Tax Accounting Services

Seven principles to consider when preparing a tax provision for subsidiary or carve-out financial statements

Businesses that prepare consolidated (or group) financial statements also often prepare separate financial statements for one or more divisions, business units and/or subsidiaries. Such statements (herein referred to as “carve-out” or “stand-alone” financial statements) can be necessitated by a pending transaction such as an initial public offering, spin-off or business combination. Alternatively, they may be required for certain statutory or regulatory filings on an ongoing periodic basis. Carve-out financial reporting is even more common outside the United States.

The preparation of carve-out financial statements can be complex and is often highly judgmental; there are limited specific accounting rules or guidance governing the composition of the carve-out entity and resulting application of U.S. Generally Accepted Accounting Principles. Preparing the tax provision for carve-out financial statements can likewise be challenging, particularly if separate financial statements (including a tax provision) have not historically been prepared. For taxable entities, the exclusion of a tax provision in such financial statements is *not* an option because a tax provision is required for the carve-out financial statements to be in compliance with FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109).

While not all-inclusive, this paper explains several key principles, which, if kept in mind, will enable preparers to manage a carve-out tax provision process more smoothly.

1. Understand the purpose of the carve-out financial statements and the corresponding pre-tax accounting

Carve-out financial statements are often guided by the legal or strategic form of a business transaction that involves capital formation, or the acquisition or disposal of a portion of a larger entity. Alternatively, the statements may be guided by regulatory requirements for certain industry-specific filings. Understanding the overall context and intended use of the statements is important in deciding which tax provision allocation “method” to apply and in aligning the application of the chosen allocation method to the pre-tax accounts.

Tax provision preparers should coordinate closely with those responsible for the pre-tax aspects of the carve-out financial statements. The tax provision should be based on the financial statement accounts that are included in the carve-out entity. Accordingly, one must fully understand the pre-tax accounts that will be included in the carve-out statements, as well as the impacts of any adjustments to such accounts, in order to reflect the appropriate income tax effects.

The tax provision can be affected by methodologies being used for revenue or cost allocations that differ from historical practices. Carve-out financial statements should reflect all the costs of doing business. That typically requires an allocation of corporate overhead expenses (and the related tax effects) to the carve-out entity—even if allocations were not previously made. Similarly, it may be necessary to allocate other expenses, such as stock-based compensation, to the carve-out entity. An appropriate methodology for determining the pool of “windfall benefits” applicable to the carve-out entity will then also need to be adopted, in accordance with FASB Statement No. 123 (R), *Share-Based Payment*.

Stand-alone financials may also reflect “push-down” accounting adjustments, which can often relate to debt obligations of the parent or other members of the reporting group. The tax provision would be prepared based upon such pre-tax accounts. Accordingly, the stand-alone entity would be assumed to have tax basis in such debt for purposes of applying FAS 109 and, as a consequence, no temporary difference or deferred tax consequence arising from the push-down.

Intercompany transactions that were formerly eliminated in the consolidated financial statements (for example, transactions between the carve-out entity and other entities in the consolidated financial statements) generally would not be eliminated in the carve-out financial statements. For example, sales of inventory to a sister company that are eliminated in the consolidated financial statements generally would remain in the carve-out statements. Accordingly, the income tax accounting for those transactions would also change. Specifically, FAS 109, paragraph 9(e) (which prescribes the accounting for the income tax effects of intercompany transactions) would not apply to such transactions in the carve-out financial statements.

Similarly, it may be appropriate to reflect in carve-out statements intercompany transaction gains (or losses) that were previously deferred in a consolidated tax return. It would be necessary to assess whether the respective income tax accounting effects are recognized in equity, in accordance with FAS 109, paragraph 36(c) or EITF Issue 94-10, *Accounting by a Company for the Income Tax Effects of Transactions among or with its Shareholders under FASB Statement No. 109*.

2. The separate return method is the preferred method

FAS 109, paragraph 40 requires that the current and deferred tax expense for a group that files a consolidated return be allocated among the group members when those members issue separate financial statements. While FAS 109 does not require the use of any particular allocation method, it does require that the method be systematic, rational and consistent with the broad principles of FAS 109. It goes on to indicate that the separate return method meets those criteria. In addition, the SEC staff has stated that it believes the separate return method is the preferred method.

Under the separate return method, the carve-out entity would calculate its tax provision as if it were filing its own separate tax return based on the pre-tax accounts included in the carve-out entity.[1] This can result in perceived inconsistencies between the tax provision of the carve-out entity and the tax provision of the consolidated group. This is acceptable, however, under FAS 109, which acknowledges that if the separate return method is used the sum of the amounts allocated to individual members of the group may not equal the consolidated amount.

For example, it is possible that the carve-out entity could recognize a deferred tax asset for a loss or credit carryforward, even if there is no carryforward on a consolidated basis (e.g., the attribute was used in a consolidated tax return). In other cases, the carve-out entity could reflect a current-year loss as being carried back against its taxable income in the carryback period, even though the consolidated group was in a loss carryforward position. In another common scenario, a valuation allowance might be necessary for the carve-out entity (because it cannot rely on the taxable income of the group) even though no valuation allowance is needed for the consolidated group. This might be the case if the carve-out entity has been generating losses while the other members of the group are profitable. Alternatively, the converse may be true: a profitable carve-out entity may require a tax provision even though the remaining members of the group are generating losses. As a result, a valuation allowance may not be needed for the carve-out entity, even though a valuation allowance is required for the consolidated group.

Because the separate return method requires the carve-out entity to prepare its tax provision as if it were filing its own separate tax return, it may be appropriate to consider whether calculations performed for the consolidated financial statements should be adjusted. For example, the state tax apportionment factors may be different for the carve-out entity than for the consolidated group. Items such as research and foreign tax credits may also be calculated differently for the carve-out entity than for the consolidated group.

The separate return method, however, is nonetheless an "allocation" of the group tax provision. Accordingly, certain aspects of historical tax provision accounting should not be changed. For example, it is generally not appropriate to revisit historical assertions made by management of the consolidated group on the basis that the assertions would have been different if made by the stand-alone entity. Thus, it would generally not be appropriate for the carve-out financial statements to reflect a different assertion with respect to indefinite reversal of investment basis in a foreign subsidiary pursuant to APB Opinion No. 23, *Accounting for Income Taxes-Special Areas*. Nor, as explained later, would it be appropriate to reassess the application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), on a stand-alone basis. Elections made in a consolidated tax return should also generally be followed in the carve-out tax provision. If the carve-out entity expects its assertions or tax elections may change in the near future (e.g., after it has been separated from the consolidated group), it may be appropriate to disclose such expectations and the estimated financial reporting impact of such a change.

1 If the carve-out entity includes multiple subsidiaries that would qualify as a consolidated (or unitary) tax group, it would be appropriate to calculate the tax provision as if the carve-out entity were filing a consolidated (or unitary) tax return for such group.

Similarly, the historical legal entity structure should generally not be recasted for purposes of the carve-out tax provision. For example, if the carve-out entity includes either newly created corporations (heretofore corporate divisions or business units) or businesses whose stock is not owned directly by an entity in the carve-out group, the historic legal entities would be considered as remaining intact for purposes of the carve-out tax provision.

3. Other Methods May Be Acceptable

Although the separate return method is the preferred method, FAS 109 does not require the use of any particular allocation method. Therefore, if a company has not previously adopted the separate return method[2] another method may be acceptable as long as it is systematic, rational and consistent with the broad principles of FAS 109.[3] One such method is the "benefits-for-loss" approach.

The benefits-for-loss approach modifies the separate return method so that net operating losses or other tax attributes are characterized as realized by the carve-out entity when those tax attributes are utilized in a consolidated tax return. Accordingly, when such tax attributes have been utilized by other members of the consolidated group, the related deferred tax asset would be eliminated and replaced by a receivable from the parent. The benefits-for-loss approach also enables the carve-out entity to consider expected sources of taxable income of the consolidated tax group when evaluating the realizability of its deferred tax assets. A valuation allowance would not be necessary in the carve-out financial statements if a valuation allowance was not required for the consolidated group. Thus, the benefits-for-loss approach may eliminate some of the perceived inconsistencies that would arise from applying the separate return method.

Because the separate return method is the preferred method for allocating income taxes to carve-out financial statements, companies should carefully evaluate whether the use of another method is appropriate. Consideration should be given to any tax sharing agreements and to whether another method provides more useful information to the users of the financial statements. Depending upon the overall circumstances, the use of another method may provide more useful information to those users.

If, however, carve-out financial statements will be included in an initial public offering with the SEC using a method other than the separate return method (for example, the "benefits-for-loss" approach), a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated using the separate return method will be required.

4. Differences between the tax allocation method and the tax sharing agreement should be reflected in equity

Companies that file consolidated tax returns often have tax sharing agreements which govern the intercompany settlement of tax obligations. Although a tax sharing agreement could be a factor in determining what method the company will use to allocate its tax provision, the tax sharing agreement does not dictate the choice of a tax provision allocation policy. In fact, it may be inappropriate to allocate an income tax provision based on a tax sharing agreement because the agreement may not satisfy the requirements of FAS 109. If a tax sharing agreement differs from the chosen method of tax allocation under FAS 109, the difference between the amount paid or received under the tax sharing agreement and the expected settlement amount based on the tax allocation method is treated as a dividend or capital contribution (i.e., recorded in equity).

5. The use of hindsight is prohibited

FAS 109, paragraph 50 indicates that hindsight should not be used when restating interim or annual periods. This guidance also applies to the preparation of carve-out financial statements; carve-out statements for multiple years are often prepared simultaneously. Accordingly, if an assertion or measurement that existed in one year changed in the succeeding year as a result of economic events, hindsight should not be used to apply the new

2 A change in tax allocation method is considered a change in accounting principle. Therefore, a change from the preferred method (i.e., the separate return method) to another method would not be appropriate. Companies should consider whether they have previously adopted a tax allocation method for other subsidiaries or carve-out entities. Generally, the same allocation method should be applied to all members of the consolidated reporting group. However, there may be instances, depending on the facts and circumstances, in which it is acceptable to apply different tax allocation methods to different members of the group.

3 FAS 109 specifies that methods not consistent with its principles include methods that a) allocate only current taxes payable to a member of a group that has taxable temporary differences, b) allocate deferred taxes using a method that is fundamentally different than the asset and liability method prescribed by FAS 109, or c) allocate no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

assertion to the prior year. For example, assume that a company is preparing carve-out financial statements for the current and prior years. If a deferred tax asset was supportable in Year 1 based on evidence that existed at that time, but as a result of subsequent losses required a valuation allowance in Year 2, it would not be appropriate to use hindsight and record a valuation allowance in Year 1. Instead, the company would record the deferred tax asset with no valuation allowance in Year 1 and then record a valuation allowance in Year 2 based on subsequent developments.

6. FIN 48 applies to the carve-out entity

Although FIN 48 does not specifically address carve-out entities, it does apply to all tax positions accounted for in accordance with FAS 109. Accordingly, for all periods in which a carve-out entity is part of a reporting group that is subject to FIN 48, it must likewise apply the provisions of that standard. The carve-out entity would not be eligible for the temporary deferral of FIN 48 granted to non-public enterprises[4] if the carve-out entity is owned by an enterprise that had adopted FIN 48 or if the carve-out financial statements are being filed with a regulatory agency in preparation for the sale of securities.

When applying FIN 48, it would generally be inappropriate for the carve-out entity to change the assumptions used historically to assess the recognition and measurement of its uncertain tax positions. The preparation of carve-out financial statements, in and of itself, should not be considered to constitute *new information* that would justify recording a change with respect to uncertain tax positions.[5] Therefore, management should generally not change the historical amounts of FIN 48 liabilities (or other unrecognized tax benefits) when preparing carve-out financial statements—even if it believes that it would have applied different assumptions for the carve-out entity on a stand-alone basis.

If the carve-out entity uses the separate return method, any changes with respect to the carve-out entity's uncertain tax positions would be allocated to the carve-out entity as if it were a separate taxpayer. If a company chooses another method, the outcome may be different. For example, in circumstances where the tax sharing agreement allocates changes relating to uncertain tax positions to the parent company, it may be acceptable to apply a modified separate return method that is more closely aligned with the tax sharing agreement. This method may in other respects be identical to the separate return method except that any subsequent changes relating to uncertain tax positions are allocated to the parent.

7. Transparent disclosures should be provided

The selection of an appropriate tax provision allocation method requires significant judgment. Accordingly, disclosures regarding the chosen policy should be sufficiently transparent to enable users of the financial statements to make informed decisions.

FAS 109, paragraph 49 requires an entity that is a member of a group that files a consolidated tax return to disclose the following in its separate financial statements:

- The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax related balances due to or from affiliates as of the date of each statement of financial position presented.
- The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group, and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which disclosures are presented.

Although these disclosure requirements are in lieu of, rather than in addition to, the general disclosure requirements of FAS 109, it is generally advisable to include a description of the types (and potentially the amounts) of significant temporary differences. In addition, if the carve-out financial statements will be filed with the SEC, the disclosures should generally be as comprehensive as if the carve-out entity were a separate taxpayer.

Similarly, FIN 48 disclosures regarding uncertain tax positions of the carve-out entity would generally be appropriate. The level of FIN 48 disclosures, however, may vary depending on the tax allocation method chosen as well as the other FAS 109 disclosures provided. For example, if income taxes are allocated to a carve-out entity using a method that provides that subsequent

4 On December 30, 2008, the Financial Accounting Standards Board issued FASB Staff Position ("FSP") No. FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*. The FSP defers the effective date of FIN 48 for nonpublic enterprises within its scope to the annual financial statements for fiscal years beginning after December 15, 2008.

5 FIN 48, paragraph 12 indicates that changes in judgment regarding recognition and measurement should result from the evaluation of *new information* and not from a new evaluation or new interpretation of information that was available in a previous period.

changes relating to uncertain tax positions are allocated to the parent company, the carve-out entity may not need to provide all the required FIN 48 disclosures. On the other hand, if the carve-out entity is allocated income taxes using the separate return method, it should generally provide all the required FIN 48 disclosures.

It is also generally appropriate to disclose any tax attributes that have been allocated to the carve-out entity that will not remain with the carve-out entity upon separation from the consolidated group. For example, there may be a separate return method deferred tax asset for a loss or credit carryforward that has been used in a consolidated tax return. Any such carryforwards or other attributes should be identified with appropriate disclosures to enable the users of the carve-out financial statements to make informed decisions.

In conclusion

Preparation of an income tax provision for carve-out financial statements can be complex. The selection of an appropriate tax allocation method requires significant judgment and many issues can arise when applying the chosen allocation method. Consideration of the key principles discussed in this paper will enable preparers to establish a solid foundation from which to build an appropriate tax provision for the carve-out entity.

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 or comments:

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