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Accounting for Income Taxes (ASC 740): Some Momentum toward Simplification



The designated body for establishing the accounting for income taxes (ASC 740) standards, the Financial Accounting Standards Board (FASB), is charged with establishing rules intended to give investors and other users of financial reports useful information for decision-making.

Unfortunately, the complexity of ASC 740 makes it difficult to hit this mark. Additionally, financial executives, with constrained budgets, often find it challenging to comply as intended.

Recently, however, the FASB has been meeting to discuss potential changes to ASC 740 and hopefully, to begin a longer-term process toward simplification. The recent meetings have focused primarily on three areas: (1) share-based compensation, (2) intra-entity asset transfers and (3) balance sheet classification.

Share-based Compensation

Currently, the tax accounting rules for stock options or similar awards provide that an excess tax benefit (commonly referred to as a *windfall benefit*) is not recognized in the company's financial statements until the company realizes a reduction in taxes payable. Further, the windfall benefit is recorded as an increase to additional paid-in-capital (APIC), rather than an income tax benefit from continuing operations. A windfall benefit occurs when the tax deduction is in excess of the share-based compensation expense recognized in the financial statements. This treatment, among other things, can create differences in tax attributes (e.g., net operating losses) reported on a tax return versus reported as a deferred tax asset in the financial statements.

Additionally, a company must track its historic windfall benefits realized (windfall or APIC pool), to determine the financial reporting when the ultimate tax deduction for a share-based compensation award is less than the tax benefit previously recognized in its financial statements (commonly referred to as a *shortfall*). When a shortfall occurs, it is recorded as a reduction to APIC to the extent a windfall pool exists, and any excess shortfall is a charge to income tax expense recorded in continuing operations.

The FASB proposal currently under consideration would require the recognition of all windfall benefits and all shortfalls within the income statement, with no impact on APIC. Further, the proposal would eliminate the existing prohibition on recognizing an excess benefit until a cash benefit is realized. The effect of these proposals eliminates the need to track the *pool* of windfall benefits.

The proposal would simplify the accounting and record keeping requirements related to share-based compensation; however, it will potentially introduce more volatility to a company's effective tax rate from the recognition of windfalls and shortfalls in continuing operations. Finally, the board agreed to pursue the recommendation to eliminate an existing rule under U.S. GAAP that requires entities to list the excess tax benefits as a cash inflow within the financing activities section of the statement of cash flows.

Intra-entity Asset Transfers

Currently, there is a prohibition on the recognition of deferred tax impacts on the intra-entity transfer of assets. For financial statement purposes, the seller defers recognizing tax expense related to the transfer until the asset is depreciated, amortized or sold to a third party. For example, tax paid by a U.S. parent on the sale of assets to an affiliate in a different tax jurisdiction, is not reported as current tax expense. Instead, the exception results in another deferred charge or prepaid tax being recorded, which is then either amortized and included in the effective tax rate over future years as the asset is depreciated, or included in the effective tax rate when it is sold to a third party.

This exception creates significant complexity as companies must separately track these asset transfers until the asset leaves the group. In an effort to simplify these rules, the FASB is proposing to eliminate this exception. Therefore, recognition of the current and deferred income tax consequences of an intra-entity asset transfer is to be required when the transfer occurs.

The FASB decided on transition methods and effective dates and agreed to propose a modified retrospective transition approach and provide proper disclosure. The disclosure should include the nature and reason for the accounting change and the effects of the change on any financial statement line item and amounts for current period. The proposal, if ultimately adopted, would make U.S. GAAP consistent with IFRS for the treatment of intra-entity transfers.

The board agreed that if the guidance is finalized, the changes would be effective for financial reporting years

beginning after December 15, 2016 (for public companies), and 2017 (for private companies). According to the FASB, early adoption would be permitted.

Balance Sheet Classification

The FASB has lastly focused its simplification efforts on balance sheet classification. Currently, the deferred taxes for each component of an entity are to be presented as a net current asset or liability and a net non-current asset or liability. The model requires deferred taxes to be classified based on the underlying asset or liability, instead of the expected reversal period in which cash taxes will be impacted. The FASB has acknowledged this requirement is both costly to apply and potentially misleading.

The FASB is proposing to require all deferred tax assets and liabilities to be classified as noncurrent. The FASB agreed to propose a prospective transition method and to require entities to provide proper disclosure. The disclosure should contain the nature and reason for the change in accounting principle. However, in lieu of disclosing the effect of the change on the balance sheet, the disclosure should note that the presented balance sheets are not comparable. The proposal, if ultimately adopted, would make U.S. GAAP consistent with IFRS related to classification.

The board agreed that if the guidance is finalized, the changes would be effective for financial reporting years beginning after December 15, 2016 (for public companies), and 2017 (for private companies). According to the FASB, early adoption would be permitted.

In Summary

These simplification proposals are a welcome effort by the FASB and if adopted, will provide some relief in dealing with the oftentimes burdensome compliance requirements under ASC 740.



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Avoiding Hazards in Transferring Carried Interests



Gifts and sales of carried interests have gained popularity as a method for intergenerational wealth transfer due to the low valuations supportable in the early stages of an investment fund. It is important to be aware of certain hazards and best practices related to transfers of these interests.

A carried interest (sometimes referred to as a *profits interest*) is typically granted to the sponsor/manager of private equity, hedge, venture, or similar funds and entitles the holder to a percentage of the fund's profits. While it may be structured in a variety of ways, holders commonly receive 20% of profits after the capital investors receive a return of their capital and, sometimes, an interest-like return. The sponsor/manager also might invest capital alongside the other investors and thereby receive a capital interest in the fund.

The sponsor/manager may grant a portion of the carried interest to key employees. Under current income tax law (Rev. Proc. 93-27), the employee generally recognizes no income upon grant if nothing would be distributed to the employee assuming a hypothetical liquidation of the fund at that time (because the investors have the right to capital return before anything is distributed to the carried interest owners).

However, if the carried interest is transferred to a member of the holder's family, the amount of the transfer for gift tax purposes equals the fair market value of the interest transferred.

Valuation Considerations

The two most commonly considered and employed methods for valuing a carried interest are the option pricing and discounted cash flow (DCF) methods, both of which have been accepted by IRS.

Although the option pricing model is less understood, it is ultimately easier to employ. At its most basic level, a call option is the right, but not the obligation, to buy an asset for a predetermined price at a future date. Call options have value to the extent that the value of the underlying asset is expected to exceed that predetermined *strike* price. Similarly, a carried interest has value to the extent that the fund is expected to realize gains from its investments.

However, there are key differences between basic call options and carried interests that need to be considered in estimating the value of the carried interest being transferred. For example, if management fees are due to the entity or interest being valued, the transfer may include an economic right that may need to be considered separately. Other potential factors that could impact the valuation include any preferential returns to be paid, management fees waived in exchange for deemed capital contributions, and the possible dilution from the acceptance of new general partners, among others. It is critical to ensure that the valuation reflects not only the legal structure and conditions in place as of the valuation date, but also the expectations for those conditions over the life of the fund.

Many of the same assumptions utilized in the option pricing model are incorporated into the DCF method. An added complexity, however, is that the timing and amount of investment proceeds expected for the fund are explicitly forecasted and, as a result, need to be estimated. In addition, while the DCF method is relatively straightforward, it involves the appraiser making a number of subjective assumptions that can have a significant impact on the valuation of the carried interest.

Finally, valuation discounts for lack of control and marketability are considered and generally applied in the valuation of a carried interest. Often these can be material given the long holding period of the interest, the lack of regular cash flows, and the volatility associated with the interest.

The value of a carried interest is typically higher (i) in more mature funds, since the fund's investments have had significant opportunity to appreciate in value, and (ii) for interests that receive management fees or other economic benefits.

Artificial Valuation Rules

Sec. 2701 of the Internal Revenue Code provides special valuation rules that may apply to gifts or sales of carried interests to family members. If this very complex provision applies, the valuation might be increased artificially by the value of any capital interest retained by the senior generation. The result could be a substantial, unexpected taxable gift. One may avoid Sec. 2701 by transferring a *vertical slice* of each interest (i.e., both a carried and capital interest). For example, transferring 25% of a capital interest along with 25% of a carried interest avoids the potential application of this artificial rule and its unexpected gift tax. You should speak with your tax advisor to determine whether this provision might apply.

Vesting

Some carried interest owners may be subject to vesting provisions, such as required continued employment.

Transferring unvested carried interests raises additional issues. If the recipient is an employee, it may be appropriate to make an election under Sec. 83(b) to recognize the value of the interest at date of grant, which typically is zero, as compensation income. Otherwise, the employee will recognize the value as of the vesting date as compensation income, which could be substantial.

If an unvested carried interest is transferred to a family member, IRS may argue that the transfer is incomplete for gift tax purposes. The transfer would become complete at the vesting date. If this view were to prevail, the appreciation in the value of the carried interest between the transfer and the vesting dates would be subject to gift tax, unraveling the wealth transfer plan.

Audit Observations

IRS concerns about carried interest valuations often revolve around the underlying assumptions used. It is important that the assumptions be well-supported and documented in any valuation. One of the most significant assumptions is the underlying value of the investments. Often, pricing information for the fund's investments is not readily available and valuations of the investments are needed. Significant, rapid, and realized increases in value of the underlying investments would be cause for IRS concern. Additionally, adjustments for lack of control and marketability without demonstrated support for the degree of the adjustment, and an analysis of the underlying factors requiring such an adjustment, are often areas of IRS focus.

Numerous complexities associated with successful transfers of carried interests require careful planning and consideration of complex tax rules, valuation assumptions, and IRS audit review processes.



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A Post-Quantitative Easing World



In December 2008, the Federal Reserve cut its target interest rate to historic lows in an effort to help revive the U.S. economy, which had struggled due to the global financial crisis.

Additionally, over the course of the past six years the Fed has engaged in three distinct quantitative easing programs aimed at stimulating economic growth. These programs have lasted much longer than originally anticipated and are only recently beginning to conclude. Current Fed Chair Janet Yellen announced the end of the third and presumably final round of quantitative easing in October 2014. U.S. equity markets have reached all-time highs while recovering from a recession that began over six years ago. However, while equity markets have experienced significant gains over that time, the recovery of the U.S. economy has lagged. What will now happen as the largest buyer of U.S. debt since 2008 is set to leave the market?

Effect of the Fed's Monetary Policy

We may not be far enough removed from quantitative easing to formulate a final opinion of the Fed's bond-buying

program and aggressive monetary policy; however it is abundantly clear that some efforts succeeded while others failed. While accomplishing some of its goals – removing subprime mortgages from banks' balance sheets, stabilizing the U.S. economy, keeping interest rates low enough to revive the housing markets and stimulate economic growth – the Fed's policies had far less of a positive impact in other areas.

Quantitative easing did not lead to a significant increase of economic output or hiring. Though the unemployment rate has declined to 5.9%, much of the decrease can be attributed to individuals leaving the workforce as evidenced by the declining labor force participation rate. Quantitative easing also did not achieve the Fed's goal of making credit more available. Banks, receiving billions of dollars of cash through the Fed's bond repurchase programs, remained wary of new regulation, consumer credit standards, and overall economic uncertainty. Consequently, many banks have been reluctant to lend to consumers and instead have used this cash for dividend payouts to shareholders and stock buybacks. Without increased lending, the expansion of the money supply has been limited and inflation has been kept at bay.

Some Fed officials are not ruling out future quantitative easing if circumstances call for such measures. As global growth rates decline (both in developed and emerging markets) and geopolitical tensions increase in many parts of the world, the Bank of Japan is resorting to quantitative easing to help solidify its economy (beginning in 2015), and there is overwhelming consensus that the European Central Bank will soon follow suit, which poses a threat to the U.S. economy. Nevertheless, with U.S. GDP growth expected to be over 3%, it is the Fed's belief that the current economy has sufficient underlying strength to support ongoing growth.

Structuring Your Portfolio Post-QE

While the end of QE does indicate that the U.S. economy and job market are expanding, albeit at a moderate pace, the Fed has detailed its commitment to keep interest rates near zero for a considerable time after the conclusion of the Fed's bond-purchasing program. It is the Fed's goal to be accommodative until the U.S. economy can sustain itself and grow on its own. Despite economic worries, the Fed cautions that investors should be prepared for the possibility that it will raise interest rates sooner than anticipated should U.S. economic performance exceed expectations. However, history has shown that when yields are below 5%, rising rates lead to an increase in stock prices. It is when rates exceed 5% that they become a headwind and lead to negative stock performance. Most Fed watchers believe it is unrealistic that a rate increase will take place before mid-2015. Nevertheless, whenever the rate increase does occur it will be the first since 2006, and there are many effective strategies that can be implemented in a portfolio to prepare for this event.

As short duration bonds are less sensitive to movements in interest rates, they will protect a portfolio when it is expected that rates will rise, but the timing is unknown. As these shorter duration bonds mature, the proceeds can be tactically allocated depending on the standing rate environment and how the market is reacting to any Fed policy changes.

Normal bond prices have an inverse relationship with interest rates. However, with floating rate loans the opposite is true: loan prices move in tandem with changing rates. Thus, floating rate loans adjust at regular intervals to reflect changes in short-term interest rates, allowing for a lower degree of sensitivity to changes in interest rates when compared to fixed-rate bonds.

If economic activity were to increase rapidly after the stimulus is removed, there could be significant inflationary pressures. Monetary policy works with a lag, and changes in interest rates usually take a few quarters to impact the economy. Given how close we are to the Fed's long-term target on inflation and unemployment, and how far away

we are from the Fed's long-term target on the federal funds rate, the Fed could be reactionary in raising interest rates to curb the excess inflation.

Real assets, which can include real estate, commodities and infrastructure, have tended to perform well in inflationary periods. In the real estate sector, rising interest rates typically coincide with increasing commercial rents as the costs of higher rates are passed on to lessees. Given that rising interest rate periods typically occur with expanding economies, the resulting demand for energy would boost commodity prices. Infrastructure can provide a steady stream of income and capital appreciation as most infrastructure projects are essential services and tend to perform well regardless of economic cycle.

Finally, the conclusion of quantitative easing creates a terrific opportunity for active fund managers. Expansionary monetary policy tends to buoy markets as a whole, causing securities to deviate less from their benchmark index. In this new market environment, experienced managers with the resources and track record to efficiently analyze the fundamentals of individual securities will have a better opportunity to outperform than they have had since before the global financial crisis. If you have any questions relating to this newsletter article or your investment portfolio, please contact an Andersen Tax investment consultant.



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