

## MONTHLY TOPIC (July 2011) - ARE YOUR DEFERRED TAX ASSETS CORRECT?

### The following provides a few of the causes of incorrect deferred tax assets:

1. A company that acquires a target in an asset acquisition may inadvertently set up a deferred tax asset in purchase accounting for the target's accruals. The acquirer in an asset purchase must track the acquired accruals using FIFO, LIFO, or specific identification, and not deduct these accruals when they turn.
2. A company that acquires a target in a stock acquisition, where a 338 election is not made, faces the challenge of maintaining the tax cost and accumulated depreciation of the acquired target company on a historical tax basis. For financial accounting purposes fixed assets may reflect a step-up in basis. The stepped-up book basis may be incorrectly used as the cost for tax purposes resulting in an incorrect deferred tax asset or liability for the difference in net book versus net tax value of the acquired fixed assets.
3. Determining and maintaining the correct stock compensation deferred tax asset can be difficult. Companies with shortfalls may inadvertently not remove the deferred tax asset related to a grant that has been sold or terminated. One suggestion is to test your stock compensation deferred tax asset by downloading from your stock compensation tracker software the entire history of all stock compensation plans. Then edit out any that are ISOs, ESPPs, and non-qualified stock option grants that have been exercised. Also edit out any grants that have been terminated. The remainder should be a list of all non-qualified stock option plans, including RSAs, RSUs, etc. that have not yet been exercised. The financial accounting stock compensation (former "FAS 123R" or "APB 25" book expense) related to these non-qualified stock options multiplied by the applicable statutory rate should be your deferred tax asset. Be careful to adjust for grants that are allocated out of the U.S. to countries for which a stock compensation deduction is not permitted. Remember to consider the grant or the exercise method allocation impact. Also consider whether any book stock compensation expense has been capitalized into inventory and adjust your deferred tax asset for stock compensation accordingly.
4. The stock compensation deferred tax asset on a target's books may no longer exist after being acquired because no compensation cost has been recorded in the acquirer's financial statements.
5. At the time of the tax provision it is not always known how much of a certain accrual will be paid within 2 1/2, or 8 1/2 months per the recurring item exception. Estimates are used to prepare a tax provision that need to be true-up in the quarter the tax return is filed. The true-ups need to be properly monitored to avoid incorrect deferred tax assets.

6. Tax attributes such as net operating losses and credits may be impacted by section 382/383 limitations. The limitations may impact the amount of tax attributes that can be utilized within the remaining carry forward period.
7. Companies often use a blended state statutory rate to calculate their state deferred tax assets. The blended state statutory rate is based on apportionment factors and state tax rates. Companies with subsidiaries that do not do business in the same states may require separate blended state statutory tax rates for each legal entity if material. For example, if Company A is in a separate stand-alone state with a 5% tax rate but Company B is in a state with a 10% rate, using a blended tax rate of say 7.5% maybe incorrect in valuing deferred tax assets. What if all the deferreds are for Company A only? Then the deferreds should be valued at the Company A statutory blended tax rate and not a blended Company A and Company B state statutory tax rate. It is also important to track potential apportionment law changes, such as the California single sales factor change, that can reset a company's deferred tax assets.
8. Intangible assets recorded in a stock acquisition where there is no 338 step up may require a setup of a deferred tax liability at the time of the acquisition. The deferred tax liability needs to be monitored for last minute purchase price allocation changes. It is recommended that you maintain an amortization schedule for all intangibles and test that the deferred tax liability tie to the remaining tax-effected net book versus tax value of the intangibles.
9. A target's acquired stock compensation tainted" net operating losses/credits may lose their "taint" and therefore be reflected on a "with" basis.
10. Companies that kept deferred tax assets on a "with" basis prior to adoption of FAS 123R may have deferreds that are kept on a "with" basis for deferreds that still exist from pre-FAS 123R adoption and on a "without" basis for post FAS 123R adoption new deferreds.
11. Foreign deferred tax assets should be monitored to reflect tax rate changes. Recently the trend has been for foreign countries to reduce their corporate income tax rates. For example Germany, Canada, and the UK have reduced their corporate income tax rates the last few years. It appears Japan may be reducing their corporate tax rate by 5%. These rate changes may impact the balance of foreign deferred tax assets in these countries. In some countries the rate decreases come down over time. The deferred should be analyzed as to when the expected "turn" will occur and valued at the tax rate when the "turn" will occur.
12. Deferred tax assets may have a corresponding contingency (i.e., R&D credit deferred tax asset with a "FIN 48" contingency). The netting of the contingency against the deferred should be recorded and tracked correctly. Also consider the state tax and interest deferred tax issues related to contingencies.

13. The need for a valuation allowance should be monitored on an entity, tax jurisdiction and specific deferred tax asset basis. A valuation allowance may be needed on a particular deferred tax asset such as capital losses that require an offset of capital gains that the company does not expect to have on a more likely than not basis. In determining the valuation allowance certain deferred tax liabilities should not be considered as offsets against deferred tax assets because it is not known if the deferred tax liability will turn within the same period as the deferred tax asset.
  
14. A deferred tax liability may be needed related to other comprehensive income (“OCI”). OCI increases are booked net of tax with the corresponding credit to deferred tax liability.

The above list is just a sample of how your company’s deferred tax assets and liabilities may be incorrect. Please use my LinkedIn account, call me at 408-464-4323, or email me at [Louis.Gomes@TPCtax.com](mailto:Louis.Gomes@TPCtax.com), to contact me if you have any questions.