/reversal of the deferred tax liability related to the outside basis difference that had accumulated as of the end of <em>prior year</em></td>
</tr>
<tr>
<td>Rate</td>
<td>Any change in intention on unremitted earnings of the <em>current year</em></td>
</tr>
</tbody>
</table>
Multiple Jurisdictions and Loss Jurisdictions – Basic Example

Facts and Question:

• Company T operates in and is subject to tax in Jurisdiction A and Jurisdiction B. Management has projected income/loss each quarter of the following:

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>(50)</td>
<td>(70)</td>
<td>(100)</td>
<td>(100)</td>
<td>(320)</td>
</tr>
<tr>
<td>B</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>800</td>
</tr>
<tr>
<td>Consolidated</td>
<td>150</td>
<td>130</td>
<td>100</td>
<td>100</td>
<td>480</td>
</tr>
</tbody>
</table>

• Assume there are no “permanent” items impacting the AETR

• Management does not expect to benefit the losses in Jurisdiction A and any resulting deferred tax assets at the end of the year will require a valuation allowance. The statutory tax rates for Jurisdictions A and B are 30% and 40%, respectively.

• What is the AETR? Assuming that the actual income per quarter is the same as above, what is the quarterly tax expense?
Multiple Jurisdictions and Loss Jurisdictions – Basic Example (continued)

- **Solution**
- Since the ASC 740-270-30-36a exception applies to the losses in Jurisdiction A (i.e. jurisdiction A is excluded from ETR calc), the AETR used to calculate the quarterly tax expense and the tax expense recognized in each interim period are as follows:

  - **Total tax expense** = $320 = 40%
  - **Total operating income** = $800

<table>
<thead>
<tr>
<th></th>
<th>Pre-tax Income</th>
<th>Tax Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>Q1</td>
<td>(50)</td>
<td>200</td>
</tr>
<tr>
<td>Q2</td>
<td>(70)</td>
<td>200</td>
</tr>
<tr>
<td>Q3</td>
<td>(100)</td>
<td>200</td>
</tr>
<tr>
<td>Q4</td>
<td>(100)</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>(320)</td>
<td>800</td>
</tr>
</tbody>
</table>
ASC 740-10 – Valuation Allowance

July 28, 2015
Valuation Allowance – General Overview

– Reduces DTA to amount “more-likely-than-not” to be realized (valuation allowance may offset a portion or all of DTA)

– All gross DTAs (vs. net of DTLs) should be evaluated including
  • The tax-effect of deductible temporary differences or
  • A tax attribute such as a carryover of an NOL, loss or credit

– Evaluation is made after any unrecognized tax benefit adjustments

– Unrecognized tax benefit (”UTB”), not valuation allowance, addresses technical quality of deferred tax asset

– Future realization depends on sufficient taxable income (of appropriate character, jurisdiction and timing)

– Based on specific facts and circumstances

– Should be well-documented since based on management judgment and generally impacts the income statement
Valuation allowance — when required

– All deferred tax assets must be examined to determine their ultimate realization, whether the DTA is:
  • the tax-effect of deductible temporary differences or
  • a tax attribute such as a carryover of an NOL, loss or credit

– If full realization is not more-likely-than-not, a valuation allowance is needed to reduce the net asset to the amount that more-likely-than-not will be realized.

– Future realization of the tax benefit ultimately depends on the existence of sufficient taxable income
  • of the appropriate source and character of income
  • within the allowable carryback period and carryforward period
Evaluating the Need for a Valuation Allowance

- “All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed”

- “Information about an enterprise’s current financial position and its results of operations for the current and preceding years ordinarily is readily available”

- “That historical information is supplemented by all currently available information about future years”

- “Sometimes, however, historical information may not be available (for example, start-up operations”) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required”

ASC 740-10-30-17
Weight of Available Evidence

- Cumulative losses - current year plus prior two years (or other established period)
- History of expiring losses and credit carryovers
- Unsettled circumstances
- Short carryback or carryover period
- Unrealized losses (depreciated assets)
- Cumulative profits
- No history of losing attributes
- Existing backlogs
- Long or indefinite carryback or carryover period
- Unrealized gains
- Losses are an isolated event
- Strong history of profits
Cumulative Losses
Cumulative Loss – a Comprehensive Analysis

− Cumulative Book losses are among the most objectively verifiable form of negative evidence available (carries more weight than other subjective evidence) as it is a better illustration of economic reality;

− ASC 740-10-30-21 states it is difficult to avoid recording a valuation allowance when there is negative evidence such as cumulative losses

• Generally includes discontinued operations, extraordinary items, and other so-called “nonrecurring” items (e.g., restructuring or impairment charges)

• Use reasoning and vet when determining whether OCI should be included in cumulative loss analysis

• Generally does not include cumulative effect of accounting changes

− Analysis must be done jurisdiction by jurisdiction based on book income
Cumulative Losses – “3-Year Test”

- "Cumulative losses" is deliberately not defined, common starting point is cumulative pretax book results of the current and two preceding years adjusted for permanent items (e.g., nondeductible goodwill impairments)

- 3-year test originally included in exposure draft as “bright line” but not included in the final ASC 740 due to:
  - perceived difficulty in determining how to apply the test
  - difficulty with reducing valuation allowance as the company returns to profits

  - SEC has consistently questioned registrants with 3-year cumulative loss and no valuation allowance
  - inquired as why no valuation allowance
  - requested documentation to support such conclusion
Activity - Cumulative Losses

A company with the following income/(loss) is evaluating the need for valuation allowances on its DTAs as of 12/31/20X3:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>3 Yr. total</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. federal consolidated group</td>
<td>$ 600</td>
<td>$(200)</td>
<td>$(300)</td>
<td>$ 100</td>
</tr>
<tr>
<td>Foreign jurisdiction X</td>
<td>(100)</td>
<td>(100)</td>
<td>(200)</td>
<td>(400)</td>
</tr>
<tr>
<td>Foreign jurisdiction Y</td>
<td>200</td>
<td>200</td>
<td>100</td>
<td>500</td>
</tr>
<tr>
<td>Consolidated financial reporting group</td>
<td>$ 700</td>
<td>$(100)</td>
<td>$(400)</td>
<td>$ 200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>3 Yr. total</th>
</tr>
</thead>
<tbody>
<tr>
<td>State A worldwide unitary group</td>
<td>$ 700</td>
<td>$(100)</td>
<td>$(400)</td>
<td>$ 200</td>
</tr>
<tr>
<td>State B stand-alone entity</td>
<td>$ 200</td>
<td>$(300)</td>
<td>$(300)</td>
<td>$(400)</td>
</tr>
<tr>
<td>State C stand-alone entity</td>
<td>$(100)</td>
<td>$(100)</td>
<td>$(100)</td>
<td>$(300)</td>
</tr>
</tbody>
</table>

Absent other compelling evidence, which jurisdictions are most likely to require a valuation allowance?
Effect of Nonrecurring Items on Estimates of Future Income

Question

• When estimating future income or loss in recent years, should an entity consider the effects of discontinued operations, cumulative effects of accounting changes, extraordinary items, and nonrecurring items?
Effect of Nonrecurring Items on Estimates of Future Income

**Question**

- When estimating future income or loss in recent years, should an entity consider the effects of discontinued operations, cumulative effects of accounting changes, extraordinary items, and nonrecurring items?

**Answer**

Generally, no. Discontinued operations, cumulative effects of accounting changes, and extraordinary items are not relevant items of historical income or loss and are not indicative of an entity's ability to generate taxable income to incur tax losses in future years. Similarly, any nonrecurring items included in the three year historical amounts of pretax income or loss from continuing operations are excluded because their effects are also not indicative of future operations.
Effect of Nonrecurring Items on Estimates of Future Income

<table>
<thead>
<tr>
<th>Non-recurring items that are typically excluded (judgment required)</th>
<th>Items typically not considered non-recurring</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-time restructuring charges that permanently eliminate fixed costs</td>
<td>Unusual loss allowances (e.g. loan loss or bad debt loss provisions)</td>
</tr>
<tr>
<td>Litigation settlements or awards not expected to recur in future years</td>
<td>Losses attributable to change in the focus/directives of a business unit</td>
</tr>
<tr>
<td>Interest expense on debt that has been restructured or refinanced</td>
<td>Poor operating results caused by economic downturn, government intervention, or changes in regulation</td>
</tr>
<tr>
<td>Historical fixed costs that have been reduced or eliminated</td>
<td>Losses attributable to change in the focus/directives of a subsidiary/unit</td>
</tr>
<tr>
<td>Severance payments relating to management changes</td>
<td>The onerous effects attributable to prior management decisions</td>
</tr>
<tr>
<td>Large permanent differences</td>
<td></td>
</tr>
</tbody>
</table>

Answer - continued
Source of Taxable Income
Sources of Taxable Income – ASC 740-10-30-18

– ASC 740-10-30-18 provides four possible sources of taxable income that should be considered to realize a tax benefit for deductible temporary differences and/or tax attribute

#1 Future reversals of existing taxable temporary differences
#2 Future taxable income exclusive of reversing temporary differences and tax attributes
#3 Taxable income in prior carry back year*
#4 Tax planning strategies

* While the capacity is objectively verifiable, whether you expect to utilize that capacity may not be
Source 1: Future Reversals of DTLs — Indefinite-lived Intangible Asset

— A deferred tax liability that relates to an asset with an indefinite useful life cannot be used as a source of taxable income

— The taxable income related to indefinite-lived assets should typically not be scheduled as occurring in the foreseeable future, so the related DTL should not be netted with DTAs unless those DTAs are also indefinite (e.g. AMT).

<table>
<thead>
<tr>
<th></th>
<th>DTA/(DTL)</th>
<th>Reversal</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL</td>
<td>1,000</td>
<td>Expires pro-rata over next 20 years</td>
</tr>
<tr>
<td>Stock Compensation</td>
<td>300</td>
<td>Options expire over next 10 years and c/f for additional 20 years</td>
</tr>
<tr>
<td>Tradename</td>
<td>(400)</td>
<td>When impaired or sold – timing unknown</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(200)</td>
<td>Reverses Pro-rata over next 15 years</td>
</tr>
<tr>
<td>Net DTA/DTL</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>(1,100)</td>
<td>Equal to DTL on Tradename – “naked DTL”</td>
</tr>
<tr>
<td>DTA/DTL after VA</td>
<td>(400)</td>
<td></td>
</tr>
</tbody>
</table>
Source 2: Taxable Income in Future Periods

- Because taxable income in future periods is inherently not objectively verifiable, it naturally carries less weight. However, it is a potential source of income for recognizing DTAs.

- Since source 2 is defined as future taxable income exclusive of reversing temporary differences, it is generally interpreted as pre-tax book income adjusted for permanent items.

- Need to consider impacts of originating temporary differences.

  Generally, originating temporary differences will only affect the timing but not the amount of future taxable income but in certain instances (see following slide) originating temporary differences can affect the amount of source 2.
### Source 3: Taxable Income in Carryback Period – Temporary Differences That Don’t Net Reverse

Consider the following scenario of a DTA that does not net reverse:

<table>
<thead>
<tr>
<th>Carryback Period</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax book income</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Bad Debt Reserve - BOY</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td>Bad Debt Reserve - EOY</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>40%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>$400</td>
<td>$400</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Reporting Date DTA = $200

$2,000 taxable income ($800 tax) in C/B

- In this case, the temporary difference does not net reverse and will not reach the income in the carryback period.
- Consult as different firms may have different views.
Source 4: Tax Planning Strategies

• Must be prudent and feasible.
• Action that management might not otherwise take but would take to prevent loss of DTA.
• Significant expenses to implement a tax-planning strategy must be included in the valuation allowance.
• Must be primarily within the control of management but need not be within the unilateral control of management (e.g. can consider 3rd party involvement when selling assets through established secondary markets).
• An entity shall consider tax-planning strategies in determining the amount of valuation allowance required – failure to consider may result in an error in the financial statements
  • Management must reasonable effort to identify
  • If sufficient other sources of taxable income exist that support realization of DTA, management is not obligated to identify available tax planning strategies.
• Unrecognized tax benefits principles must be applied in determining whether tax planning strategies provide a source of future taxable income.
Accounting for Income Taxes: Beyond the Basics of ASC 740

Analyzing and Reporting Uncertain Tax Positions

Catherine Fox-Simpson, CPA
Analyzing and Reporting UTPs

◆ Scope:

◆ All tax positions covered by ASC 740 NOT sales and use, VAT, non-income
◆ All enterprises – including pass-through, non-taxable entities
◆ Business combinations: carryovers, purchase price allocations, tax return positions prior to combination
Analyzing and Reporting UTPs

◆ Unit of Account
  ◆ Judgment required, there is no bright line test
  ◆ Level at which you prepare and support
  ◆ Determine “more likely than not” at unit of account level
  ◆ Consistent application in recognition and measurement
  ◆ Any change in judgment should be applied prospectively
    ◆ Driven by facts and circumstances NOT accounting policy election
Recognizing and Reporting UTPs

- Recognition
  - Examination by Taxing Authority
- Evaluation
  - Technical Merits
  - All available Evidence
- Administrative Practices and Precedents
Analyzing and Reporting UTPs

◆ Authoritative Tax Laws

◆ Code, Regs, Case Law, PLRs, etc

◆ Weighting Evidence

◆ Relevance

◆ Persuasiveness

◆ Type of Document

◆ Foreign Tax Jurisdictions
Analyzing and Reporting UTPs

◆ Tax Opinions – not required

◆ Four Types of Tax Opinions
  ◆ Substantial Authority
  ◆ More Likely Than Not
  ◆ Should
  ◆ Will

◆ Evaluate facts and circumstances to ensure accuracy

◆ Tax opinions do not relieve auditor or the company from performing their own evaluation.
Accounting and Reporting UTPs

◆ Measurement

◆ Cumulative probability – largest amount of benefit that is more likely than not of being realized upon ultimate settlement.

◆ Upon settlement – Audit, etc

◆ Amended Tax Returns

◆ Claims presented in examination

◆ Protective claims

◆ Informal claims
Accounting and Reporting UTPs

- Subsequent recognition, derecognition, measurement
- Evaluation of Events
  - Completion of an Audit
  - Stages of an Audit
  - Audit Milestones
- Evaluation based on management’s best judgment given the facts, information, and circumstances.
Accounting for Income Taxes: Beyond the Basics of ASC 740

Reporting Current and Deferred Income Tax Expense and Balance Sheet Items

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Presentation and Disclosure

◆ Balance Sheet
  ◆ Current vs Non-Current
  ◆ Allocation of Valuation Allowance
  ◆ Offsets of DTA’s and DTL’s
  ◆ Subsequent recognition

◆ Income Statement Presentation

◆ Disclosures
Accounting for Income Taxes: Beyond the Basics of ASC 740

Workpaper and Schedule Maintenance

Catherine Fox-Simpson, CPA
Workpaper and Schedule Maintenance

- Historical tracking
- Notes, disclosures, etc.
- What to track?
- Rollforwards
- Business Combinations
- Disclosure
- Correlation with tax return