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Tax indemnification arrangements: Navigating the financial reporting

Tax Accounting Services

Income tax indemnifications are established in a variety of transactions, including business acquisitions, corporate spin-offs and initial public offerings (IPOs). Accounting for an income tax indemnification arrangement depends upon whether the company is obligated to the taxing authority, the relationship between the parties and the type of transaction. This paper provides a framework to apply in determining the appropriate accounting.

General direction of tax indemnification arrangements

Sale of a subsidiary that previously filed a separate tax return	**Seller**	→	**Buyer**
Sale of a subsidiary that previously filed as part of a consolidated tax return	**Seller**	→	**Buyer**
Spin-off, IPO or carve-out of an entity that previously filed a separate tax return	**Previous owner**	→	**New entity or shareholders**
Spin-off, IPO or carve-out of an entity that previously filed as part of a consolidated tax return	**Previous owner**	↔	**New entity or shareholders**

Background

Income tax indemnifications are contractual arrangements between two parties whereby one party will reimburse the other for income taxes paid to a taxing authority related to tax positions that arose, typically, prior to the transaction in which the indemnification was established. Common scenarios in which an indemnification is provided, and the general direction of the arrangements, are illustrated above.

It should be noted that the framework highlighted in this paper may differ from the accounting that applies to insurance coverage or to indemnification arrangements in commercial or financing transactions such as leases. The accounting for such arrangements and transactions is not addressed in this paper.

While the income tax accounting principles (ASC 740) do not apply to taxes other than income taxes, the other elements of this framework may be applied with respect to indemnifications for such taxes.

Accounting by the indemnifying party

Determining the applicable accounting model

The applicable model will determine the initial accounting, as well as subsequent changes in the recognition and measurement of the liability throughout the term of the arrangement. To determine the appropriate accounting, consideration should be given to whether there is an obligation to the taxing authority, the attribution of any such obligation and the relationship between the parties to the arrangement.

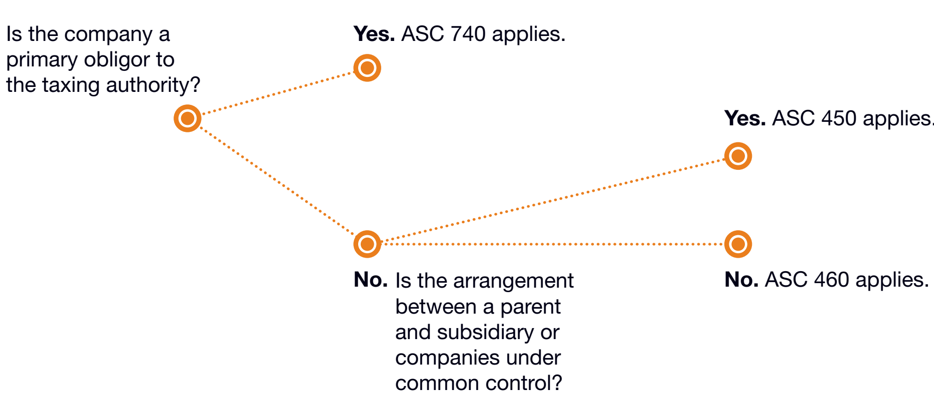
The indemnifying party should determine whether it is a *primary* obligor to the taxing authority. If an entity that previously filed a separate tax return is sold to a third party or spun off to shareholders, the determination may be clear. For example, when a U.S. company sells its interest in a foreign subsidiary, the consolidated enterprise generally has no legal obligation to pay back taxes in the foreign jurisdiction subsequent to the sale. The determination may be less clear, and more than one party may be considered a primary obligor, in situations when the transferred entity was previously included as part of a consolidated return.

If a company is a primary obligor to the taxing authority, it should account for the indemnification pursuant to the provisions within ASC 740, Income Taxes (ASC 740), dealing with accounting for uncertain tax positions. These provisions set out a two-step recognition and measurement approach. A liability is recorded for the full amount of a position that is not considered more-likely-than-not to be sustained upon examination based on its technical merits. For positions more-likely-than-not to be sustained, a liability is recorded for the difference between the tax benefit claimed and the largest amount of benefit that is greater than 50% likely of being sustained. The possibility of offset with other positions should not be considered when assessing an individual tax position. Further, an entity should assume that the taxing authority will examine the position with access to all relevant facts and information. The resulting liability for unrecognized benefits is recorded on an undiscounted basis. The same principles apply when the unrecognized benefits reduce a tax asset (e.g., loss carryforward), rather than being recorded as a liability.

If an indemnifying party is not a primary obligor to the taxing authority, it should account for the indemnification pursuant to ASC 460, Guarantees (ASC 460), which requires the use of fair value based upon the guidance in ASC 820, Fair Value Measurements and Disclosures (ASC 820). The scope of ASC 460 does not include an indemnification issued between a parent and its subsidiary or between companies under common control. If a parent indemnifies a subsidiary prior to a spin-off, a decision to retain the guarantee subsequent to the spin-off is considered the equivalent of a new guarantee established at the date of the transaction when the parent-subsidiary relationship no longer exists. As a result, ASC 460 would apply subsequent to the spin-off.

A company should account for the indemnification pursuant to ASC 450, Contingencies (ASC 450), if the ASC 460 parent-subsidiary scope exception applies. In a partial IPO, for example, a parent may sell a minority ownership stake in its subsidiary but retain control of the subsidiary. As a result, the parent-subsidiary scope exception applies and the company should follow ASC 450, which generally requires an accrual for a loss contingency when the loss is probable and reasonably estimable.

The path to the relevant accounting guidance



Accounting under ASC 460—fair value considerations

Companies will often use a discounted cash flow approach to determine the fair value of a guarantee. Management will need to make various assumptions including the date or a range of potential dates the liability will be resolved, the amount or a range of potential future cash flows, the probabilities associated with the potential resolution dates and potential future cash flows, and the appropriate discount rate to apply. These assumptions will impact the fair value of the indemnification, but do not change the amount owed by the reporting entity (i.e., the indemnifying party) to the third party. As a result, while payment of the liability may result in a tax benefit for the reporting entity, tax benefits are generally not considered in determining the fair value of the liability.

Management's assumptions may differentiate between positions for which the taxing authority has asserted an adjustment (or is in the process of reviewing a position) and those that are not under examination. For positions in the former category, the entity may be better able to estimate a range of resolution dates and potential cash flows. For positions that have not yet been examined, management may face more uncertainty when evaluating the range of resolution dates and potential cash flows.

Fair value is a market-based measurement and therefore cash flow projections used in the analysis should be those that a market participant would assign to the liability as opposed to the company's own specific assumptions. For example, a company would not necessarily incorporate its own specific past practices in negotiating settlements with the taxing authority. A company may need to incorporate more or different possible outcomes into the fair value analysis than would be considered under ASC 740.

Companies will also need to consider other factors in calculating fair value from the perspective of a market participant, such as the appropriate discount rate. For example, it may not be appropriate for a company to use its internal borrowing rate to calculate the time value of money unless it is consistent with the rate that would be used by a market participant.

Entities that previously filed as part of a consolidated return

Unique considerations may arise when, for example, a subsidiary that was previously included as a member of a consolidated federal income tax return is spun off to its parent's shareholders. In such a case, the subsidiary may agree to indemnify the parent for any income taxes that the parent may be assessed related to the resolution of the subsidiary's prior uncertain tax positions. Because the entities were previously included as part of a consolidated return, both the parent and the subsidiary may be considered primary obligors with respect to those positions.

The subsidiary, however, generally should not record a liability for the income taxes related to the parent's (or other former group members') operations. Although legally it may be liable for its former group's taxes, the convention under U.S. GAAP is that each entity should recognize income taxes related to its own operations. Special circumstances, such as the insolvency of the parent, may require that the subsidiary account for its liability in accordance with ASC 450.

Indemnification payments

Payment of an indemnification liability will often result in a tax benefit. Thus, the liability results in a deductible temporary difference giving rise to a deferred tax asset. In a spin-off transaction or IPO, it is possible (depending upon the nature of the particular transaction) that the payment would be treated as a reduction of capital with the deferred tax effect recorded as an adjustment to equity.

Accounting by the indemnified party

The indemnified party must determine the amount to recognize for the indemnification asset. The relevant accounting guidance may vary depending upon whether the transaction is a business combination.

Business combinations

ASC 805, Business Combinations (ASC 805), provides guidance on the recognition and measurement of an indemnification asset in a business combination. The guidance requires what is sometimes referred to as "mirror image" accounting for indemnifications. The indemnified party recognizes an indemnification asset at the same time that it recognizes the indemnified item and measures the asset on the same basis as the indemnified item. Accordingly, an indemnification asset related to an uncertain income tax position is recorded on the same basis as the related liability, subject to collectability or contractual limitations on the indemnified amount, using the ASC 740 guidance. Indemnification assets recognized on the acquisition date continue to be measured on the same basis as the related indemnified item until they are collected, sold, cancelled, or expire.

Mirror image accounting applies to the extent that the terms of the indemnification arrangement fully cover the related exposure. Where that is not the case, there can be accounting differences, such as in the following scenarios:

- An income tax uncertainty relates to the timing of a deduction. For example, a tax deduction was claimed in year 1, but there is risk that the deduction should be taken over 15 years. Where the indemnification covers the implied interest cost associated with spreading the deduction over a longer period, the indemnification asset would not equal the related liability. In this case, the indemnification receivable would presumably equal only the outstanding interest accrual.
- The indemnification covers any tax exposure that exceeds a specified dollar amount. In this situation, mirror image accounting will apply only to the excess over the specified amount.

To the extent more than one accounting model may be applicable, the selection of an approach would be an accounting policy which should be applied consistently.

There may be scenarios where the terms of the indemnification fully cover the tax exposure, but the related classification or measurement may differ, such as:

- A company does not classify interest and penalties in the same line as the liability for an income tax exposure. In this situation, mirror image accounting may apply (assuming that interest and penalties are covered by the indemnification); however, the indemnification asset would mirror the total of the tax liability and the related interest and penalty accruals.
- The company records a reserve against the indemnification asset due to collection risk.

There may also be scenarios where the seller provides a blanket indemnification for taxes owed in prior years, but no specific tax positions are reserved. If no liability is recorded for tax uncertainties in the covered years, an indemnification asset should not be recognized. To the extent a liability is subsequently recorded, a respective mirror image asset would be recognized.

Another scenario to consider is when an uncertain tax position had increased a loss carryforward. In this situation, the guidance in ASC 740 requires a net presentation. For example, assume that a buyer acquires a $100 loss carryforward (tax-effected). The buyer determines that $20 of the loss carryforward is an unrecognized tax benefit and, therefore, reduces the loss carryforward asset to $80. If the seller indemnifies the buyer for the related tax exposure, the buyer would record a $20 indemnification asset even though no liability is presented.

Transactions other than business combinations

The guidance in ASC 805 is limited to business combinations and does not apply to transactions such as spin-offs, IPOs or other asset acquisitions. Accordingly, the question arises whether mirror image accounting should be applied to transactions other than business combinations.

In connection with the implementation of ASC 740 by public investment funds, certain investment management businesses approached the SEC staff for guidance on accounting for potential indemnification provided by a fund's advisor. The SEC staff indicated that the recognition of a receivable for such a contractual indemnification, to the extent of recovery of the tax accrual, would generally be an acceptable practice. The SEC staff guidance, along with analogy to the guidance in ASC 805, may, in some circumstances, support the use of mirror image accounting for indemnification arrangements arising outside of business combinations.

If mirror image accounting is not applied, the applicable accounting may be ASC 450. Generally, under ASC 450 contingent gains are not recognized prior to their realization. As a result, there may be reporting periods in which a liability is recorded for indemnified tax exposures without recognition of a respective indemnification asset.

To the extent more than one accounting model may be applicable, the selection of an approach would be an accounting policy which should be applied consistently.

Indemnification payments

The payment of an indemnified liability is offset by an indemnification payment from the seller. From the indemnified party's perspective, there would generally be no net deferred tax effect or impact on earnings or goodwill from either a book or tax perspective.

Presentation and disclosure

An indemnification asset should not be netted against the related liability. Adjustments to the indemnification asset recorded in income should be recorded in pre-tax income, not as part of income tax expense. The income tax line item is reserved for only those amounts expected to be paid to (or received from) the taxing authorities. Therefore, although dollar-for-dollar changes in an income tax liability and a related indemnification asset will offset on an after-tax basis, pre-tax income measures and a company's effective tax rate will be impacted.

Companies should ensure that unrecognized income tax benefits, even if covered by an indemnification agreement, are included in the company's annual disclosures. That is, the disclosures required for unrecognized tax benefits would not include any offset or netting for an indemnification. For example, they would be included in the tabular reconciliation disclosure of gross amounts of increases and decreases in unrecognized tax benefits and amounts that, if recognized, would affect the effective tax rate. It may be prudent to provide additional disclosure of indemnification arrangements so that financial statement readers can appropriately assess the net economic exposure to the entity.

An indemnifying party would provide disclosure based upon the applicable accounting model for the indemnification. If ASC 450 or 460 applies to what was previously an ASC 740 unrecognized tax benefit, the reclassification would be a decrease in unrecognized tax benefits reported in the tabular reconciliation.

In conclusion

The determination and application of the appropriate accounting model for tax indemnifications can be challenging. To identify and apply the appropriate accounting model, companies will likely need to involve a cross-functional group of resources. The team may include tax and financial reporting management, as well as legal counsel. In addition to addressing the underlying accounting and financial reporting controls, companies should be mindful of financial statement presentation and disclosure considerations. The framework discussed in this paper should assist management in navigating the path of financial reporting for tax indemnification arrangements.

Contacts

The paper 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 or comments.

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