

Fair value accounting: Tax considerations



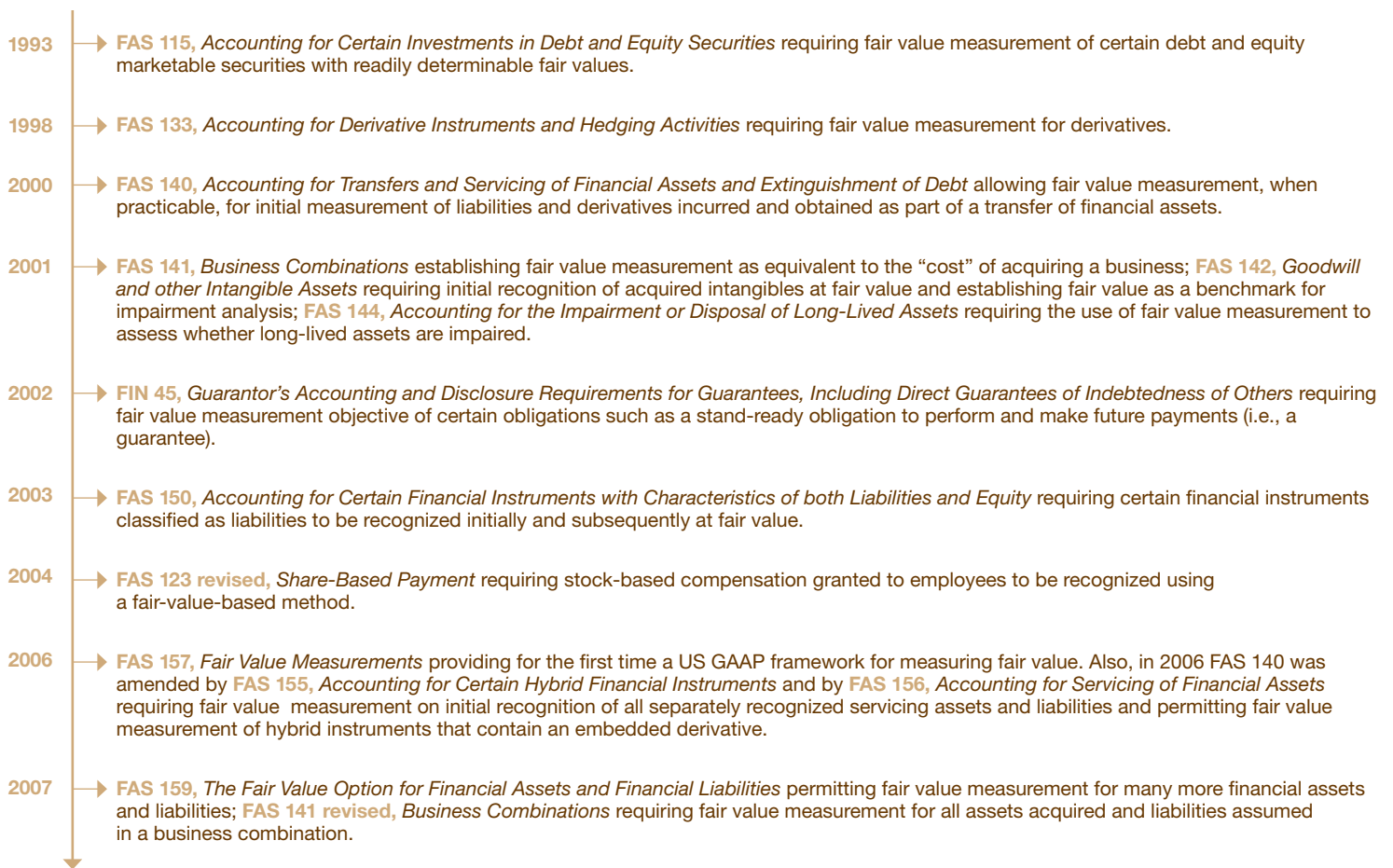
Background

Elements of fair value accounting have been used for decades in US GAAP. Although the growth of fair value accounting has been incremental, its use has accelerated in recent years as a means of enhancing financial statement quality, transparency, and relevance. An increasing variety of assets and liabilities are subject either to required or elective fair value accounting. This trend aligns with global accounting convergence, because the use of fair value measurement is even more prevalent in International Financial Reporting Standards (IFRS).

The recent turmoil in the capital and credit markets has heightened the focus on certain aspects of fair value accounting. On October 3, 2008, the US president signed into law H.R. 1424, *The Emergency Economic Stabilization Act of 2008*. Pursuant to section 133 of the

Act, the Securities and Exchange Commission (SEC), in consultation with the Treasury and the Financial Accounting Standards Board (FASB), has 90 days to study and report to Congress on the application of FAS 157, *Fair Value Measurements* to financial institutions, including depository institutions. The issuance of FAS 157 was a watershed event, providing the first US GAAP framework for measuring fair value. On October 10, 2008 the FASB issued guidance clarifying how FAS 157 should be applied in valuations of securities in markets that are not active.

The following partial timeline of US GAAP pronouncements highlights the recent evolution of fair value accounting:



Fair value accounting is not limited to financial assets or financial businesses. It can apply to any business, and with respect to a wide variety of assets, liabilities and activities including:

- Derivatives and trading activities
- Investments in trading and available-for-sale securities
- Intangibles acquired in business combinations
- Asset retirement obligations
- Impairments of long-lived assets
- Exit and disposal activities
- Pensions and other post-retirement benefit plans
- Share-based compensation
- Guarantees and indemnifications

This paper highlights the significance of the movement toward fair value accounting to those responsible for company tax matters. It addresses the trend from the perspective of each of several diverse areas in which tax matters intersect with fair value measurement. The importance of coordination around these topics on a fully integrated basis, across company management functions, is underscored.

Effects of tax considerations on fair value measurements

Tax considerations can have a direct effect on the use of the income (or discounted cash flows) valuation approach for fair value measurements used in financial accounting. For example, tax amortization benefits, which are the cash flows expected from tax depreciation or amortization deductions, 1) are generally included in the assigned value of an asset acquired in a business combination and 2) may be considered when performing tests for impairment under FAS 142 and 144. Tax benefits associated with assumed liabilities are likewise to be considered.

Fair value measurement should reflect tax amortization benefits irrespective of whether the particular owner acquired the asset in a manner that provides amortizable

tax basis, or whether the owner is a tax paying entity, and regardless of an owner's loss or credit carryforwards. That is, the benefits are included from the viewpoint of a neutral "market participant" (or third party). Consideration may similarly be given to tax planning strategies that would typically be available to a market participant.

At the same time, however, the tax benefits should reflect the tax laws of the jurisdiction(s) that applies to the assets or liabilities. If there are no tax benefits possible (in any circumstance) under the relevant jurisdiction's tax laws, the fair value measurement should not include tax benefits. When the relevant tax laws provide for tax benefits, the timing and amount of tax benefit cash flow should be considered.

It is also important to consider that the tax laws governing purchase price allocations in taxable business acquisitions or in certain asset exchanges may not follow applicable book principles. There may be different valuation approaches or models that are permitted or required under the tax laws. In addition, for financial reporting purposes, goodwill impairment testing is performed on a reporting unit basis which typically reflects an assignment of assets and liabilities across legal entities.

An assessment of potential fair value measurement may be needed for contingencies relating to taxes that are not based on income (e.g., sales and use, property, gross receipts, VAT, duties and excise taxes). FAS 141(R), the new standard on business combinations (effective in 2009 for calendar year companies), requires fair value measurement for certain acquired contingencies. On December 15, 2008, the FASB released a proposed amendment limiting that measurement to contingencies having a fair value that can be "reasonably determined" and providing guidance for making that assessment. If fair value can not be reasonably determined, initial recognition and measurement should be determined in accordance with the guidance for contingencies outside of a business combination. Disclosure will be required of the nature of recognized contingencies and, if not measured at fair value, the reason that fair value could not be reasonably determined.

Tax personnel should be sufficiently engaged to identify and analyze the relevant tax laws applicable to valuations and purchase price allocations. This includes consideration of income tax rates that would be expected to apply to recover an asset and settle a liability as well as an assessment of acquired non-income-based tax exposures. A timely and thorough review of such tax matters will reduce the likelihood that reported financial statements will need to be revised.

Effects of fair value measurements on cash taxes

The tax consequences of fair value measurements may be significant in jurisdictions that have net worth taxes instead of, or in addition to, income tax. For example, some state and local jurisdictions in the United States have taxes based on net worth or equity, including certain franchise taxes for the privilege of doing business in the jurisdiction. There are also foreign jurisdictions that have hybrid tax systems under which the tax payable is based on a measurement of net income or net assets, whichever produces more tax revenue. To the extent such taxes are based upon capital value or financial statement shareholders' equity, fair value measurements will directly impact cash taxes payable.

Even within an income tax system, particular items of income or deduction may be affected by fair value accounting measurements. For example, US federal tax law permits dealers in securities and/or commodities to mark-to-market their assets using fair values reported in eligible financial statements. The IRS is now considering expanding the definition of eligible financial statements to include financial statements prepared under IFRS. If adopted, financial institutions with headquarters outside the United States that pay US taxes (through a US branch or a subsidiary) will be allowed to use their IFRS fair value measurements when they elect for US federal tax purposes to mark-to-market such assets.

Effects of fair value accounting on income tax accounting

The US GAAP and IFRS accounting for income tax standards (FAS 109 and IAS 12, respectively) currently require a "balance sheet" approach to recognizing and measuring deferred income taxes. The book carrying amounts of assets and liabilities reported on a balance sheet are compared with their tax bases and the resulting differences, with limited exceptions, are considered taxable or deductible temporary differences. To the extent that fair value measurements impact book carrying amounts, the measurements thereby affect the calculation of temporary differences and recognition of deferred taxes.

Volatilities in the US and global capital markets have made fair value measurements all the more significant to accounting for income taxes. Consider, for example, the FAS 115 requirements. That standard requires that certain equity and debt securities with readily determinable fair values be marked-to-market periodically, with an offsetting entry to income (for securities classified as trading), or to other comprehensive income (for securities classified as available-for-sale). Periodic adjustments to the book carrying amount of a security without corresponding adjustments to the security's tax basis affect temporary differences and deferred taxes. During periods of volatility in market pricings, the impact on deferred taxes can be significant.

Market volatility in some cases can even have a material impact on the enterprise's effective tax rate. Consider an available-for-sale, marketable debt security that has suffered other-than-temporary impairment (OTTI) in value because of the issuer's credit risk. Although, OTTI is recognized in income, it may not be deductible on a tax return until the unrealized loss is realized through a sale, liquidation, or other disposition. In that case it would create a deductible temporary difference and a deferred tax asset that must be assessed for realization. To the extent the asset requires a valuation allowance (or, in IFRS accounts, cannot be recognized), there will generally be an impact on the effective tax rate.

Consider, similarly, an equity security that had previously appreciated in value. The unrealized book gain represents a taxable temporary difference for which a deferred tax liability was recognized. If the value of that security “flips” to below its tax basis (e.g., original cost), the unrealized book loss represents a deductible temporary difference for which a deferred tax asset is recognized, subject to a valuation allowance assessment. If the deferred tax liability that previously existed was a source of income that supported a conclusion that a valuation allowance was not necessary, the reversal in value has a dual impact: it removes a potential source of income and it increases the total deferred tax assets potentially requiring a valuation allowance.

Similar consequences may arise, for example, with respect to a financial institution that has elected under FAS 159 to apply the fair value option to measuring its own debt obligations. Likewise, pursuant to FAS 159, an entity may elect to fair value an investment that has been accounted for under the equity method of accounting. In each of these (and many other similar) circumstances, fair value measurements will affect deferred taxes. A decline in the value of an issuer’s debt would result in a deferred tax liability that could support deferred tax assets related to other items; whereas, a decline in the value of an equity method investment could precipitate the need for a valuation allowance.

Several of the changes introduced by FAS 141(R) could result in greater earnings volatility in connection with, and following, an acquisition. The new standard places greater emphasis on fair value accounting and in differentiating acquisition accounting from accounting for acquirer-specific and post-acquisition events. Similar revised principles will go into effect (in 2010 for calendar year companies) under IFRS, though the IFRS revisions are not as significant in relation to IFRS principles already in effect. Key changes driven by fair value measurement objectives include accounting for deal costs and restructuring charges as costs outside the business combination and the recording of acquired

in-process research and development, replacement stock options, certain contingencies and earn-outs at fair value. Increased volatility can be expected both in pretax earnings and in effective tax rates.

With respect to share-based compensation, FAS 123(R) requires the recording of anticipated future tax benefits relating to various awards that are recorded using a fair-value-based method as they vest. Prior to fair value share-based compensation accounting, tax benefits generally would have had impact only on shareholders’ equity. As a result of fair value pre-tax accounting, impacts on the effective tax rate will vary depending on the nature of the transactions. At the same time, however, one aspect of share-based compensation deferred tax accounting is especially worth noting in relation to current market conditions. That is the principle under US GAAP that respective deferred tax assets are not to be re-measured or derecognized based on the increase or decline in the fair value of the award. Notably, this principle differs from IFRS wherein tax benefits are generally reported (or re-measured) based on the fair value of the stock at each reporting date. Under IFRS deferred taxes are adjusted over the life of the award based upon increases or decreases in the fair value of the stock.

Disclosure considerations, although always important, should receive additional attention because of the impacts of current market conditions. The distressed markets and liquidity crisis are impacting investment portfolios, causing impairments of other business assets, including goodwill, and affecting the value of share-based compensation awards. Related transparency for deferred tax assets should be considered. In a number of instances in recent months, the SEC staff has required companies to provide additional disclosure for the evidence and analysis applied to deferred tax benefits. Overall disclosures should be carefully considered and aligned with disclosed business risks and relevant pretax accounting.

Effects of fair value accounting on tax planning

Fair value accounting can have tax strategy and planning implications. In business acquisitions under FAS 141(R), for example, in-process R&D will be capitalized at fair value. As a result, subsequent taxable transfers or cost-sharing related to those R&D projects may need to be analyzed with reference to such fair values. Companies should assess and document any departures from such reported values for transfer pricing purposes. Fair value measurements will also be applied to more acquired liabilities and contingencies and to contingent purchase price arrangements. It will be important to assess and differentiate any associated tax analyses of those matters. For example, tax personnel should consider whether liabilities have been assumed (thereby creating additional tax basis goodwill) in a taxable acquisition, rather than being subsequently accrued (and currently deductible) for tax purposes.

Tax planning for compensatory share-based award programs needs to be approached with care so that effective tax rate benefits are sufficiently certain. This includes emphasis on compliance with various tax qualification rules for domestic awards programs, as well as establishment of effective cross-border chargeback arrangements to support tax benefits available outside the United States.

On an overall basis, the use of fair value measurements may affect debt-equity ratios and other financial metrics. These metrics may have tax impacts in areas such as inter-company pricing and inter-company debt. The implications of those ratios and metrics on transfer pricing and interest deductibility can vary across tax jurisdictions.

Fair value accounting can also apply to a company that indemnifies another company's tax obligations. Tax indemnifications might arise in a sale of a business, a spin-off, a joint venture or similar transactions. When the indemnifying party (or guarantor) is not legally obligated (under the tax law) to pay taxes covered by an indemnification agreement, FIN 45 may apply to require the guarantor to recognize a liability for the fair value of the guarantee at inception.

It is important for company tax personnel to understand, both on a detailed and broader basis, the potential impact of fair value accounting on tax planning and structuring. Consideration may need to be given to the effects on previously established tax plans, as well as on anticipated planning and budgeting of effective tax rates. As for indemnifications, company tax personnel should be working together with legal counsel as well as those involved with corporate development or transactional planning.

Conclusion

Tax management can, and should, play a significant role in assessing the various dimensions of fair value accounting. It is important for tax management to be closely involved in the consideration of pretax accounting analyses, fair value accounting measurements, due diligence for transactions, and the cash and tax planning implications of fair value accounting. Recent market volatilities serve to heighten the focus on and possibly make even more significant the need for careful tax management input and assessment. The continued movement towards fair value accounting brings with it a variety of implications best managed through appropriate coordination across company functions.

Contacts

The article is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of Fair Value Accounting:

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