Mergers & acquisitions — a snapshot
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Cross-border acquisitions
Accounting considerations relating to income taxes

Lower foreign tax rates and accumulated offshore cash have contributed to the growing appetite for international expansion through cross-border M&A transactions. The acquisition of a foreign business by a U.S. multinational, however, can introduce complex financial reporting issues when accounting for income taxes. For example, the fair value of certain assets recognized under the M&A Standards will need to incorporate tax amortization benefits. The recognition of deferred taxes and uncertain tax positions will have a direct impact on the amount of goodwill recognized and, as a result, affect pre-tax earnings in future periods through any goodwill impairment charges.

A thorough understanding of the foreign target’s operations and tax structure is needed to understand the legal entity in which the acquired assets reside, the relevant taxing jurisdictions, and applicable tax rates that may impact the recognition of deferred taxes. In addition, buyer-specific plans related to existing or acquired unremitted foreign earnings may trigger a tax liability. Further, evaluating whether post-acquisition transactions or elections are included in acquisition accounting or reported in earnings can require a significant amount of judgment.

This edition of Mergers & acquisitions — a snapshot is the third in our series focused on cross-border acquisitions and provides insight into the complexities and judgments in accounting for income taxes in cross-border M&A deals.

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1 Accounting Standards Codification 805 is the U.S. standard on business combinations, and Accounting Standards Codification 810 is the U.S. standard on noncontrolling interests (collectively the “M&A Standards”).
### Transaction costs

Transaction costs incurred for an acquisition are immediately expensed under the M&A Standards. Timing differences between the periods in which such costs are expensed under the M&A Standards and deducted (if allowed) for tax purposes may result in the recognition of a deferred tax benefit.

Transaction costs incurred for a cross-border acquisition can present issues in determining which taxpayer should account for such costs. For instance, a U.S. parent may incur costs for an acquisition that it effects through a wholly-owned foreign subsidiary. Determining which taxpayer should account for such costs may depend upon which taxpayer benefitted from the costs, which entity received the services, which taxpayer was obligated to make a payment, and consideration of any reimbursement arrangements in place. Deferred taxes recognized for transaction costs need to be recognized in the appropriate jurisdiction using the applicable tax rate.

The type of transaction costs may also require identification. Success-based fees (i.e., fees contingent on successful closing of an acquisition) are subject to a safe-harbor election in the U.S. federal tax system that allows the buyer to irrevocably elect to deduct 70% of all success-based fees incurred, with the remaining 30% capitalized.

Deferred taxes for transaction costs are required to be included in earnings (i.e., outside of acquisition accounting), and may lead to volatility in the buyer’s effective tax rate.

### Tax amortization benefits

The acquisition of a foreign business is typically structured to be non-taxable. In a non-taxable acquisition, there is generally no “step-up” in the tax basis of assets in the foreign jurisdiction. Nonetheless, the fair value of an intangible asset recognized under the M&A Standards should reflect expected “tax amortization benefits” (TAB). That is, the present value of the intangible asset’s projected cash flows should reflect the tax benefit that would result from amortizing the hypothetical tax basis in the intangible asset, regardless of whether the particular acquisition was taxable or non-taxable.

The expected TAB should reflect the tax rate of the jurisdiction(s) in which the asset resides, as well as the tax amortization period prescribed under those tax laws for the asset. Accordingly, calculation of the TAB involves much of the same analysis that is performed when establishing deferred taxes, as discussed below.

### Complexities in establishing deferred taxes

Differences between the financial reporting basis and tax basis of assets acquired and liabilities assumed may result in taxable or deductible amounts in future years when the asset is recovered or the liability is settled. This gives rise to deferred taxes, which should be recorded in acquisition accounting. An acquisition of a foreign business often entails unique issues when measuring a deferred tax asset (DTA) or deferred tax liability (DTL) that should be carefully evaluated. These and other acquisition related income tax effects impact the amount of recognized goodwill.

The following table lists some key issues to consider when establishing deferred taxes in cross-border M&A transactions.

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### Reporting unit versus legal entity purchase price allocation

Purchase price allocations under the M&A Standards are generally performed at a higher level (i.e., reporting unit level) than the level required for tax purposes (i.e., legal entity level). A foreign target may have established multiple legal entities in different tax jurisdictions to hold certain assets, which may not be readily apparent from the target’s financial statements. While the overall valuation may not have been performed on a legal entity basis, a more granular allocation of the purchase price to the legal entity level will be required for tax purposes.

In situations where multiple legal entities reside in different tax jurisdictions but are accounted for in one reporting unit for financial reporting purposes, deferred taxes will need to be measured based on the enacted tax rate for each legal entity in which an acquired asset or assumed liability resides. For legal entities subject to taxation in multiple jurisdictions, such as those having foreign branches, deferred taxes would typically be provided for all jurisdictions.

The following example highlights how the purchase price allocation on a legal entity basis can impact the measurement of deferred taxes recognized in acquisition accounting.
thereby transfer While legal ownership of an intangible asset may reside recognition and measurement of deferred taxes. legal entity to ensure that there is a process in place identified with one specific legal entity. subsidiaries legal entity (e.g., customers not assets reside rights subsidiaries A foreign target may hold several tiers of foreign certain assets or licenses to the rights to certain assets. Identifying where the acquired assets reside on a legal or taxpaying entity basis is often not a straightforward exercise. For instance, a customer relationship asset that creates value for more than one legal entity (e.g., customers serviced by two or more subsidiaries in different jurisdictions) may not be clearly identified with one specific legal entity. A buyer will want to ensure that there is a process in place to identify the legal entity associated with such assets for proper recognition and measurement of deferred taxes.

While legal ownership of an intangible asset may reside with one entity, arrangements between legal entities may transfer “economic ownership” of certain assets, and thereby ownership for tax purposes. Judgment may be required to determine whether an arrangement transferred the ownership risks and rewards of an intangible asset through a sale or whether the arrangement constituted a licensing arrangement granting the right to use the intangible asset.

The specific location and relevant tax law is important to understand as certain jurisdictions may limit or even prohibit tax amortization (e.g., goodwill may be non-deductible). Tax holiday and similar special incentive arrangements can also have an impact on the applicable tax rate and the measurement of deferred taxes. In addition, consideration should be given to whether the acquired entities are subject to a “dual-rate” for earnings that are distributed to a foreign parent. Tax credits or surcharges that would be triggered when earnings are distributed may need to be considered in the measurement of deferred taxes.

Assessing the need for a valuation allowance on deferred tax assets

A valuation allowance (VA) is recognized for acquired DTAs that are considered not realizable. A thorough understanding of the foreign tax laws and the nature of the foreign target’s operations is necessary when evaluating whether it is “more likely than not” that acquired DTAs will be realizable. For instance, certain foreign tax jurisdictions may limit (or prohibit) the ability to realize acquired foreign net operating losses (NOLs) post-acquisition. In contrast, some jurisdictions provide an unlimited carryforward period for acquired foreign NOLs. Tax structures (e.g., cost-plus structures) and transfer pricing arrangements should also be considered when evaluating whether a VA is needed for acquired DTAs.

A buyer’s existing DTAs may also be impacted by a foreign acquisition. For instance, a buyer may be able to release a VA on a foreign tax credit carryforward DTA due to increased future foreign source income. The tax effects of changes in VA on the buyer’s existing DTAs will be recognized in earnings.

Uncertain tax positions

Income tax uncertainties may be assumed by the buyer or created by the acquisition. Uncertain tax positions may arise from the buyer’s purchase price allocation for tax purposes or with respect to tax positions taken in the pre-acquisition tax returns that may be challenged by the foreign taxing authorities. The interpretation of complex tax laws and regulations in foreign jurisdictions should be considered when determining whether a liability for an uncertain tax position should be recognized in acquisition accounting. Subsequent changes or settlements of uncertain tax positions may impact earnings and the effective tax rate.

Example 1 – Reporting unit versus legal entity purchase price allocation

Facts: Company A completes an acquisition of a foreign business, which is accounted for as a business combination under the M&A Standards. The acquisition includes intellectual property (IP), recorded at $1 million. The purchase price (including the IP) is allocated to Company A’s reporting unit (which operates in a jurisdiction with a 35% tax rate) for financial reporting purposes. However, it is determined under the applicable tax laws that the IP is 50% owned by legal entity FS1 and 50% owned by legal entity FS2. The tax basis of the IP is zero. FS1 is located in a jurisdiction with a 10% tax rate, and FS2 is located in a jurisdiction with a 20% tax rate.

Analysis: The acquired IP results in a temporary difference because its financial reporting basis ($1 million) exceeds its tax basis ($0). This will result in a DTL being recognized in acquisition accounting, which impacts the amount of goodwill recognized in the acquisition. If Company A used the 35% tax rate in the jurisdiction where the reporting unit is located, it would overstate the measurement of the DTL (as well as goodwill) and understate the effective tax rate in future periods. Instead, the DTL should be measured using the applicable tax rate in the jurisdictions in which the asset will be recovered. In this example, Company A would measure the DTL using the 10% tax rate for FS1 and the 20% tax rate for FS2.

The purchase price may also differ for book and tax purposes. For instance, contingent consideration and certain liabilities may be treated differently under tax laws than under the M&A Standards. Different purchase prices will lead to different amounts allocated to reporting units, legal entities, and assets (including goodwill) that may result in deferred taxes.

Identifying the relevant tax jurisdiction and rate

A foreign target may hold several tiers of foreign subsidiaries that hold certain assets or licenses to the rights to certain assets. Identifying where the acquired assets reside on a legal or taxpaying entity basis is often not a straightforward exercise. For instance, a customer relationship asset that creates value for more than one legal entity (e.g., customers serviced by two or more subsidiaries in different jurisdictions) may not be clearly identified with one specific legal entity. A buyer will want to ensure that there is a process in place to identify the legal entity associated with such assets for proper recognition and measurement of deferred taxes.

While legal ownership of an intangible asset may reside with one entity, arrangements between legal entities may transfer “economic ownership” of certain assets, and thereby ownership for tax purposes. Judgment may be
U.S. taxation of foreign earnings

The difference between the financial reporting basis and tax basis of an investment in a foreign entity is referred to as the “outside basis difference.” Deferred taxes recognized for outside basis differences will often depend on buyer-specific assertions. For instance, when the financial reporting basis exceeds the tax basis (i.e., there is an excess of book-over-tax outside basis difference), a buyer may assert that it has the intent and ability to indefinitely prevent the outside basis difference from reversing with tax consequences (i.e., indefinite reinvestment assertion). This would result in no DTL recognized for the outside basis difference in acquisition accounting.

If the buyer does not have the intent and ability to avoid a tax consequence on an outside basis difference, a DTL would be recorded taking into account factors that impact the expected tax burden, such as (i) unrecognized foreign tax credits that would reduce the tax burden when incurred, (ii) foreign withholding taxes that would be triggered upon the distribution of earnings, and (iii) potential dividends received deductions (if the difference is expected to be recovered through dividends).

An acquisition may impact the buyer’s existing indefinite reinvestment assertions related to unremitted earnings in foreign subsidiaries owned prior to the acquisition. For instance, if an acquisition is funded by repatriating unremitted earnings that were previously considered indefinitely reinvested, the tax effect of the change in assertion will be recognized in earnings. As this assertion reflects an “intent and ability” based model, the timing of such reversal (and related earnings impact) will need to be carefully evaluated. Additionally, a change in the assertion may make it more challenging to continue to support the indefinite reinvestment assertion related to the remaining foreign earnings that were not remitted by the buyer.

The tax basis and financial statement carrying amount of the investment in the acquired foreign entity are typically both fair value at the acquisition date. Therefore, any potential outside basis difference on the acquisition date may be inconsequential. However, a buyer’s assertions on the acquisition date and thereafter will impact the recognition of deferred taxes for post-acquisition earnings and other outside basis differences that arise. This can include the effects of intercompany debt between the buyer and foreign target.

The following example illustrates the potential tax effects from intercompany debt.

Example 2 – Intercompany debt

Facts: Company A (USD functional currency) completes an acquisition of a foreign entity (EUR functional currency). Company A funds the acquisition with $100 million in debt borrowed from a third-party bank. Company A and the foreign target enter into an intercompany debt arrangement that mirrors the terms with the third party bank. The intercompany debt is denominated in EUR, and Company A asserts that settlement of the intercompany debt is not planned or anticipated in the foreseeable future (i.e., considered a long-term investment in nature).

Analysis: Pursuant to Company A’s assertions, the intercompany debt would likely be treated as permanent capital and viewed as part of the net investment in the foreign target. Accordingly, foreign currency translations, and the related deferred tax effects, would likely be considered a component of the outside basis in the foreign target. The recognition of deferred taxes, therefore, would depend on whether Company A has the intent and ability to assert the indefinite reinvestment assertion (i.e., prevent the outside basis difference from reversing with tax consequences). Assertions made for financial reporting purposes, in this case with respect to the intercompany debt, should align with assertions submitted to the relevant taxing authorities for positions taken on the tax return.

The deferral of U.S. taxes may not always be within the buyer’s control, and the recognition of deferred taxes would be required despite a buyer’s intention to indefinitely prevent the outside basis difference from reversing with tax consequences. The U.S. “Subpart F” tax rules require certain types of income to be currently taxable. Unlike portions of the outside basis difference for which the buyer may be able to control the timing of taxation simply by avoiding repatriations of cash, the taxation of Subpart F income upon reversal of certain temporary differences may not be controlled by the buyer.

There may also be scenarios in which a buyer asserts that it will indefinitely reinvest a portion of the outside basis difference related to certain operations and not others. This may give rise to additional complexities when isolating the portion that is not indefinitely reinvested in order to measure the DTL. Justification of a partial indefinite reinvestment assertion will need to include sufficient evidence and plans to support the assertion.

The taxation of foreign earnings may also be impacted by U.S. tax election to treat a non-taxable acquisition as a taxable acquisition. The step-up in tax basis for U.S. tax purposes will impact the tax consequences expected when foreign earnings are ultimately subject to U.S. taxation. This may impact the measurement of deferred taxes when not asserting indefinite reinvestment.
Other post-acquisition issues

It is not always clear whether the related tax effects of certain post-acquisition transactions or elections should be recognized in acquisition accounting or outside of acquisition accounting. Examples of such transactions may include (i) the transfer of IP, which may trigger certain tax effects, (ii) the migration of operations into different jurisdictions that trigger exit taxes, (iii) certain intercompany transactions, (iv) elections to change the tax status of foreign entities (e.g., converting controlled foreign corporations to branch operations), (v) certain mergers provided for under foreign tax law, and (vi) certain elections to treat a non-taxable acquisition as a taxable acquisition.

Post-acquisition transactions not recognized in acquisition accounting may impact earnings and create volatility in a buyer’s effective tax rate. Determining whether post-acquisition transactions or elections should be recognized in acquisition accounting requires careful consideration of specific facts and circumstances. The following table provides some of the factors that can affect these determinations.

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<thead>
<tr>
<th>Evaluating the tax effects of post-acquisition transactions/elections</th>
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<td>2) Whether the election or transaction is primarily within the buyer’s control with no significant uncertainties as to completion</td>
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<td>3) Whether the election or transaction requires a separate payment to be made to obtain tax benefits</td>
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The acquisition of a foreign business may also result in a significant amount of foreign currency denominated DTAs and DTLs. Post-acquisition, this may increase foreign currency risk resulting in higher volatility in the buyer’s cumulative translation account or earnings (depending on the functional currency of the entities involved). The related tax effects of the foreign currency movements will need to be carefully considered.

In summary

Cross-border M&A deals can raise a number of unique reporting issues relating to income taxes. Considerable due diligence is necessary to evaluate the differences between the M&A Standards and the relevant tax law(s) in the applicable foreign jurisdictions. Post-acquisition transactions and elections offer another set of challenges in deciphering what is recognized within versus outside of acquisition accounting. Teaming interdisciplinary skill sets of valuation, accounting, and global tax expertise will likely be the best way to anticipate and manage these issues in a coordinated manner.

For more information on this publication please contact:

John Glynn
Valuation Services Leader
(646) 471-8420
john.p.glynn@us.pwc.com

Henri Leveque
Capital Markets & Accounting Advisory Services Leader
(678) 419-3100
h.a.leveque@us.pwc.com

Ken Kuykendall
Global & U.S. Tax Accounting Services Leader
(312) 298-2546
o.k.kuykendall@us.pwc.com

Principal authors:

Lawrence N. Dodyk
U.S. Business Combinations Leader
(973) 236-7213
lawrence.dodyk@us.pwc.com

Edward Abahoonie
National Professional Services Group Partner
(973) 236-4448
edward.abahoonie@us.pwc.com

Brian Staniszewski
National Professional Services Group Director
(973) 236-5122
brian.staniszewski@us.pwc.com
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