



Interim Reporting – Accounting For Income Taxes



TPC/DLA



ASC 740-270 – Interim Reporting

- Estimated annual effective tax rate (“AETR”) approach for computing a tax provision for interim periods
- Interim reporting has
 - Complexity in AETR approach
 - Challenges in AETR approach
 - Counterintuitive results under AETR approach

ASC 740-270-25-1 through 7

- AETR is applied to year to date operating results
- All other items shall be computed on discrete basis
- Tax (benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported
- Previously not recognized tax benefit (NOL from prior years) is included in AETR if tax benefit is expected to be realized in the current year
- The effects of new tax legislation and tax rates is recorded after the effective date and reflected no earlier than the first interim period that includes the enactment date
- Judgment on realizability of DTA (release of V.A.) shall not be apportionment among interim periods but shall be recognized in the interim period in which the change occurs

Section 1 - Forecasting

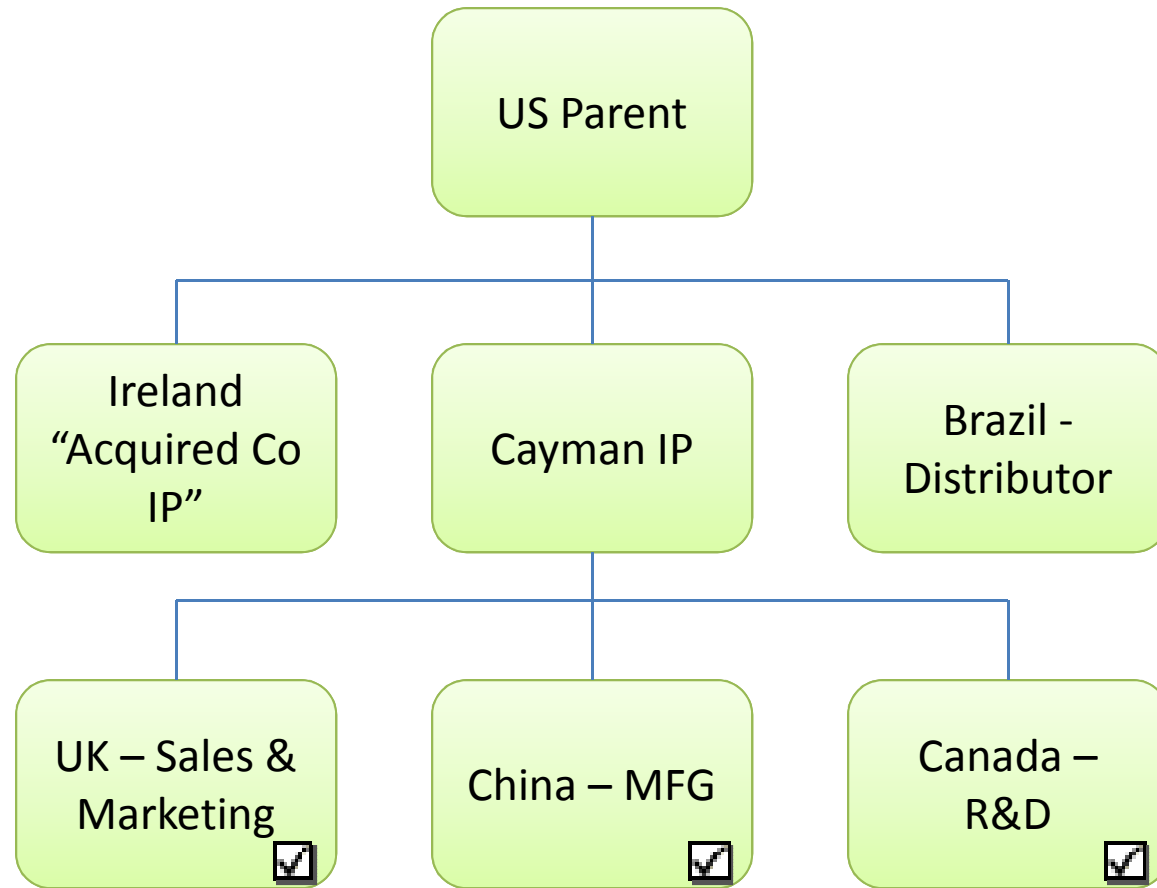
Best Estimates

- Importance of forecasting
 - The estimated annual effective tax rate (“AETR”) should represent the best estimate of the tax provision *in relation to*
 - The best estimate of worldwide pre tax book ordinary income for the fiscal year

Interim Tax Provision Model – General Steps

- A Forecasted Annual Management Forecast
- B Transfer Pricing
- C Forecasted Annual Before Tax Ordinary Income/(Loss)
- D Forecasted Annual Permanent Differences
- E Forecasted Annual Interim Taxable Income
- F Release of Valuation Allowance
- G Statutory Tax Rate
- H Forecasted Annual Interim Tax Liability
- I Forecasted Annual Tax Credits
- J Forecasted Annual Withholding Taxes
- K Forecasted Annual Uncertain Tax Positions (non-disclosure)
- L Forecasted Annual Net Interim Tax Liability
- M Estimated Annual Effective Tax Rate (L/C)
- N Actual YTD Before Tax Ordinary Income/(Loss)
- O Actual YTD Tax Liability (Before Discrete)
- P Discrete Taxes
- Q Net Actual YTD Tax Liability
- R Actual YTD ETR (Q/N)

Organizational Chart



Assumptions

US Parent – Owns IP, N & S Americas rights, Principal, R&D, S&M, Admin, Stewardship (Cost Share w/Cayman – RAB 60%)

Ireland – Acquired, Owns Legacy IP, Distributes WW, R&D, S&M, Admin

Brazil – Distributor for U.S. Parent (30% Discount List)

Cayman – Rest of World Rights, Principal (Cost Share w/U.S. – RAB 40%)

UK – S&M Service, CTB (Cost plus 10%)

China – Contract Mfg, CTB (Cost plus 10%)

Canada – R&D Service, CTB (Cost plus 10%)

Management Forecast

Management Forecast (Exhibit A)		
		Consolidated
Revenue		5,000
Cost of Sales		(1,000)
Gross Profit		4,000
R&D Expenses		(1,000)
Sales & Marketing Expenses		(1,500)
Administrative Expenses		(500)
Other Operating Expenses		(200)
Operating Income/(Loss)		800
Other Income/(Expenses)		(100)
Profits Before Income Tax		700

- GAAP vs. Non-GAAP
- Revenue recognition
- Investor guidance
- ETR
- Managing expectations

Management Forecast

Management Forecast by Jurisdiction (Exhibit B)										
			U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Total
Revenue			2,500	500	500	-	1,500	-	-	5,000
Cost of Sales			(500)	(100)	(100)	-	(300)	-	-	(1,000)
Gross Profit			2,000	400	400	-	1,200	-	-	4,000
R&D Expenses			(400)	-	(200)	-	-	-	(400)	(1,000)
Sales & Marketing Expenses			(600)	(150)	(300)	-	(450)	-	-	(1,500)
Administrative Expenses			(250)	(50)	(50)	-	(100)	(25)	(25)	(500)
Other Operating Expenses			(200)	-	-	-	-	-	-	(200)
Operating Income/(Loss)			550	200	(150)	-	650	(25)	(425)	800
Other Income/(Expenses)			(100)	-	-	-	-	-	-	(100)
Profits Before Income Tax			450	200	(150)	-	650	(25)	(425)	700

Accounting vs. Tax

- F/S consolidated presentation
- Tax by jurisdiction
- Budget meetings
- Communication/education

Allocation by jurisdiction

- Sales by jurisdiction
- Costs by function
- Partner w/FP&A
- Reasonable method

Application of Transfer Pricing - Steps

- First, ensure that “cost plus” entities (UK, Canada, China) have appropriate intercompany revenues, and therefore, targeted cost plus mark-up profits
 - Typically, Costs in Management Reports are true costs of that entity
 - However, Revenues in Management Reports may not be that entity
- Second, make COGS adjustments for distributors to ensure GM / Profits targets or ranges (Brazil)
- Third, allocate R&D expenses (no mark-ups) between the cost sharing participants (US, Cayman)
- Fourth, allocate any other expenses between the principals as necessary, such as G&A, S&M, Other (US, Ireland, Cayman) incurred in one country for the benefit of the other
 - Typically, such entries are made based upon estimates:
 - Amounts of prior year cross-charges
 - Percentage of current year expenses X historic cross-charge %

Transfer Pricing – Common Issues

- R&D Cost Sharing - How to determine the % share?
 - Check the Cost Sharing Agreement for RAB Share: typically relative revenues
 - Use current year projected sales? Last year sales? Multiple year projections?
- R&D Cost Sharing - Any “True Ups” from prior year financial statements?
- Are there any unusual or large expenses in the management forecast? If so, should they be treated any differently?
- Are there any prior year post-year-end adjustments that need to be taken into account?
- Are there any changes in the GM / Profits targets based upon transfer pricing comparables updates?
- Sanity Check - are the profits per each entity, after TP adjustments, reasonable for the functions / assets / risks?
 - Principals can have high profits or losses
 - Distributors typically have a modest level of profits, but might have modest losses
 - Service providers typically have a modest level of profits

Transfer Pricing and Forecasting

		U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Total
Revenue		2,500	500	500	-	1,500	-	-	5,000
Cost of Sales		(500)	(100)	(100)	-	(300)	-	-	(1,000)
Gross Profit		2,000	400	400	-	1,200	-	-	4,000
R&D Expenses		(400)	-	(200)	-	-	-	(400)	(1,000)
Sales & Marketing Expenses		(600)	(150)	(300)	-	(450)	-	-	(1,500)
Administrative Expenses		(250)	(50)	(50)	-	(100)	(25)	(25)	(500)
Other Operating Expenses		(200)	-	-	-	-	-	-	(200)
Operating Income/(Loss)		550	200	(150)	-	650	(25)	(425)	800
Other Income/(Expenses)		(100)	-	-	-	-	-	-	(100)
Profits Before Income Tax		450	200	(150)	-	650	(25)	(425)	700
Transfer Pricing									
Step 1	Cost Plus Adj	(281)			381	(595)	28	468	-
Step 2	COGS Adj (Distributor)	300	(300)						-
Step 3	R&D Cost Sharing	160			(160)				-
Step 4	Other Adj (Admin)	50		(50)					-
Profits Before Income Tax After Adj		680	(100)	(200)	221	55	3	43	700

FX – Actual vs. Forecast

- FX impacting actual results
- Potential causes
 - Timing of recording TP adjustments
 - FX used to translate TP adjustments vs. FX used to translate PL
- Impact to actual YTD expense
- Possible solution?

FX – Case Study

(Exhibit C)		UK - Full YR	UK - Full YR	UK - YTD Q3
		Forecast	Forecast	Actual
		In LC	USD (@1.5)	In USD
Revenue		1,000	1,500	975
Cost of Sales		(200)	(300)	(195)
Gross Profit		800	1,200	780
R&D Expenses		-	-	-
Sales & Marketing Expenses		(300)	(450)	(293)
Administrative Expenses		(67)	(100)	(65)
Other Operating Expenses		-	-	-
Operating Income/(Loss)		433	650	423
Other Income/(Expenses)		-	-	-
Profits Before Income Tax		433	650	423
TP Adustment (Cost Plus 10%)		(397)	(595)	(476)
Revised PBT		37	55	(54)
Estimated Annual ETR (55*28%=15.4)(15.4/55)			28%	

- Difficult to forecast FX
- Forecast vs. actual
- Income vs. loss
- Apply ETR to actual will produce tax benefit
- What is the cause?

FX – Case Study

(Exhibit D)		UK - Full YR	UK - YTD Q3		UK - YTD Q3
		Forecast	Actual		Actual
		In LC	In LC	FX	In USD
Revenue		1,000	750	1.3	975
Cost of Sales		(200)	(150)	1.3	(195)
Gross Profit		800	600		780
R&D Expenses		-	-	1.3	-
Sales & Marketing Expenses		(300)	(225)	1.3	(293)
Administrative Expenses		(67)	(50)	1.3	(65)
Other Operating Expenses		-	-	1.3	-
Operating Income/(Loss)		433	325	0	423
Other Income/(Expenses)		-	-	0	-
Profits Before Income Tax		433	325	0	423
TP Adjustment (Cost Plus 10%)		(397)	(298)	1.6	(476)
Revised PBT		37	28	0	(54)

- P&L is measured using monthly FX rate
- Depending on when TP adjustments are recorded, a different FX rate is used
- FX fluctuates significantly, can cause distorts actual results in USD
- Possible solution?

FX – Case Study

(Exhibit E)		UK - YTD Q3	UK - Q4	UK - Full YR
		Actual	Forecast	Forecast
		In USD	In USD	In USD
Revenue		975	375	1,350
Cost of Sales		(195)	(75)	(270)
Gross Profit		780	300	1,080
R&D Expenses		-	-	-
Sales & Marketing Expenses		(293)	(113)	(405)
Administrative Expenses		(65)	(25)	(90)
Other Operating Expenses		-	-	-
Operating Income/(Loss)		423	163	585
Other Income/(Expenses)		-	-	-
Profits Before Income Tax		423	163	585
TP Adjustment (Cost Plus 10%)		(476)	(149)	(625)
Revised PBT		(54)	14	(40)
		b		a
	Estimated Annual Tax Liability (55*28%) (c)			15
	Rolling Forecasted PBT (a)			(40)
	Estimated AETR (d=c/a)			-39%
	Actual YTD Q3 PBT (b)			(54)
	Actual YTD Q3 Tax Expense (e=b*d)			21

Possible Solution?

- Prepare rolling forecast
- Using actual YTD Q3 + Q4 forecast
- Actual FX is embedded in the rolling forecast
- Produce a negative AETR

- When should TP adjustments be made?
- What translation rate should be used?

Section II – Modeling Estimated Annual ETR

Estimated Effective Tax Rate

- ASC 740-270 requires estimated AETR for current year ordinary income (loss) considering estimated provision for income taxes from
 - Current tax payable and
 - Change in deferred tax assets and liabilitiesin accordance of ASC 740-10
- Practical solution: estimate AETR considering only
 - Rate differential items (due to an offset of temporary differences in current and deferred tax provisions)

Interim Provision Model

Interim Tax Provision Model			A	B	C	D	E	F	G	H	I
			DOMESTIC	FOREIGN							
DESCRIPTION	REF.	Total (Excluding Ireland)	FEDERAL	BRAZIL	IRELAND	CAYMAN	UK	CHINA	CANADA	ELIM	WW
PRE TAX BOOK INCOME (LOSS)											
Total Pretax Income											
PERM. DIFFERENCES & STATE TAXES											
MEALS & ENTERTAINMENT											
TAX EXEMPT INTEREST											
STOCK OPTIONS ISO & ESPP & FOREIGN - BOOK											
FINES AND PENALTIES											
CLUB DUES											
LOBBYING EXPENSES											
SUBTOTAL PERMANENT DIFFERENCES											
STATE TAXES											
TAXABLE INCOME (LOSS) B4 APPORT.											
APPORIONMENT											
TAXABLE INCOME (LOSS)											
TAX RATE											
SUBTOTAL											
VALUATION ALLOW. INCR (RELEASE)											
TAXES OWED (BENEFIT)											
R&D CREDIT											
FOREIGN TAX CREDIT											
TAX EXPENSE (BENEFIT)											
OTHER TAX-FOREIGN WITHHOLDING TAXES											
AMT											
FIN 48 RESERVES - R&D											
NET TAX EXPENSE (BENEFIT)											
FORECASTED ANNUAL ETR											
ACTUAL FY 2011 Q1 PBT INCOME (LOSS)-rev											
Less Ireland PBT Income/(loss)											
Total Actual Q1 PBT Income (Loss)											
FORECASTED ETR											
ACTUAL FY 2011 Q1 TAX (BEFORE DISCRETE)											
DISCRETE ITEMS											
FY 2011 Activity											
Ireland Withholding Tax											
UTP - INTEREST & Penalty											
Disqualifying Dispositions of ISO/ESPPs											
Return to Provision True Ups											
Change in Tax Rates - Deferred Taxes											
TOTAL Q1 YTD TAX PROVISION EXPENSE / (BENEFIT)											

Case Study

Modeling Interim Tax Provision Computation

- Loss Limitation
- Multiple Jurisdiction Exclusion of Entity in AETR Computation
- Valuation Allowance Consideration
- Subsequent Event Consideration

Case Study – Limitation on Benefits of Losses

- **Tax Benefit recognized in interim periods limitation**
 - ASC 740-270-30-30 ~-34: Limit tax benefit recognized to the amount that is expected to be
 - (a) **realized during the year** or
 - (b) **recognizable as a DTA at the end of the year**

Loss limitation Case Study 1

Estimated AETR

	<u>Entity X</u>
Annual Projected Ordinary Loss	(100)
Tax Rate	40 %
Tax Liability	(40)
Tax Credit	(10)
Annual Tax Benefit recognized	(50)
AETR	50%

Believes loss to be recognized as DTA at year end.

	YTD Ordinary Income (Loss)	AETR	Tax Provision (Benefit) AETR x YTD Ordinary income (loss)
Q1	20	50%	10
Q2	(60)	50%	(30)

Loss limitation Case Study 2:

Estimated AETR	Entity X
Annual Projected Ordinary Loss	(100)
Tax Rate	40 %
Tax Liability	(40)
Tax Credit	(10)
Annual Tax Benefit recognized	(50)
AETR	50%
Q3 Ordinary Loss YTD:	(120)

Question:

Q3 – Company’s YTD loss was greater than projected loss.

YTD Ordinary Loss – (120)
Forecast loss – (100)

How should we apply AETR to Q3 results?

Option 1

Q3 Tax Benefit

$$(60) = (120) \times 50\%$$

Option 2

Q3 Tax Benefit

Limited to
(50) as projected

Option 3

Re-compute tax benefit based on YTD Loss

$$\text{Q3 Tax Benefit} = (58)$$

Loss limitation Case Study 2: Answer

ASC 740-270-55-16

Estimated AETR	Entity X
YTD Ordinary Loss	(120)
Tax Rate	40 %
Tax Liability	(48)
Tax Credit	(10)
Annual Tax Benefit Limitation	(58)

Monitor YTD loss vs. forecast loss

There is limitation

Option 3

Limited to Lesser of recomputed benefit of (58) vs. $(120) \times 50\% = (60)$

Because YTD Loss exceeds forecasted loss, the tax benefit recognized for YTD loss is limited to the amount that would be recognized if the YTD ordinary loss was the forecast loss for the year.

Includible vs. Excludible Entities

Jurisdictions with Pretax Losses and No Tax Benefit to losses

ASC 740-270-30-36(a)

- The Company should exclude that jurisdiction's loss from the overall ETR calculation.
- A separate ETR (generally zero, assuming there is a full valuation allowance) should be computed for and applied to ordinary income (or loss) in that jurisdiction.

Includible vs. Excludible Entities

	<u>Loss Benefited</u>			<u>Loss Not Benefited</u>		
	US	Ireland	WW	US	Ireland	WW
Forecasted Income(Loss)	500	(100)	400	500	(100)	400
Tax Rate	40%	12.50%		40%	12.50%	
Tax Liability	200	(13)	188	200		200
Estimated AETR			<u>46.88%</u>			<u>40.00%</u>
Q2 YTD	200	(60)	140	200		200
Q2 Tax Provision			66			80
Actual ETR	46.88% (66 over 140)			57.14% (80 over 140)		

Consideration

- Historical Earning
- YTD PBT
- Tax planning (Acquired IP DTL)
- TP integration



Can Ireland Recognize DTA at Year End on more likely than not basis?

Converting to an Includible Entity

- It may be possible to engage in transactions or employ transfer pricing techniques to make an entity profitable, thereby making it an Includible Entity
- Participation in Cost Sharing / Platform Contribution - If the entity has its own IP (Ireland) it might enter into Cost Sharing with another entity, which may create the receipt of a Platform Contribution (buy-in) from the other entity
- Buy-Out of Existing Cost Sharing Arrangement - If the entity has engaged in Cost Sharing in the past, it might be desirable to transfer all of some (limited geographic territories; specific product lines) of the rights to the acquired IP back to the other Cost Sharing Participant
- Conversion of Entity to Different Function - For example, a Principal might be converted to a distributor of another entity's products. Are there any unusual or large expenses in the management forecast? If so, should they be treated any differently?
- Review of Transfer Pricing Policies - Should the transfer pricing be established on some other method, for example a conversion from a Resale Price Less a Discount approach to a fixed Return on Sales approach

Valuation Allowance Considerations

- ASC 740-270-25-4
 - Tax Benefit of loss carry forward from prior years shall be included in the AETR computation if the tax benefit is expected to be realized as result of ordinary income in the current year (AETR)
 - In case of judgment of realizability of the related DTA in future years, the effect shall be recognized in the interim period in which the change occurs (Discrete)

Valuation Allowance Considerations (AETR)

Entity's NOL Carryover at 2010	500,000
Tax Rate	40%
DTA relating to NOL	200,000
Valuation Allowance	(200,000)
Net Tax Benefit Taken in PY	-

AETR Consideration

Forecasted Taxable Income in 2011	100,000
Tax Rate	40%
Tax on Current Year Income	40,000
Reversal of V.A. to CY taxable income	(40,000)
Total Current Tax Based on AETR	-
AETR	0%

(Exhibit J)	Quarterly			Cumulative		
	PBT		Provision	PBT		Provision
Q1	30,000	0.0%	-	30,000	0.0%	-
Q2	40,000	0.0%	-	70,000	0.0%	-
Q3	20,000	0.0%	-	90,000	0.0%	-

Valuation Allowance - Discrete

Entity's NOL Carryover at 2010	500,000
Tax Rate	40%
DTA relating to NOL	200,000
Valuation Allowance	(200,000)
Net Tax Benefit Taken in PY	-

AETR Consideration

Forecasted Taxable Income in 2011	100,000
Tax Rate	40%
Tax on Current Year Income	40,000
Reversal of V.A.	(40,000)

In Q2, Company determines on more likely than not basis the DTA relating to NOL is recognizable.

How should we record the release effects in Q2?

AETR Benefit (component 1)	Discrete Benefit (component 2)
\$40K release through AETR	\$160K release as discrete (200K less 40K)
	DR DTA / V.A. 160K
	CR Tax Benefit 160K

Timing of IP Migration: Valuation Allowances

- Implementing an IP Migration may result in a long term low ETR, but the transaction itself (Platform Contribution) is a taxable event in the U.S., potentially increasing the ETR during the period of the Buy-In
- For U.S. parent companies with federal NOLs, the Buy-In might simply use up NOLs and is not a current cash cost
- Timing is critical for tax accounting purposes:
 - Ideally, the IP Migration occurs before - or triggers - the release of the NOL valuation allowance
 - To be avoided: an IP Migration immediately after the release of the NOL valuation allowance
 - Significant ETR decrease from NOL valuation allowance release
 - Followed by significant ETR increase from IP Migration
 - Extreme swings in ETR can be discomfoting to stock analysts

Valuation Allowance and Loss Limitation Case Study

	<u>US</u>	<u>Foreign</u>	<u>WW</u>	Q1 YTD Income (Loss)	
Forecast PBT	100	50	150	US	(500)
NOL VA release	(100)	0		Foreign	20
Taxable income	0	50		Total	(480)
Tax rate	40%	25%			
Tax	0	12.5	12.5		

What is the AETR ?

If US included $12.5 / 150 = 8\%$

If US excluded $12.5 / 50 = 25\%$

Should US be included in provision?

If US included, $8\% \times (480) = (38)$

If US excluded, $25\% \times 20 = 5$

Subsequent Events - ETR

- Significant subsequent event occurs after the interim balance sheet date before FS are issued
 - Forecast updated to include subsequent event?
 - Use information available that existed on BS date?
- Both methods can be supported
- Accounting policy established once method is selected
- Case study

Subsequent Event – Case Study

Assumptions

- FY 11 Q2 – June 30, 2011
- Company announces restructuring charge on July 1, 2011
- The total restructuring charge of 500 are allocated to various entities
- Company has a history of recording restructuring charges

US - 200

Cayman - 0

Brazil - 50

UK - 50

Ireland - 100

China - 50

Canada - 50

Subsequent Event – Case Study

Status quo approach – information available on BS date

(Exhibit M)	U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Total
Includible Entity PBT	2,000	75	-50	1,000	100	125	150	3,400
Tax Rate	40%	34%	12.5%	0%	27%	25%	30%	
Tax Liability	800	26		-	27	31	45	923
AETR (Tax Liability/ Includible Entity PBT - exclude Ireland)								26.74%

Subsequent Event – Case Study

Include subsequent event – information available on BS date

(Exhibit N)	U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Total
Includible Entity PBT	2,000	75	(50)	1,000	100	125	150	3,400
Restructuring	(200)	(50)	(100)	-	(50)	(50)	(50)	(500)
Revised PBT	1,800	25	(150)	1,000	50	75	100	2,900
Tax Rate	40%	34%	12.5%	0%	27%	25%	30%	
Tax Liability	720	9		-	14	19	30	791
AETR (Tax Liability/ Includible Entity PBT - exclude Ireland)								26.81%

- Assess impact of subsequent event
- **Should service subsidiary bear restructuring costs?**

Restructuring Costs and Transfer Pricing

- Restructuring costs typically are comprised of:
 - Employee severance costs
 - Lease termination / idle facilities costs
 - Termination of contracts
 - Abandonment of assets
- The key question is, are such restructuring costs:
 - Reimbursed with a mark-up like ordinary operating costs
 - Reimbursed, but with no mark-up
 - Not reimbursed at all
 - Reimbursed in some cases, but not in all cases
- The answer will make a significant difference to the net income of affected cost plus entities, and hence the ETR

Restructuring Costs - Example

- \$100 Total Costs: \$90 Ordinary and \$10 Restructuring
 - Assume cost plus 10% arrangement
- Alternatives:
 - Reimbursed with a mark-up like ordinary operating costs
 - \$100 of Costs X 110% = \$110 of Intercompany Revenue
 - \$110 of Revenue less \$100 of Costs = \$10 Profit
 - Reimbursed, but with no mark-up on restructuring costs
 - $(\$90 \times 110\%) + \$10 = \$109$ of Revenue
 - \$109 of Revenue less \$100 of Costs = \$9 Profit
 - Not reimbursed at all
 - $\$90 \times 110\% = \99 of Revenue
 - \$99 of Revenue less \$100 of Costs = \$1 Loss
 - Reimbursed in some cases, but not in all cases
 - Assume \$1 Loss can be justified by transfer pricing techniques, so no reimbursement in this particular case

Restructuring Costs: Contract Review

- Does the inter company agreement define “Costs” to
 - Exclude restructuring or extraordinary costs
 - Best legal contract case, but rare in practice
 - Include all ordinary and extraordinary costs
 - Worst legal contract case, but not common
 - Somewhat ambiguous (common):
 - All Direct and Indirect Costs
 - All Costs incurred in providing the Services
 - All ordinary and necessary Costs
- Should the inter company agreement be amended?
 - Pro: can make the agreement fit with the strongest legal case
 - Con: highlights the issue to tax authorities and might not be arm’s length behavior (why would service provider agree now)

Restructuring Costs: Economic Arguments

- At arm's length, a service recipient would not pay for excess costs of a service provider
 - Hiring too many employees or leasing too much space is the service provider's risk, and therefore solely its problem when it occurs
- The cost plus ranges created from TP studies use an Arm's Length Range, but a restructuring is a unique situation
 - Comparables studies systematically *exclude* companies with losses, but those might be the *most* comparable to a restructuring
 - Comparables studies use an Inter Quartile Range, which focuses on the most common situations: why not use the Full Range?
- Cost plus operations are often labeled "limited risk" or "minimal risk" - but are not labeled "no risk under any conceivable circumstances forever," and this is one of those limited risks that the service provider bears

Restructuring Costs: Analysis and Resolution

- Test #1: Does excluding the restructuring costs create a local loss, or is the result nonetheless a profit in the IQ range?
- Test #2: Does excluding the restructuring costs create a local loss in the current year, but, when combined with profit from the last several years, nonetheless result in a multiple-year average mark-up which is still in the IQ range?
- Test #3: Does excluding the restructuring costs create a loss in the current year, which cannot be carried back as a NOL to prior years?
- Test #4: Is it anticipated that the profits in the future can offset the losses from the current year?
- Test #5: Do the local country tax advisors indicate that the risk is so high that a FIN 48 reserve is required in all events?
- Test #6: What is the ETR under all scenarios?

Subsequent Event – Case Study

Include subsequent event – information available on BS date

(Exhibit O)	U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Total
Includible Entity PBT	2,000	75	(50)	1,000	100	125	150	3,400
Restructuring	(200)	(50)	(100)	(150)	-	-	-	(500)
Revised PBT	1,800	25	(150)	850	100	125	150	2,900
Tax Rate	40%	34%	12.5%	0%	27%	25%	30%	
Tax Liability	720	9		-	27	31	45	832
AETR (Tax Liability/ Includible Entity PBT - exclude Ireland)								28.19%

- Cayman bears the restructuring cost
- Increase in ETR due to deduction not tax benefited

Section III – Discrete Tax

Discrete Taxes – (ASC 740-270-25-3 to 7)

GENERAL EXCEPTIONS TO ETR APPROACH

Cannot estimate
ordinary
income/(loss)

Significant unusual
or infrequently
occurring items

Items not
attributable to
“Ordinary Income”

Extraordinary
items, discontinued
operations, change
in accounting princ.

DISCRETE TAX

Items not attributable to “Ordinary Income”

Change in realizability of deferred taxes (not current period)

Change in APB 23 assertions

Prior period tax return true ups

Change in tax law – measurement of deferred taxes

Change in tax rates – measurement of deferred taxes

Uncertain tax positions – changes to prior period’s positions

Interest & penalty on uncertain tax positions

Change in Uncertain Tax Position – Case Study #1

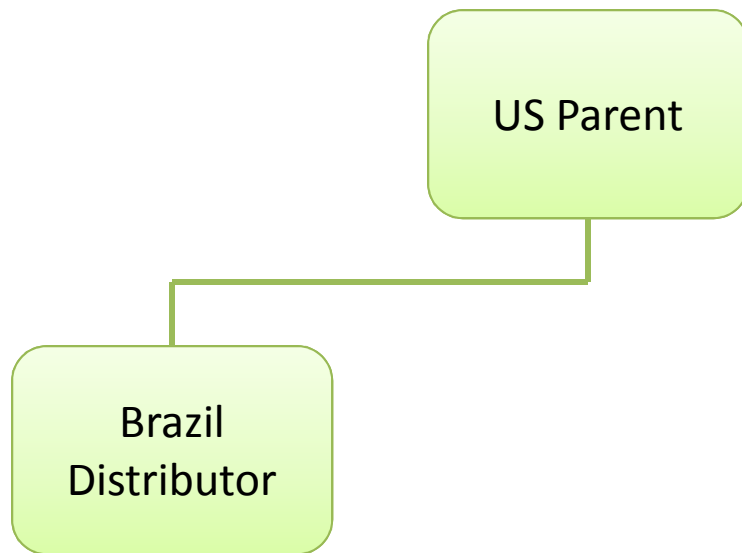
- U.S. parent corporation (principal) with IP structure in Cayman (principal) and logistics branch in Taiwan
 - Taiwan branch compensated on a cost plus 5% basis
 - Cayman purchases goods from Taiwan fabs and sells to customers
 - Cayman passes title to goods to customers in Taiwan
- Hynix Court Case holding: foreign entity’s sales taxable in Taiwan when title passes in Taiwan
 - Taxpayer disagrees with holding and Cayman does not plan to file
 - Company recognizes some exposure for current and prior years
- FIN 48 position: accrue Taiwan tax on “distribution profit” (say, 3% ROS) but not full “IP profit” of Cayman
 - Query: is the reserve for prior years due to a change in law, or a change in judgment? Did the Hynix case uphold the existing rules?
 - Query: how far back in time should the company create a FIN 48 reserve? Does the Taiwan statute of limitations ever close?

Change in Uncertain Tax Position – Case Study #2

- U.S. parent corporation (principal) with IP structure in Ireland (principal) and Contract R&D sub in India
 - India R&D sub compensated on a cost plus 10% basis by U.S. parent
 - In 2009, India Transfer Pricing Officer assesses 2005 taxable year on cost plus 30% basis; rejects taxpayer's transfer pricing study
- Initial FIN 48 reserve: assume settlement > 50% probability at cost plus 15%, for all years 2005 and beyond
- U.S. parent applies for U.S. – India Competent Authority
- India subsidiary appeals TPO assessment
- New developments in 2011:
 - India appeals are rejected
 - Taxpayer learns U.S. CA negotiating team offers cost plus 20%, which India CA negotiating team rejects
- Result: Must increase reserve to at least a cost plus 20% level, based upon specific developments in taxpayer's case

FX Deferred Tax – Case Study

Reporting Currency (RC) = USD



Functional Currency (FC) = USD

General Rule for Foreign Operations (ASC 830/740)

- FC does not equal RC, changes in FX → CTA on BS
- FC equals RC, monetary assets/liabilities, remeasurement of FX → recognize deferred tax (via P&L)
- FC equals RC, nonmonetary assets/liabilities, remeasurement of FX → do not recognize deferred tax

FX Deferred Tax – Case Study

Brazil Distributor		(Exhibit V)				
Assume all monetary assets/liabilities						
			Spot Rate: 1.666		Spot Rate: 1.6432	
			12/31/10	12/31/10	3/31/10	12/31/10
<u>Inventory of Deferred Taxes</u>		In LC	in USD	In LC	In USD	
Deferred revenue		500	300	500	304	
Prepaid expenses		(300)	(180)	(300)	(183)	
Net operating losses		1,000	600	1,000	609	
Total Deferrals		1,200	720	1,200	730	
			a		b	
Conclusion						
Recognize additional deferred tax asset of 10 (b-a).						
Journal Entries:	Debit	(Credit)				
Deferred tax asset	10					
Tax benefit		(10)				
		OR				
Deferred tax asset	10					
Income cont. ops		(10)				

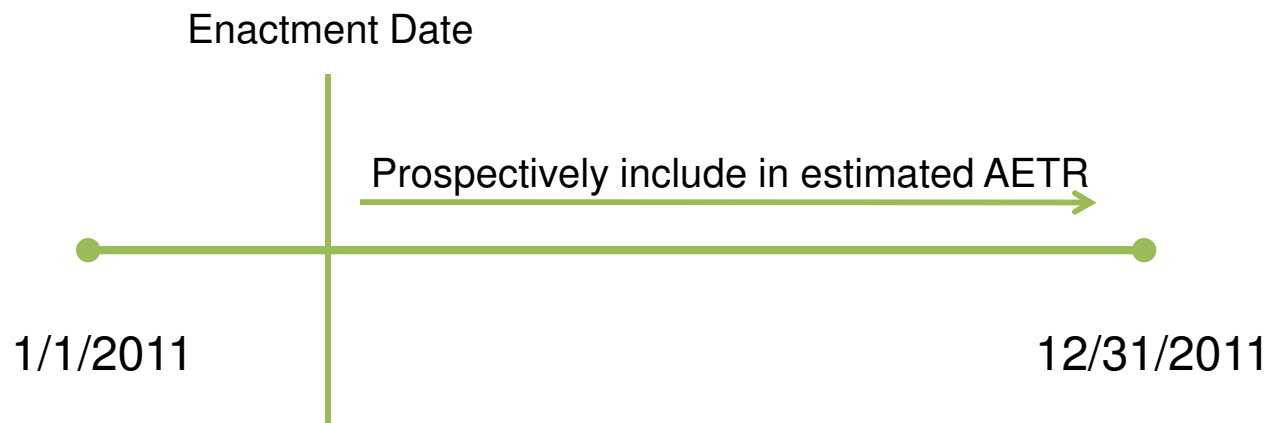
Observations

- Record as discrete tax
- Above the line or below the line, accounting policy election.

Change in Tax Rates – Case Study

UK – Sales & Marketing

Corporate Tax Rate Reduced From 28% to 26%



On date of enactment, remeasure deferred tax with new tax rate

Change in Tax Rates – Case Study

UK Sales & Marketing		(Exhibit W)										
Date of Enactment					Prospective Application on Estimated AETR							
		Gross Bal.	Tax Rate	Tax Rate			UK					
<u>Inventory of Deferred Taxes</u>		In USD	28%	26%	Before Tax Income		500					
Deferred revenue		500	140	130	Tax Rate		26%					
Prepaid expenses		(300)	(84)	(78)	Interim Tax Liability		130					
Net operating losses		1,000	280	260								
Total Deferreds		1,200	336	312	Recalculate estimated AETR							
			a	b	using new tax rate.							
<u>Tax Journal Entries</u>	Debits	(Credits)										
Tax Expense (a-b)	24											
	Deferred Tax	(24)										
(To record change in tax rate as discrete)												

Observation

What if tax rates are gradually reduced?

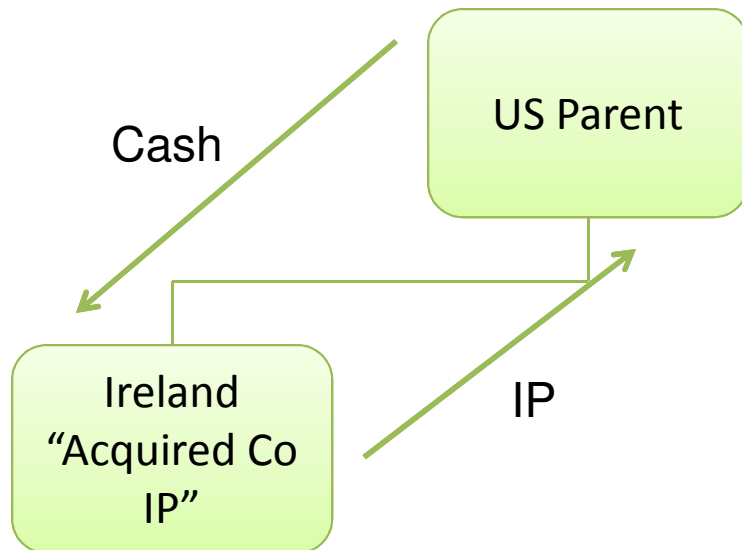
Change in Tax Rates – Case Study

UK Sales & Marketing		(Exhibit X)								
Date of Enactment										
Example only (fiction) - presume gradual tax rate reduction										
			2011	2011	2012	2013	2011	2011	2012	2013
			Gross Bal.	Turn	Turn	Turn	Tax Rate	Tax Rate	Tax Rate	Tax Rate
<u>Inventory of Deferred Taxes</u>			In USD	In USD	In USD	in USD	28%	26%	24%	22%
Deferred revenue			500	500	-	-	140	130	-	-
Prepaid expenses			(300)	(300)	-	-	(84)	(78)	-	-
Net operating losses			1,000	300	400	300	280	78	96	66
Total Deferreds			1,200	500	400	300	336	130	96	66
							e	a	b	c
<u>Tax Journal Entries</u>		Debits	(Credits)							
									d=a+b+c	292
Tax Expense (e-d)		44								
	Deferred Tax		(44)							
(To record change in tax rate as discrete)										

Observation

Revisit each future quarter, estimating the realizability of deferred tax with future tax rate

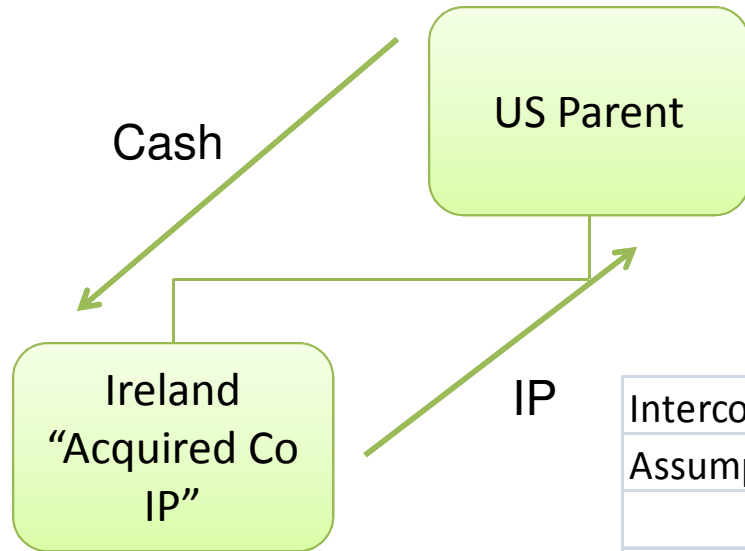
IP Transfer Interim Period – Case Study



Planning Opportunity

- Ireland's losses not benefited – negative impact to ETR
- Transfers economic rights to US (product is only sold in US)
- Moving losses from an entity with no tax benefit to an entity that can benefit
- Reduce ETR

IP Transfer Interim Period – Case Study



Intercompany IP Transfer (Ireland to US) (Exhibit R)				
Assumptions				
<u>Ireland</u>		<u>U.S</u>		
Basis of IP	-	Basis of IP	300	
Proceeds	300	Life	3 Years	
NOL (w/VA)	500			
Purchased Tech - DTL	(50)			
@ 12.5%	12.5%			
PPA Tech - DTL Tax Eff.	(6)			

Going the Other Way: The IP Buy-Out

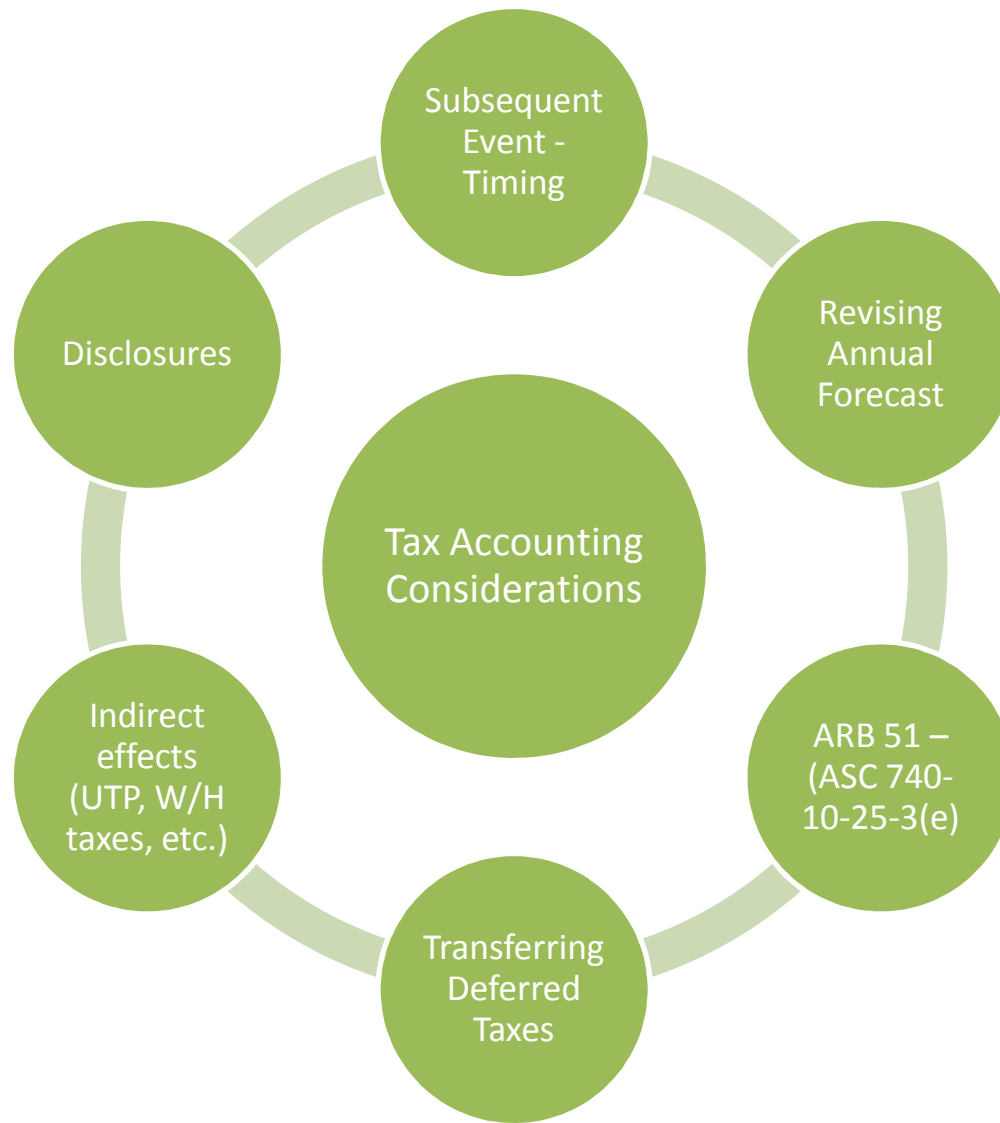
- In some circumstances, an IP migration does not achieve a lower global ETR; rather, it can be 40%+
 - Typically, the Company overall is break-even or incurring losses
 - The operations in Cayman / Ireland are incurring losses at either a 0% tax rate or a full valuation allowance situation, with no carry backs
- Consider a “Buy-Out” (opposite of a Buy-In)
 - Partial: transfer a territory or a product line back to US, which must pay for the IP received
 - Full: terminate the cost sharing arrangement entirely between the entities
 - Full: check the box on Cayman / Ireland, so for US purposes there is a liquidation of foreign affiliates
- Issues
 - How is the Buy-Out valued?
 - May be possible to “reverse” recent cost sharing cross-charges
 - Is the offshore loss (negative E&P) just lost forever?

IP Transfer Interim Period – Case Study

Before IP Transfer	(Exhibit S)	U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Elim	Total
Includible Entity PBT		2,000	75	-500	1,000	100	125	150	-	2,950
Tax Rate		40%	34%	12.5%	0%	27%	25%	30%	0%	
Tax Liability		800	26		-	27	31	45	-	866
AETR (Tax Liability/ Includible Entity PBT - exclude Ireland)										25.11%
Actual YTD PBT (Excluding Ireland loss of 250)										1,725
Actual YTD Q2 Tax Liability										433
Discrete Events										-
Net Actual YTD Q2 Tax Liability										433
Actual YTD Q2 ETR										25.11%

After IP Transfer	(Exhibit T)	U.S.	Brazil	Ireland	Cayman	UK	China	Canada	Elim	Total
Includible Entity PBT		1,500	75	0	1,000	100	125	150	-	2,950
Amortization		(100)							100	
Tax Gain				300						
NOL/Release of VA				-300						
Net Interim Taxable Income		1,400	75	-	1,000	100	125	150	100	2,950
Tax Rate		40%	34%	12.5%	0%	27%	25%	30%	0%	
Tax Liability		560	26	-	-	27	31	45	-	689
AETR (Tax Liability/ Includible Entity PBT - exclude Ireland)										23.35%
Actual YTD PBT										1,475
Actual YTD Q2 Tax Liability										344
Discrete Events (Transfer Technology DTL from Ireland to U.S. - (50)*(35%-12.5%))										11
Net Actual YTD Q2 Tax Liability										356
Actual YTD Q2 ETR										24.11%

IP Transfer Interim Period – Case Study



TPC/DLA

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