

Notice

- *The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.*
- *The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.*

TEI-SJSU High Tech Tax Institute
(32st Annual)

Accounting for Income Taxes

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Outline of Topics

1. SEC and PCAOB on income taxes
 - 2015 and 2014 AICPA National Conference on Current SEC and PCAOB developments
 - SEC Comment Letters
 - Non-GAAP measures
2. Recently issued and Proposed ASUs
 - ASUs
 - Disclosure framework
3. New accounting pronouncements
 - ASU 2016-09: Employee share-based payment accounting improvements
 - ASU 2016-16: Intra-entity asset transfers
5. State Aid update
 - Accounting and reporting

SEC and PCAOB on income taxes

2015 AICPA National Conference

- Mary Jo White, Chair of the SEC
 - The SEC staff's initiative to make disclosure more effective is about not only reducing volume and complexity, but also considering whether investors need more information in certain areas
 - In certain circumstances (foreign tax disclosure is one) the staff believes that more disclosure would help investors
 - Encouraged companies to continue to undertake individual efforts to enhance disclosures for the benefit of investors
- Division of corporation finance
 - Continue to focus on clear disclosure of income tax activity and positions, especially for multinational corporations
 - One area that needs continued improvement is the disclosure of overseas profits, taxes and cash
 - Recommended to use the rate reconciliation as a starting point for clear, comprehensive income tax disclosures (either in the footnotes or within MD&A) aimed at describing material information about what is happening, why, and its susceptibility to change

2015 AICPA National Conference (continued)

- Division of corporation finance (continued)
 - Examples of insufficient disclosures related to income taxes
 - Insufficient details describing the foreign tax rate differential, especially when many foreign tax jurisdictions are grouped together
 - Aggregation of individually significant tax transactions or outcomes with recurring transactions in rate reconciliation line items, such as a nondeductible goodwill impairment charge
 - Unclear linkage between amounts in the qualitative discussion and the information in the rate reconciliation
 - Use of boilerplate disclosure to describe changes in tax estimates, such as changes in valuation allowances or reinvestment decisions
 - Unclear description of what is included in Other
 - To remediate these problems, the staff encouraged companies to use a disaggregated, tabular rate reconciliation by country
- SEC Office of Chief Accountant
 - The three most commonly identified restatement areas are debt/equity, statement of cash flows and accounting for income taxes

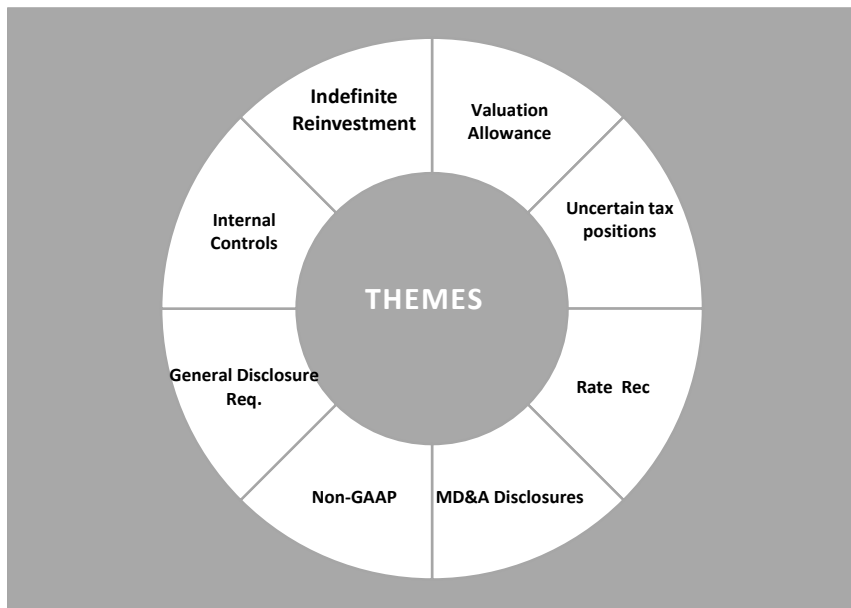
2014 AICPA National Conference

- At the 2014 AICPA National Conference on Current SEC and PCAOB Developments, representatives of the SEC indicated the trend of frequent comments on income taxes has continued
- The Division of Corporation Finance Staff discussed circumstances where there could be improvements in income tax disclosures, including situations in which there are:
 - Significant differences between the expected income tax expense and the actual income tax expense
 - Significant changes in the annual effective income tax rate or materially volatile but offsetting components
 - Material components in the rate reconciliation that significantly impact the effective income tax rate
 - Foreign earnings that are a significant component of a registrant's total pretax earnings

2014 AICPA National Conference (continued)

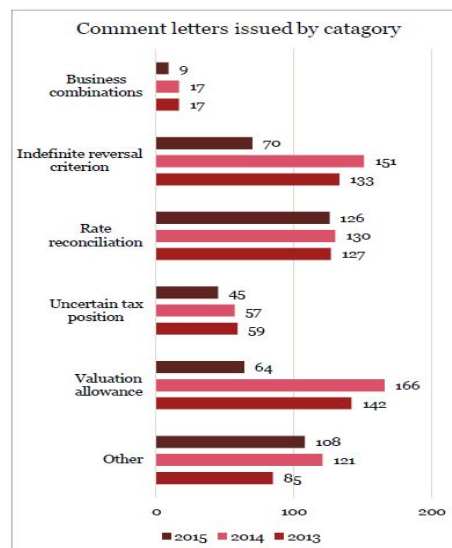
- Division of Corporation Finance Staff have been and will continue to be focused on foreign income and related taxes
- The Staff observed that they continue to see registrants making generic disclosures about changes in foreign taxes that are not sufficient for investors to understand the material risks and uncertainties associated with an entity's foreign taxes
- When foreign pretax earnings are significant, the Staff recommended disclosing the following:
 - A description of what is included in the foreign earnings line of the rate reconciliation
 - The material jurisdictions that are included in the foreign earnings
 - Pretax earnings
 - Statutory and effective tax rates
 - Material reconciling items between the statutory and effective rates
 - Trends, uncertainties and expectations associated with the specific jurisdictions in which the company operates

SEC Comment Letter Themes



SEC Comment Letter Trends

- SEC comment letters continue to highlight:
- Foreign earnings unremitted to the US and the tax impact of their potential repatriation
- Judgments around the need for a valuation allowance
- The components of companies' effective tax rate reconciliation
- Uncertain tax positions



SEC Comments

MD&A – General observations

Enable users to see the company through the eyes of management. MD&A disclosures should be:

- Transparent in providing relevant information
- Tailored to the company's facts and circumstances
- Consistent with financial statements and other public communications
- Comprehensive in addressing the many business risks that exist in today's economic environment

"We note from your income tax and segment disclosures in Notes X, Y, and Z respectively, what appear to be disproportionate relationships among domestic and foreign revenues, pre-tax income (losses) and related provisions both within and across the three years presented. For example, the relationship of your non-U.S. revenues to non-U.S. pre-tax loss and related foreign tax provision appears to require expanded MD&A disclosures as to how your mix of geographic revenues and related income tax planning has historically impacted or is reasonably likely to impact future results of operations and financial position. Please explain the material components of foreign effective income tax rates ..."

SEC Comments

MD&A – Results of operations

Highlight and explain activities driving material changes period-over-period.

- Disclosing known trends - disclose events that have occurred and how those events were a positive or negative indicator of future performance
- Drivers behind fluctuations – disclose significant fluctuations between periods, including quantification of factors
- Consistency of information – staff may question why information disclosed on earnings calls and press releases are not included in the MD&A discussion
- Segment discussion – staff comments have encouraged the use of segment analysis to provide more in-depth explanation

"When you identify multiple factors contributing to the changes in the line items comprising income from continuing operations, please quantify each factor in accordance with the guidance in Item 303(a)(3) of Regulation..."

SEC Comments

Income Tax – Other specific areas

- Discussion of underlying factors included in the effective tax rate reconciliation
- Provide support for the recognition or release of a valuation allowance
- Uncertain tax positions
- Indefinite reinvestment of foreign earnings and liquidity constraints
- Disclosures regarding pre-tax income from U.S. and foreign jurisdictions

SEC Comments

Effective tax rates

- Volatility of effective tax rates
- Effective tax rates do not change because material changes in components are offsetting
- Tax rates that appear unusual relative to the expected statutory rate

“We note that your effective tax rate is substantially different than the U.S. Statutory tax rate of 35%. With reference to your reconciliation of United States statutory rates to the effective rates, please revise future filings to expand your discussion to thoroughly address all items impacting your effective tax rates for each period, including foreign taxes and valuation allowances.”

“We note that your effective tax rate has had significant variability between all of the periods presented. Please expand the analysis to provide investors with additional insight into the other material factors impacting your effective tax rate. In this regard, it is unclear how the increased earnings in 201X as compared to 201Y affected your effective tax rates for these two periods.”

SEC Comments

Valuation allowance

- Inquiries on positive and negative evidence considered in company's assessment. Particularly in situations where there has been a return to profitability
- Information about valuation allowance movement when cumulative profitability evidence is inconsistent

"We note the evidence you considered for the release of the majority of your valuation allowance against your U.S. federal and state deferred tax assets in the fourth quarter of 201X. Based on your historical operating results, it appears that the realization of your deferred tax assets is dependent on material improvement over present levels of pre-tax income, including the impact of acquired entities. Given the significant portion of U.S. operating loss carryforwards expiring between 202Y and 202Z, tell us in detail the material assumptions underlying your determination of the expected U.S. pre-tax income amount needed to realize your deferred tax assets. Tell us how you weighted all of the positive and negative evidence, including to the extent to which it can be objectively verified, in reaching your conclusion to reverse the valuation allowance...."

SEC Comments

Uncertain tax positions

- Better understanding of changes in positions and potential changes
- Variability in the effective tax rate reconciliation caused by uncertain tax positions
- Significant prior year position changes
- Justification for changes in measurement of uncertain tax positions in a particular period
- Disclose reasonably possible significant changes within the next 12 months

"We note your disclosure in Note X that in 201X you recognized a significant income tax benefit from a reduction in uncertain tax positions. We also note from your disclosure that this reduction related to: 1) \$X million of gross reductions for tax positions taken during the prior year; 2) \$Y million of reductions from settlements with taxing authorities; and 3) \$Z million of reductions from lapse of applicable statutes of limitation. Please explain to us the nature of each of these amounts and tell us why you believe it is appropriate to recognize these reductions to your income tax expense during fiscal 201X."

SEC Comments

Foreign earnings unremitted to the US and the tax impact of their potential repatriation:

- What level of evidence is maintained and disclosed by management for specific plans on reinvesting earnings
- Details on repatriation of some current earnings while others remain indefinitely reinvested
- The SEC has sought to gain a more comprehensive understanding of the registrant's ability and intent to support its unremitted earnings assertion by inquiring about:
 - Specific countries of which indefinitely reinvested foreign earnings are located
 - Amount of investments and other liquid assets held by foreign subs
 - Portion of cash held by foreign subs and amount of cash available for us in the US without repatriation

SEC Comments

Foreign earnings unremitted to the US and the tax impact of their potential repatriation:

"Given your significant foreign operations, please enhance your liquidity disclosures to address the following:

- Disclose the amount of foreign cash and cash equivalents you have as compared to your total amount of cash and cash equivalents as of the latest balance sheet date;*
- Discuss the fact that if the foreign cash and cash equivalents are needed for your operations in the U.S., you would be required to accrue and pay U.S. taxes to repatriate these funds but your intent is to permanently reinvest these foreign amounts outside the U.S. and your current plans do not demonstrate a need to repatriate the foreign amounts to fund your U.S. operations, if true; and*
- Disclose the nature and extent of any legal or economic restrictions on the ability of your subsidiaries to transfer funds to you in the form of cash dividends, loans or advances and the impact such restrictions have had or are expected to have on your ability to meet cash obligations."*

SEC Comments

Internal Controls

- SEC has issued comments related to potential indicators of material weakness
 - Potential indicators of a material weakness include corrections of an error or disclosures reporting material changes in internal controls
 - SEC increasingly challenged registrants' conclusions about the existence or severity of internal control deficiencies
 - Existence of material weaknesses when immaterial errors were corrected by means of revision of comparative financial statements.

Non-GAAP measures

- Chair Mary Jo White observed the following in respect to non-GAAP financial measures:
 - Used extensively
 - Can be a source of confusion in some instances
 - Deserve close attention (to make sure that the rules are being followed)
 - Consider whether existing rules are sufficient
- Asked preparers to carefully consider the following questions when they use non-GAAP measures:
 - Why is the measure being used?
 - How does it provide investors with useful information?
 - Is the explanation accurate and complete rather than boilerplate?
 - Is it being given greater prominence than GAAP measures?
 - Are there appropriate controls over the calculation?

SEC Compliance & Disclosure Interpretations

•CD&I Question 102.11, Prior to May 17, 2016

•*Question: May a registrant present an adjustment "net of tax" when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure?*

•*Answer: Yes, provided that the tax effect of each reconciling item is disclosed parenthetically or in a footnote to the reconciliation. Alternatively, the company can present the tax effect in one line in the reconciliation. Regardless of the format of the presentation, registrants should disclose how the tax effect was calculated.*

What happened?

- New/updated CD&I's issued May 17, 2016
- Previously, CD&I's had not been updated since July 2011

SEC Compliance & Disclosure Interpretations

CD&I Question 102.11, Updated as of May 17, 2016

Question: How should income tax effects related to adjustments to arrive at a non-GAAP measure be calculated and presented?

Answer: A registrant should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained. [May 17, 2016]

Non-GAAP Measures - Disclosures

- Different Measures = Different Tax Calculations
- May result in a tax rate applied that is different from a company's effective tax rate.
 - If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash
 - If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability
- Separate adjustment and, clearly explained

Non-GAAP measures – SEC comments

"You disclose (a) the change in constant currency segment income and segment income without also presenting the comparable GAAP measure and (b) you tax effect the adjustments to net income without a clear explanation for how the tax effect is calculated, which is inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your next earnings release."

PCAOB findings on income taxes

- 2016 staff inspection brief
 - The most frequently selected financial reporting areas in 2015 included revenue and receivables, non-financial assets, inventory, financial instruments, the allowance for loan losses, income taxes, benefit related liabilities and equity transactions
 - Key areas of inspection focus in 2016 include, amongst other areas, the evaluation of income tax accounting and disclosures
 - Evaluation and testing of management's assertion regarding the indefinite reinvestment of earnings when issuers have large and growing undistributed earnings in foreign jurisdictions
 - Critical evaluation of the design and operating effectiveness of controls related to income taxes
 - Often involves testing and evaluation of prospective financial information which may involve a high degree of subjectivity by management

Recently issued and Proposed ASUs

Recently issued ASUs

- ASU 2015-01: Simplifying income statement presentation by eliminating the concept of extraordinary items
 - Eliminates the extraordinary items concept which impacts interim reporting and intraperiod tax allocations
 - Retrospective or prospective application permitted
 - Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption
 - Effective for all entities for periods beginning after December 15, 2015
- ASU 2015-16: Simplifying the accounting for measurement period adjustments
 - Requires an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined
 - Prospective application required
 - Early adoption is permitted for all entities as of the beginning of any interim or annual reporting period that is not yet issued
 - Effective for periods beginning after December 15, 2015 for public business entities and for annual periods beginning after December 15, 2016 and interim periods beginning after December 15, 2017 for all other entities

Recently issued ASUs (continued)

- ASU 2016-01: Recognition and measurement of financial assets and financial liabilities
 - Includes guidance that clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale debt securities in combination with the entity's other deferred tax assets
 - Effective for periods beginning after December 15, 2017 for public business entities and for annual periods beginning after December 15, 2018 and interim periods beginning after December 15, 2019 for all other entities

Proposed ASUs

- Technical corrections and improvements
 - Proposed amendment would revise the wording in paragraph ASC 852-740-43-3 for tax benefits as of the date of quasi-reorganizations, consistent with that in paragraph ASC 852-740-55-2
 - No transition is required and the guidance would be effective upon issuance of a final ASU
 - Comments were due July 5, 2016 and the project is in the redeliberations stage
- Accounting for goodwill impairment
 - Proposal to simplify the subsequent measurement of goodwill by removing step two of the goodwill impairment test but would retain the requirement for entities to make an assumption whether a unit would be bought or sold in a nontaxable versus a taxable transaction
 - Impairment amount under an assumed taxable transaction would generally be lower than the impairment in an assumed nontaxable transaction
 - An entity would apply the proposed changes prospectively
 - Comments were due July 11, 2016 and the project is in the redeliberations stage

ASC 740 Forthcoming Developments & Other Hot Topics

Current FASB Topics - Income Tax Accounting

- ASU 2015-340: *“Government Assistance— Disclosures by Business Entities”*
Issue Date: November 12, 2015 / Comment Date: February 10, 2016

Past FASB Topics In Income Tax Accounting

- ASU 2013-11: *“Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists”* Effective for all years after December 15, 2013
- ASU 2014-02: *Accounting for Goodwill (A Consensus of the Private Company Council)*
- ASU 2015-17: *“Income Taxes – Balance Sheet Classification of Deferred Taxes”*
November 2015
- ASU 2016-09: *“ Improvements to Employee Share-Based Payment Accounting”* March 2016
- ASU 2016-16: *“Intra Entity Transfers of Assets Other Than Inventory”* October 2016

FASB projects

- The board's potential project on accounting for income taxes: presentation of tax expense/benefit is in the research stage

Proposed ASU: Disclosure framework-changes to the disclosure requirements for income taxes

Income taxes disclosures

- The Board issued the amendments in the proposed update as part of its disclosure framework project
 - The objective and primary focus of the project is to improve the effectiveness of disclosures required by U.S. GAAP in the notes to the financial statements by facilitating clear communication of information that is most important to financial statement users
 - Separate projects on inventory, income taxes, fair value measurements and defined benefit pensions and other postretirement plans
- The amendments in the proposed update include language designed to promote an entity's use of discretion that reinforces that the entity can assess the applicability of disclosure requirements on the basis of whether the resulting information is material, thereby improving the effectiveness of the notes to financial statements
- The amendments in the proposed update would modify the current disclosure requirements for income taxes
 - Replace the term public entity currently in ASC 740 with the term public business entity as defined in the Master Glossary of the Accounting Standards Codification

Income taxes disclosures (continued)

- Additional disclosure requirements for all entities
 - The following additional disclosures would be required by ASC 740
 - Description of an enacted change in tax law that is probable to have an effect on the reporting entity in a future period
 - Income (loss) from continuing operations before income tax expense (benefit) disaggregated between domestic and foreign*
 - Income tax expense (benefit) from continuing operations disaggregated between domestic and foreign*
 - Income taxes paid disaggregated between domestic and foreign, and the amount of income taxes paid to any country that is significant to total income taxes paid
 - An explanation of circumstances that caused a change in assertion about the indefinite reinvestment of undistributed foreign earnings and the corresponding amount of those earnings
 - The aggregate of cash, cash equivalents and marketable securities held by foreign subsidiaries

* Disclosures currently required by SEC regulations

Income taxes disclosures (continued)

- Additional disclosure requirements for all entities (continued)
 - Requires an entity to disclose the description of a legally enforceable agreement with a government, including the duration of the agreement and the commitments made with the government under that agreement and the amount of benefit that reduces (or may reduce) its income tax burden
 - Government would determine whether an entity will receive assistance or how much assistance an entity will receive even if the entity meets applicable eligibility requirements
 - Disclosure would not apply to circumstances in which the entity meets the applicable eligibility requirements that are broadly available to taxpayers without specific agreement between the entity and the government

Income taxes disclosures (continued)

- Additional disclosure requirements for public business entities
 - The following additional disclosures would be required by ASC 740
 - An explanation of the year-to-year changes in rate reconciling items
 - The amount and explanation of the valuation allowance recognized and released during the reporting period
 - Within the rollforward of unrecognized tax benefits at the beginning and end of the period, settlements using existing deferred tax assets separate from those that have been or will be settled in cash
 - The line items in the statement of financial position in which the unrecognized tax benefits are presented and the related amounts of such unrecognized tax benefits. If the unrecognized tax benefits are not presented in the statement of financial position, those amounts should be disclosed separately
 - The total amount of unrecognized tax benefits that offsets the deferred tax assets for carryforwards

Income taxes disclosures (continued)

- Modification of existing disclosure requirements for all entities
 - Current disclosures requirements would be modified by ASC 740 as follows
 - Eliminate the requirement for all entities to disclose the nature and estimate of the range of the reasonably possible change in the unrecognized benefits balance in the next 12 months or make a statement that an estimate of the range cannot be made
 - Disclose the amounts of federal, state and foreign carryforwards (not tax effected) by time period of expiration

Income taxes disclosures (continued)

- Modification of existing disclosure requirements for public business entities
 - Current disclosures requirements would be modified by ASC 740 as follows
 - Separate disclosure for any reconciling item that amounts to more than five percent of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate and explain year-to-year changes in that item *
 - Disclose the amounts of federal, state and foreign carryforwards (not tax effected) by time period of expiration for each of the first five years after the reporting date and a total for any remaining years
 - Amounts of deferred tax assets for federal, state and foreign carryforwards (tax effected) before the valuation allowance and further disaggregate such amounts by time period of expiration for each of the first five years after the reporting date and a total for any remaining years

* Disclosures currently required by SEC regulations

Income taxes disclosures (continued)

- Effective date and transition
 - An entity would apply the proposed changes prospectively
 - Early application is under consideration and may or may not be permitted
 - The effective date of the amendments will be determined after stakeholder feedback on the proposed amendments is considered
 - Comments were due on September 30, 2016

Income taxes disclosures (continued)

- Reporting and disclosure
 - If and when a final ASU is issued, disclosure is required of the impact that recently issued accounting standards will have on the financial statements of the Registrant when adopted in a future period (SAB 74)
 - Brief description of the new standard, the date adoption is required and the date the registrant plans to adopt (if earlier application is permitted)
 - Discussion that adoption of the standard is applied on a prospective basis
 - Disclosure of the potential impact of other significant matters that the Registrant believes might result from the adoption of the standard

ASU 2016-09: Improvements to employee share-based payment accounting

Share-based payments

- Guidance prior to the adoption of ASU 2016-09
 - Accounting for Income Taxes upon Settlement of an Award
 - Excess tax benefits are recognized in the period in which the tax deduction is realized through a reduction of taxes payable
 - Net operating loss carryforwards related to excess tax benefits do not result in deferred tax assets (maintained off-balance sheet)
 - Excess tax benefits are recognized as Additional Paid-in Capital in the period the benefit is realized
 - Deficiencies are recognized as reductions to Additional Paid-in Capital to the extent of prior realized excess tax benefits with any residual recorded as income tax expense
 - Presentation of Excess Tax Benefits on the Statement of Cash Flows
 - Excess tax benefits are presented as a cash inflow from financing activities and a cash outflow from operating activities

Share-based payments (continued)

- Guidance subsequent to the adoption of ASU 2016-09
 - Accounting for Income Taxes upon Settlement of an Award
 - Removes the requirement to delay recognition of an excess tax benefit until the tax benefit reduces income taxes otherwise payable
 - Net operating loss carryforwards or other tax attributes related to excess tax benefits will result in deferred tax assets
 - Modified retrospective transition with a cumulative effect adjustment to retained earnings, if necessary
 - All excess tax benefits and deficiencies (including tax benefits of dividends on share-based payment awards) are recognized as income tax expense (benefit) in the income statement
 - Reflected discreetly in interim periods in which exercise or vesting occurs
 - Prospective transition as of the beginning of the year of adoption
 - Presentation of Excess Tax Benefits on the Statement of Cash Flows
 - Requires that cash flows related to excess tax benefits are classified as an operating activity with other income tax cash flows
 - Retrospective or prospective transition permitted

Share-based payments (continued)

- Effective date and transition
 - Public Business Entities: Annual periods, and interim periods within such years, beginning after December 15, 2016
 - All Other Entities: Annual periods beginning after December 15, 2017, and interim periods in annual periods beginning after December 15, 2018
 - Early adoption is permitted for all entities as of the beginning of any interim or annual reporting period that is not yet issued
 - An entity that elects to early adopt the new guidance must adopt all of the amendments of the ASU in the same period
 - Adoption of the amendments will occur as of the beginning of the year for the issues adopted by the cumulative-effect and prospective methods
 - Any adjustments to previously reported interim periods of that fiscal year should be included in the year-to-date results
 - If any previously reported interim results appear in any future filings, they are reported on a revised basis

Share-based payments (continued)

- Reporting and disclosure
 - Disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period is required (SAB 74)
 - Brief description of the new standard, the date adoption is required and the date the registrant plans to adopt (if earlier)
 - Discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined
 - Discussion of the impact of adoption or a statement that it is not known or reasonably estimable
 - Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard

Share-based payments (continued)

- Reporting and disclosure (continued)
 - In the first interim and annual period of adoption, a public business entity shall disclose the following
 - The nature of and reason for the change in accounting principle
 - The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption
 - A statement that prior periods were restated and the impact of such restatement if an entity elects to adopt on a retrospective basis
 - A statement that prior periods were not restated if an entity elects to adopt on a prospective basis
 - All other entities shall make the above disclosures in the first annual period after the entity's adoption date, unless the entity elects to early adopt in an interim period, in which case the entity also shall make those disclosures in the interim periods within the first annual period after the entity's adoption date

Share-based payments (continued)

- Example

- On January 1, 20X4, ABC Corp grants 100,000 share options to employees that have an exercise price of \$5 which equals the stock price on the date of grant
- The options cliff vest after two years of service and have a grant-date fair value of \$2
- In 20X6, all of the share options are exercised when the stock price was \$11 per share, resulting in a tax deduction of \$600,000 [100,000 share options x (\$11 value at exercise – \$5 strike price)]
- ABC has no other temporary differences other than those related to share-based compensation and has determined its deferred tax assets are more likely than not of being realized
- ABC has pretax income of \$200,000 in 20X6, \$100,000 in 20X7 and \$900,000 in 20X8
- ABC's tax rate is 40 percent
- Question: What accounting for income taxes entries would be required in 20X4, 20X5, 20X6, 20X7 and 20X8 under pre-ASU 2016-09 and post-ASU 2016-09 application?

Share-based payments (continued)

| PRE-ASU 2016-09 GUIDANCE | | | | |
|--|---------|--------------------------------|-----------|--|
| Year | DR (CR) | Account description | Amount | |
| 20X4: Entry to reflect the pretax compensation cost | | | | |
| 20X4 | DR | Compensation expense | \$100,000 | (100,000 options x \$2 per share over 2 years) |
| 20X4 | CR | Additional paid-in capital | (100,000) | |
| 20X4: Entry to reflect the deferred tax consequences associated with pretax compensation cost | | | | |
| 20X4 | DR | Deferred tax asset | \$40,000 | (100,000 options x \$2 per share over 2 years) x 40% |
| 20X4 | CR | Deferred tax expense (benefit) | (40,000) | |
| 20X5: Entry to reflect the pretax compensation cost | | | | |
| 20X5 | DR | Compensation expense | \$100,000 | (100,000 options x \$2 per share over 2 years) |
| 20X5 | CR | Additional paid-in capital | (100,000) | |
| 20X5: Entry to reflect the deferred tax consequences associated with pretax compensation cost | | | | |
| 20X5 | DR | Deferred tax asset | \$40,000 | (100,000 options x \$2 per share over 2 years) x 40% |
| 20X5 | CR | Deferred tax expense (benefit) | (40,000) | |

Share-based payments (continued)

| PRE-ASU 2016-09 GUIDANCE (continued) | | | | |
|--|---------|--------------------------------|----------|--|
| Year | DR (CR) | Account description | Amount | |
| 20X6: Tax effect of pretax income (loss) | | | | |
| 20X6 | DR | Current tax expense (benefit) | \$80,000 | \$200,000 pretax income x 40% |
| 20X6 | CR | Current taxes payable | (80,000) | |
| 20X6: Reversal of the deferred tax asset due to the exercise of the share options | | | | |
| 20X6 | DR | Deferred tax expense (benefit) | \$80,000 | (100,000 options x \$2 per share) x 40% |
| 20X6 | CR | Deferred tax asset | (80,000) | |
| 20X6: Impact of stock compensation deduction on current income taxes | | | | |
| 20X6 | DR | Current taxes payable | \$80,000 | \$200,000 reversal of deferred tax asset x 40% |
| 20X6 | CR | Current tax expense (benefit) | (80,000) | |

Share-based payments (continued)

| PRE-ASU 2016-09 GUIDANCE (continued) | | | | |
|---|---------|-------------------------------|-----------|---------------------------------|
| Year | DR (CR) | Account description | Amount | |
| 20X7: Tax effect of pretax income (loss) | | | | |
| 20X7 | DR | Current tax expense (benefit) | \$40,000 | \$100,000 pretax income x 40% |
| 20X7 | CR | Current taxes payable | (40,000) | |
| 20X7: Recognition of excess tax benefit for the \$100,000 loss carryforward realized | | | | |
| 20X7 | DR | Current taxes payable | \$40,000 | \$100,000 NOL utilization x 40% |
| 20X7 | CR | Additional paid-in capital | (40,000) | |
| 20X8: Tax effect of pretax income (loss) | | | | |
| 20X8 | DR | Current tax expense (benefit) | \$360,000 | \$900,000 pretax income x 40% |
| 20X8 | CR | Current taxes payable | (360,000) | |
| 20X8: Recognition of excess tax benefit for the remaining loss carryforward utilized | | | | |
| 20X8 | DR | Current taxes payable | \$120,000 | \$300,000 NOL utilization x 40% |
| 20X8 | CR | Additional paid-in capital | (120,000) | |

Share-based payments (continued)

| POST-ASU 2016-09 GUIDANCE | | | | |
|--|---------|--------------------------------|-----------|--|
| Year | DR (CR) | Account description | Amount | |
| 20X4: Entry to reflect the pretax compensation cost | | | | |
| 20X4 | DR | Compensation expense | \$100,000 | (100,000 options x \$2 per share over 2 years) |
| 20X4 | CR | Additional paid-in capital | (100,000) | |
| 20X4: Entry to reflect the deferred tax consequences associated with pretax compensation cost | | | | |
| 20X4 | DR | Deferred tax asset | \$40,000 | (100,000 options x \$2 per share over 2 years) x 40% |
| 20X4 | CR | Deferred tax expense (benefit) | (40,000) | |
| 20X5: Entry to reflect the pretax compensation cost | | | | |
| 20X5 | DR | Compensation expense | \$100,000 | (100,000 options x \$2 per share over 2 years) |
| 20X5 | CR | Additional paid-in capital | (100,000) | |
| 20X5: Entry to reflect the deferred tax consequences associated with pretax compensation cost | | | | |
| 20X5 | DR | Deferred tax asset | \$40,000 | (100,000 options x \$2 per share over 2 years) x 40% |
| 20X5 | CR | Deferred tax expense (benefit) | (40,000) | |

Share-based payments (continued)

| POST-ASU 2016-09 GUIDANCE (continued) | | | | |
|--|---------|--------------------------------|-----------|---|
| Year | DR (CR) | Account description | Amount | |
| 20X6: Tax effect of pretax income (loss) | | | | |
| 20X6 | DR | Current tax expense (benefit) | \$80,000 | \$200,000 pretax income x 40% |
| 20X6 | CR | Current taxes payable | (80,000) | |
| 20X6: Reversal of the deferred tax asset due to the exercise of the share options | | | | |
| 20X6 | DR | Deferred tax expense (benefit) | \$80,000 | (100,000 options x \$2 per share) x 40% |
| 20X6 | CR | Deferred tax asset | (80,000) | |
| 20X6: Current tax effect of the reversal of the deferred tax asset due to the exercise of the share options | | | | |
| 20X6 | DR | Income taxes payable | 80,000 | (100,000 options x \$2 per share) x 40% |
| 20X6 | CR | Current tax expense (benefit) | (80,000) | |
| 20X6: Recognition of \$400,000 excess tax benefit to reflect the deferred tax asset on NOL carryforwards | | | | |
| 20X6 | DR | Deferred tax asset | \$160,000 | \$400,000 excess tax deduction x 40% |
| 20X6 | CR | Deferred tax expense (benefit) | (160,000) | |

Share-based payments (continued)

| POST-ASU 2016-09 GUIDANCE (continued) | | | | |
|--|---------|--------------------------------|----------|-------------------------------|
| Year | DR (CR) | Account description | Amount | |
| 20X7: Tax effect of pretax income (loss) | | | | |
| 20X7 | DR | Current tax expense (benefit) | \$40,000 | \$100,000 pretax income x 40% |
| 20X7 | CR | Current taxes payable | (40,000) | |
| 20X7: Reversal of deferred on utilization of \$100,000 of NOL carryforwards associated with excess tax deductions | | | | |
| 20X7 | DR | Deferred tax expense (benefit) | \$40,000 | \$100,000 NOL utilized x 40% |
| 20X7 | CR | Deferred tax asset | (40,000) | |
| 20X7: Current impact on utilization of \$100,000 of NOL carryforwards associated with excess tax deductions | | | | |
| 20X7 | DR | Income taxes payable | 40,000 | \$100,000 NOL utilized x 40% |
| 20X7 | CR | Current tax expense (benefit) | (40,000) | |

Share-based payments (continued)

| POST-ASU 2016-09 GUIDANCE (continued) | | | | |
|--|---------|--------------------------------|-----------|-------------------------------|
| Year | DR (CR) | Account description | Amount | |
| 20X8: Tax effect of pretax income (loss) | | | | |
| 20X8 | DR | Current tax expense (benefit) | \$360,000 | \$900,000 pretax income x 40% |
| 20X8 | CR | Current taxes payable | (360,000) | |
| 20X8: Reversal of deferred on utilization of \$300,000 of NOL carryforwards associated with excess tax deductions | | | | |
| 20X8 | DR | Deferred tax expense (benefit) | \$120,000 | \$300,000 NOL utilized x 40% |
| 20X8 | CR | Deferred tax asset | (120,000) | |
| 20X8: Current impact on utilization of \$100,000 of NOL carryforwards associated with excess tax deductions | | | | |
| 20X8 | DR | Income taxes payable | \$120,000 | \$100,000 NOL utilized x 40% |
| 20X8 | CR | Current tax expense (benefit) | (120,000) | |

ASU 2016-16: Intra-entity transfers of assets other than inventory

Intra-entity asset transfers

- Existing guidance
 - Current guidance under ASC 810, Consolidation, provides that intra-entity balances, transactions, and profit or loss on assets remaining within the group should be eliminated
 - ASC 810-10-45-8 provides that if income taxes have been paid on intra-entity profits on assets remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced
 - Results in the deferral of the net tax expense (benefit) to the seller which is generally reflected as a deferred charge (credit) as an other asset (liability) on the consolidated balance sheet
 - Further, ASC 740-10-25-3(e) provides an exception to the recognition of deferred taxes in the buyer's jurisdiction noting there is a prohibition on recognition of a deferred tax asset for the intra-entity difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements
 - Deferred tax effects of assets subject to depreciation or amortization generally should be amortized over an appropriate period
 - Current guidance under U.S. GAAP is an exception to the accounting model for comprehensive recognition of income taxes in ASC 740

Intra-entity asset transfers (continued)

- New guidance
 - Requires an entity to recognize the income tax consequences of an intra-entity asset transfer, other than an intra-entity asset transfer of inventory, when the transfer occurs
 - For intra-entity asset transfers of inventory, the existing exception in U.S. GAAP has been retained which requires an entity to recognize the income tax consequences of the transaction when the inventory has been sold to a party outside the consolidated group

Intra-entity asset transfers (continued)

Example – CoA and CoB are wholly owned subsidiaries of the same parent. CoA sells equipment to CoB for \$150. Profit of \$50. Seller's tax rate is 40%. Buyer's tax rate is 30%.

| Current US GAAP | | New US GAAP | |
|---------------------------------|---------|----------------------|---------|
| Deferred charge (balance sheet) | \$20 | Current tax expense | \$20 |
| Income tax payable | (\$20) | Income tax payable | (\$20) |
| | | Deferred tax asset | \$15 |
| Income tax expense | \$2 | Deferred tax expense | (\$15) |
| Deferred charge (balance sheet) | (\$2) | | |
| Income tax payable | \$1.5 | Income tax payable | \$1.5 |
| Current tax expense | (\$1.5) | Current tax expense | (\$1.5) |
| | | Deferred tax expense | \$1.5 |
| | | Deferred tax asset | (\$1.5) |

Intra-entity asset transfers (continued)

- Effective date and transition guidance
 - Public Business Entities: Annual periods, and interim periods within such years, beginning after December 15, 2017
 - All Other Entities: Annual periods beginning after December 15, 2018, and interim periods in annual periods beginning after December 15, 2019
 - Early adoption is permitted as of the beginning of an annual reporting period
 - The amendments are applied on a modified retrospective basis with a cumulative effect adjustment directly to retained earnings as of the beginning of the period of adoption

Intra-entity asset transfers (continued)

- Reporting and disclosure
 - Disclosure is required of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period (SAB 74)
 - Brief description of the new standard, the date adoption is required and the date the registrant plans to adopt (if earlier)
 - Discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined
 - Discussion of the impact of adoption or a statement that it is not known or reasonably estimable
 - Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard

Intra-entity asset transfers (continued)

- Reporting and disclosure
 - In the first interim and annual period of adoption, a public business entity shall disclose the following
 - The nature of and reason for the change in accounting principle
 - The effect of the change on affected financial statement line items and affected per-share amounts
 - Cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position
 - A statement that prior periods were not restated
 - All other entities shall make the above disclosures in the first annual period after the entity's adoption date, unless the entity elects to early adopt in an interim period, in which case the entity also shall make those disclosures in the interim periods within the first annual period after the entity's adoption date

State Aid Update

Impact on Financial Accounting Reporting Considerations

State Aid Update

- Overview – What is State Aid?
 - Assistance directed by governments to individual companies that is not normally available to the general population.
 - Enacted by specific state agency
 - Advantage is selective to specific group or company
 - Potential to distort competition among other member states or government agencies

State Aid Update

- Recent Findings on State Aid
 - In June , European Commission launched investigations on member countries favorable tax rulings (transfer pricing):
 - Netherland (Starbucks)
 - Luxembourg (Fiat)
 - Ireland (Apple)
 - In June 2014In October 2015, European Commission announced their conclusion that the local country tax rulings were illegal under EU state aid rules:
 - Both the Netherland (Starbucks) and Luxembourg (Fiat) tax authorities were ordered to recover upwards of €30 million from each of the taxpayers.

State Aid Update

- Recent Findings on State Aid

- The European Commission commented that:

“Tax rulings cannot use methodologies, no matter how complex, to establish transfer prices with no economic justification and which unduly shift profits to reduce the taxes paid by the company. It would give that company an unfair competitive advantage over other companies that are taxed on their actual profits because they pay market prices for the goods and services they use.”

State Aid Update

- Overview – How is a State Aid Investigation Processed?

- After initial investigation, EU Commission will issue its “Provisional Finding” on tax ruling’s compatibility with EU State Aid rules.
 - The member state, taxpayer, and competitors have 30 day window to submit comments / provide additional support to Commission.
 - The EU Commission will review findings to determine if the State Aid is compatible.
 - If determined to be adverse, a “Final Decision” will direct its member state to recover aid (plus interest) granted over the last 10 years.
 - The Commission will normally calculate the amount of aid to be recovered and can force the member state to sue the taxpayer through the national courts to collect.

State Aid Update

- Overview – How is a State Aid Investigation Processed
 - Appeals are made to the General Court of the EU. Either initiated by the Taxpayer and/or the Member State.
 - The decision by the General Court can be appealed to the Court of Justice.
 - The effects of the Commission's rulings are not suspended during the Appeals process.
 - The Taxpayer may request a delay in recovery during this time.
 - If Member States refuse to enforce the Commission's ruling, the Court of Justice could impose a daily penalty with collections made through adjustments of EU subsidies to that Member State.

State Aid Update

- Accounting for Income Taxes considerations
 - Although an evolving tax topic, the underlying principles of accounting for uncertain tax positions apply.
 - To the extent the State Aid was presented as a reduction in income taxes, the matter should be treated the same as any uncertain income tax position.
 - Determine if technical merits are MLTN.
 - If MLTN, measure and recognize the largest amount of tax benefit greater than 50% likely to be realized upon settlement.
 - Subsequent changes in judgment that lead to changes in measurement should result from evaluation of new information.
 - Consider disclosure requirements for the unrecognized benefits and timing.

State Aid Update

- Other considerations
 - Historically, tax rulings were not investigated by the Commission thus many companies considered their tax positions to be Highly Certain.
 - General perception dating back to June 2013 was that only a few rulings would be investigated by Commission.
 - In June 2015, the Commission requested tax ruling information from another 15 EU Member States suggesting that there could another wave of investigations.
 - The findings to date have suggested the Commission is focused on certain facts and circumstances such as:
 - Sufficient evidence submitted and timing of the ruling to form a basis;
 - Ruling was formed through negotiations vs conformance with general transfer pricing principles that does not reflect economic reality.
 - Use of alternative transfer pricing method to more preferred method provided by OECD.

State Aid Update

- Other considerations
 - Companies that have been named in investigations should consider whether the “reasonably possible” standard as been met in disclosing unrecognized benefits.
 - US parented companies have generally disclosed that the matter is being investigated and that there is risk that the Commission will find that they company should repay the state aid.