Program Agenda

- Basic Principles
- Key Exceptions
- Discrete Items
- Unique Complexities (Discontinued Operations, Stock Options, Valuation Allowance, Business Combination, subsequent events)
- Change in Tax Law/Rate
- Intraperiod Allocation
- Disclosures
- SEC Comments
An estimated annual global effective tax rate (ETR) for the year is required to determine income tax expense (benefit) in interim periods.

The estimated annual ETR is the ratio of estimated annual income tax expense (benefit) from “ordinary income” to estimated annual pretax “ordinary income.”

Estimates of the full-year current and deferred tax expense (benefit) from all jurisdictions’ (worldwide) “ordinary income” is required to calculate the estimated annual ETR.

The ETR does not include tax effects from “significant unusual or infrequently occurring” items.

An estimated ETR is determined/revised three times during the year (Q1, Q2, and Q3).

*Subtopic 740-270 (F/K/A FIN 18) contains special rules governing application of income tax accounting in interim periods.*
Interim Reporting Fundamentals (continued)

• Income tax provisions determined under the general recognition and measurement requirements for accounting for income taxes as per ASC 740-10

• The estimated ETR includes the anticipated effect of income tax credits and special deductions (investment, foreign, R&D, etc.)

• The tax effect of valuation allowance expected to be necessary at the end of the year for current-year NOL or/and originating deductible temporary difference

• Income tax expense (benefit) for an interim period is the sum of income tax (benefit) from year-to-date “ordinary income” (loss) and income tax (benefit) from items and events not included in “ordinary income”

• Income tax expense (benefit) from items/events not included in “ordinary income” determined individually and recognized in the interim period the item/events occurs (“discrete period” effects)

• The tax effect from a component of ordinary income which cannot be reliably estimated shall be recognized when the component of income is reported (assuming a reliable estimate of ordinary income is otherwise available)
Discrete Period Tax Effects

• Significant unusual or infrequently occurring items that are separately reported (within pretax income from continuing operations) or reported net of their tax effect
  • Unusual nature. The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to the ordinary and typical activities of the entity, taking into account the environment in which the entity operates, or
  • Infrequency of occurrence. The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates
• Gains or losses from disposal of a component of an entity (discontinued operation)
• Gains or losses from other comprehensive income (OCI)
Discrete Period Tax Effects

Examples

- Certain effects from changes in judgment related to beginning of the year valuation allowances
- Changes in judgment that result in subsequent recognition, de-recognition, or change in measurement of a prior-year tax position
- Deferred tax adjustments due to changes in tax laws, status or rates
- Provision-to-return adjustments
- Change in indefinite reinvestment (F/K/A APB 23) assertion related to beginning of the year outside-basis difference in stock of a foreign subsidiary (accumulated earnings and CTA effects)
- Tax effects of certain unusual or infrequent items if separately presented within pretax income from continuing operations: e.g., nondeductible goodwill impairment, defined benefit plan termination, major legal settlement
Effective Tax Rate Calculation

*Illustration (assuming Q1’2015 ETR estimate)*

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>France</th>
<th>UK</th>
<th>Spain (no VA)</th>
<th>Cayman</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected Pre-tax book income (loss)</td>
<td>9,000</td>
<td>1,000</td>
<td>3,000</td>
<td>(2,000)</td>
<td>8,000</td>
<td>19,000</td>
</tr>
<tr>
<td>Permanent adjustments</td>
<td>2,000</td>
<td>500</td>
<td>(500)</td>
<td>0</td>
<td>n/a</td>
<td>2,000</td>
</tr>
<tr>
<td>Total</td>
<td>11,000</td>
<td>1,500</td>
<td>2,500</td>
<td>(2,000)</td>
<td>8,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Tax Rates (assumed)</td>
<td>40%</td>
<td>33.33%</td>
<td>28%</td>
<td>30%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>Estimated Annual Tax Expense / (Benefit)</td>
<td>4,400</td>
<td>500</td>
<td>700</td>
<td>(600)</td>
<td>0</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*All foreign earnings are reinvested outside the U.S. & there are no Discrete period items/events in Q1-2015*

Est. Annual Tax Expense/(Benefit) | 5,000 | 26.32% |

Q1’15 year-to-date consolidated pretax income $10,000
Q1’15 Estimated ETR 26.32%
Q1’15 Income Tax Expense $2,632
Exceptions to General Requirement to Use a Single Effective Tax Rate Estimate

- Exceptions provided in ASC 740-270-30-36
  - Jurisdictions with pre-tax losses for which no tax benefit can be recognized ("Exception One")
    - Remove the loss from the base calculation of a single global estimated ETR
    - A separate estimated ETR for a “loss jurisdiction” is required
    - Typically, “zero ETR” due to full valuation allowance but sometimes a negative ETR due to withholding taxes or/and “naked credit” tax effects
  - Jurisdictions for which a reliable estimate cannot be made ("Exception Two")
    - Recognize a tax expense (benefit) for the year-to-date ordinary income (loss) as if a tax return were filed on the year-to-date income (loss) (discrete calculation)
    - Applies when either the estimate of pretax income or/and the estimate of total tax is not considered reliable
Loss Jurisdiction & No Benefit (Exception One)

*Illustration (assuming Q1’2015 ETR estimate)*

<table>
<thead>
<tr>
<th></th>
<th>USA (full Val allow)</th>
<th>France</th>
<th>UK</th>
<th>Spain (no VA)</th>
<th>China</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected Pre-tax book income</td>
<td>(9,000)</td>
<td>1,000</td>
<td>3,000</td>
<td>(2,000)</td>
<td>8,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Permanent adjustments</td>
<td>2,000</td>
<td>500</td>
<td>500</td>
<td>0</td>
<td>2,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total</td>
<td>(7,000)</td>
<td>1,500</td>
<td>3,500</td>
<td>(2,000)</td>
<td>10,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Tax Rates (assumed)</td>
<td>40%</td>
<td>33.33%</td>
<td>28%</td>
<td>30%</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Estimated Annual Tax Expense / (Benefit)</td>
<td>0</td>
<td>500</td>
<td>980</td>
<td>(600)</td>
<td>2,500</td>
<td>3,380</td>
</tr>
<tr>
<td>Total tax (excluding USA)</td>
<td>3,380</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q1’15 estimated ETR</td>
<td>$2,700</td>
<td>33.8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q1’15 income tax provision</td>
<td>$913</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consolidated PBT (excluding USA)</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q1’15 WW pretax income ($2,700 less $1,500)</td>
<td>$1,200</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax provision</td>
<td>($913)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income from continuing operations</td>
<td>($287)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(assume no discrete period items in Q1’15)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global ETR</td>
<td>33.8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Year-to-date pretax income (excluding USA) $2,700
Q1’15 estimated ETR 33.8%
Q1’15 income tax provision $913
Year-to-date U.S. loss ($1,500)
Q1’15 WW pretax income ($2,700 less $1,500) $1,200
Tax provision ($913)
Net Income from continuing operations $287
(assume no discrete period items in Q1’15)
Actual effective tax rate for the quarter approx. 76%
Exception Two - Inability to Reliably Forecast Rate

Estimated ETR is not required in the following instances:

- Inability to estimate an annual effective tax rate in a foreign jurisdiction in dollar (not commonly occurring), or
- Inability to determine a reliable estimate of ordinary income or the tax effect for a particular jurisdiction
- What is considered an “unreliable estimate”? Answer: It is a matter of professional judgment based on facts & circumstances
- In practice, a quantitative “sensitivity” analysis is performed to verify whether reasonable changes in the forecast would cause disproportionately higher changes in the ETR
- Hyper sensitive ETR typically results when the forecast of pretax income is close to a break-even but there are significant permanent items

**CAUTION:** The existence of a very high ETR (e.g., greater than 100%) or a negative ETR is not by itself sufficient to qualify for this exception - if the forecast of income (loss) and the expected tax effects are considered reliable, an estimated ETR must be used (not optional)
The tax effects of ordinary losses that arise in the early portion of a fiscal year can be recognized only when the tax benefits are expected to be:

- Realized during the year, or
- Recognizable as a DTA at the end of the year

Established seasonal pattern of loss in early interim periods followed by income in later interim periods is evidence that realization is more likely than not.

This principle also applies to losses from discrete period items or events (e.g., loss from discontinued operations).

Consideration of four possible sources of income including reversal of existing taxable temporary differences to support recognition of a tax benefit from current loss.
Loss Limitation Rule

• This rule places a “ceiling or cap” on the year-to-date tax benefit to be recognized for current year loss

• The loss limitation rule extends the principle that the tax benefit from a current year loss has to be realized in remaining interim periods or/and recognized as a DTA at year-end when:
  • The year-to-date loss exceeds anticipated full-year loss for the year, and
  • The effective tax rate is generally higher than the normal statutory rate due to significant permanent benefits (e.g., credits or special deductions), or due to mix of income and differing tax rates, or when a partial valuation allowance is required

• If the loss limitation applies, the ETR is revised as if the year-to-date loss would be the full-year loss (this has the effect of lowering the ETR and limiting the year-to-date benefit to the expected full-year benefit)
## Loss Limitation Rule *(Illustration)*

<table>
<thead>
<tr>
<th>Reporting Period</th>
<th>Quarterly Income/ (Loss)</th>
<th>Year-to-Date Income/ (Loss)</th>
<th>Estimated Annual Effective Tax Rate</th>
<th>YTD Computed Tax (benefit)</th>
<th>YTD Benefit Limited To</th>
<th>Tax (benefit) Previously Provided</th>
<th>Reporting Period Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1</td>
<td>$20,000</td>
<td>$20,000</td>
<td>50%</td>
<td>$10,000</td>
<td>($50,000)</td>
<td>0</td>
<td>$10,000</td>
</tr>
<tr>
<td>Q2</td>
<td>($80,000)</td>
<td>($60,000)</td>
<td>50%</td>
<td>($30,000)</td>
<td>($50,000)</td>
<td>$10,000</td>
<td>($40,000)</td>
</tr>
<tr>
<td>Q3</td>
<td>($80,000)</td>
<td>($140,000)</td>
<td>50%</td>
<td>($70,000)</td>
<td>($50,000)</td>
<td>($30,000)</td>
<td>($20,000)</td>
</tr>
<tr>
<td>Q4</td>
<td>40,000</td>
<td>(100,000)</td>
<td>50%</td>
<td>(50,000)</td>
<td>($50,000)</td>
<td>(50,000)</td>
<td>0</td>
</tr>
<tr>
<td>Fiscal Year</td>
<td>(100,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(50,000)</td>
</tr>
</tbody>
</table>

**Facts & Assumptions:**
- Single jurisdiction = U.S. and no valuation allowance due to sufficient DTLs & carryback capacity
- Applicable federal + state statutory rate of 40%
- Q1’15 full-year forecast = pretax loss of $100,000
- Permanent difference = Tax credits of $10,000
- Effective rate = 50% ($40,000 NOL DTA + $10,000 Credits DTA)/($100,000)
Unique Complexities

Discontinued Operations

- The presentation of discontinued operations necessitates revision of prior periods’ income tax provision (comparative interim periods and annual periods)
- The results of operation are revised to separate income (loss) from discontinued operations from the revised income (loss) from continuing operations
- Income tax provisions from revised continuing operations is determined without “hindsight” and based on the original forecast adjusted to remove the results of discontinued operations
- The tax allocated to discontinued operations is the difference between the tax originally allocated to continuing operations and the revised income tax provision from continuing operations
- Total tax expense (benefit) being allocated between revised continuing operations and discontinued operations must add up to the total tax expense (benefit) as reported in the previously filed financial statements
- No reallocation to OCI or equity
- Additional complexities arise with the allocation of changes in valuation allowance
Stock Compensation During Interim Periods

- Stock compensation cost included in ordinary income
- Tax effect of deductible book compensation included in ETR (i.e., a deferred tax asset for the expected future tax deduction)
- No tax benefit included in the ETR for awards not expected to result in tax consequences (e.g., ISOs, ESPPs)
- Cannot anticipate disqualifying dispositions or expiration (i.e., account for disqualifying dispositions or expiration when they occur)
- Tax calculations/measurement by jurisdictions where employees render service and receive share-based compensation
Stock Compensation During Interim Periods (continued)

- Windfalls and shortfalls recognized in the period in which they occur (discrete items)
  - Shortfalls recognized through expense in earlier period(s) can be offset by windfalls recognized in later periods (the expense is reversed)
  - Windfalls recognized if taxable income forecast is expected for the year (benefit recognized through APIC so no impact on ETR)
  - Prior year windfall NOL (off balance) recognized in the current year based on forecasted taxable income - need an accounting policy election: recognized in first quarter if sufficient taxable income is forecasted or recognized throughout the quarters based on year-to-date income
Changes in Valuation Allowance

• Valuation allowance effects related to current year income (loss) and originating temporary differences recognized in the estimated annual ETR (however, a loss jurisdiction with no benefit is excluded from the estimated global ETR)

• Changes in circumstances can cause a change in judgment about the future realizability of a beginning-of-year deferred tax asset

• Valuation allowance release related to a beginning-of-year deferred tax asset
  • Recognized in the estimated annual ETR if realization is supported by current year ordinary income
  • Recognized as a discrete period benefit if realization is supported by change in expectation about the availability of future income
  • Changes in the forecast of current year income would necessitate truing up the discrete period effect while retaining a zero ETR from ordinary income
Changes in Valuation Allowance (continued)

- Increase in valuation allowance related to a beginning-of-year deferred tax asset caused by a change in judgment about the realizability of deferred tax assets in future years recognized entirely in the interim period the change in judgment occurs (discrete period effect)
- Complexities with valuation allowance changes caused by discontinued operations and gains (losses) in OCI
Business Combinations

• Anticipated business combinations not considered for accounting prior to the acquisition period

• The effects of a business combination included in the acquirer’s income forecast and estimated annual ETR when the business combination is complete

• Acquirer’s valuation allowance release enabled by newly acquired deferred tax liabilities (generally, nontaxable acquisitions) recognized discretely when the event occurs

• Transaction costs may or may not be included in the forecast of ordinary income
  • If included in ordinary income forecast: Legal/accounting/due diligence not tied to successful transaction completion - included in estimated annual ETR
  • Success-based fees - discrete period effect
Effect of Subsequent Events

- Events that arise after the interim period date but before the issuance of the quarterly financial statements would not be included in year-to-date income (non-recognized subsequent events)

- Quarterly estimation/revision of the estimated annual ETR intended to reflect management’s best estimate of full-year income and tax effects

- Two potentially acceptable approaches emerged in practice (accounting policy):
  - Approach 1 - estimated annual ETR includes *certain* information available up to the date on which financial statements are issued,
    - However, certain events occurring after the balance sheet date are always “discrete” and cannot be considered even under Approach 1 (e.g., changes in tax laws and rates, business combinations, events affecting the recognition and measurement of tax positions, etc.)
  - Approach 2 - The effects of a non-recognized subsequent event should not be reflected in the estimated annual ETR (other than disclosure if significant)
Uncertain Tax Benefits Interest and Penalties

- Uncertain tax benefits related to current year income/tax positions included in the estimated annual ETR
- Changes in uncertain tax benefits related to prior years’ positions recognized in the interim period the assessment changes (discrete period)
- Interest is accrued in the first period in which the interest would begin accruing according to the relevant tax law
- Penalties are recorded when a position giving rise to the penalty is either taken or anticipated to be taken on a current year return
Change in Law/Rate

- Effect on deferred tax balances
  - Included in income tax expense from continuing operations in the interim period that includes the enactment date
- Effect on current-year taxes payable or receivable
  - Reflected in the computation of the estimated annual ETR beginning with the first interim period that includes the effective date
- Retroactive legislation
  - Reflected in the period of Enactment date (date the bill becomes law)
  - Prior interim periods should not be restated
Intraperiod Allocation

- The annual intraperiod allocation involves a “3-step” approach (i.e., with-and-without calculation of total annual income tax expense or benefit):
  - **Step 1** - Compute total annual tax expense (benefit) from all financial statements components (comprehensive income plus equity) (“all in”)
  - **Step 2** - Compute annual tax expense (benefit) attributable to continuing operations
  - **Step 3** - Difference between “all in” (Step 1) and continuing operations (Step 2) allocated to other financial statement components (discontinued operations, OCI, and equity) generally pro rata subject to special “loss” components rules
Intraperiod Allocation (continued)

• The annual intraperiod allocation “with-and-without” approach must be considered in interim periods.

• The results of “Step 2” (continuing operations) reflected in the estimated annual ETR from ordinary income plus any discrete effects from continuing operations.

• Gain (losses) from OCI and discontinued operations not forecasted/estimated but recognized when occur.

• Tax P&L “gross up” required when losses in continuing operations would have a valuation allowance absent income in another component (OCI, discontinued operations, equity).
  • Tax benefit for the current year loss recognized through the estimated annual ETR.
  • Offsetting tax expense recognized in other component in the period (s) the income arises.
  • Typically, a tax balance-sheet credit would be recognized for the difference between the year-to-date tax benefit and the discrete period expense (the credit would be reclassified to income tax benefit in remaining interim periods).
Disclosures

• Interim period statements generally require less tax disclosures than in annual statements

• In certain circumstances, disclosures should explain:
  • Tax effects of discrete items (i.e., significant unusual or infrequently occurring items or items recognized net of tax)
  • Significant changes in estimates (i.e. changes in assessment of valuation allowances)
  • Significant differences in the usual relationship of income tax expense to pre-tax book earnings
  • Impact of recently issued accounting standards on future financial statements
  • Material changes to UTPs, changes that would impact the effective rate, interest and penalties, and certain positions if it is reasonably possible that a significant increase/ decrease in UTP would occur within 12 months; and the open tax years in major jurisdictions
SEC Comments Summary

- SEC reviews recognition and timing of valuation allowance changes
- SEC registrants should include sufficient and transparent disclosures to explain the recognition & the timing of changes in valuation allowance in an interim reporting period
- Increased focus on significant variations in estimated annual ETR and disclosures of significant items that impact the tax rate or recognized discretely
- Recent trend in annual reports to disaggregate material items including the impact of foreign earnings on effective tax rate
- Two slides of SEC comments focusing on WHEN (i.e. what reporting period) valuation allowance changes are recorded
- One slide of SEC comments focusing on items included in the estimated annual ETR versus recorded discretely in the quarter
- The SEC would inquire as to the reason a registrant concluded that a reliable estimate of ETR cannot be made and thus taxes are computed on a discrete basis approach. Registrants should have good quantitative/sensitivity analysis to back their decision
SEC Comment Sample

Valuation Allowance

Please explain to us why it is appropriate to recognize a benefit in continuing operations of $[X] in the first quarter of 2011 related to your Phase [X] clinical services business classified as a discontinued operation in the fourth quarter of 2010. Tell us whether you rely at least in part on the guidance in ASC 740-10-45-20 and ASC 740-20-45-4, and separately tell us why it was appropriate to record a full valuation allowance at December 31, 2010 for the deferred tax assets recognized in 2010 when you reversed it in the next quarter. Please tell us what factors changed in the first quarter of 2011 causing you to reverse this valuation allowance. Explain why this tax loss would more-likely-than-not be benefitted as a worthless stock deduction in the first quarter of 2011 but not in the fourth quarter of 2010. Where appropriate, reference for us the authoritative literature you relied upon to support your accounting.
The $[X] million reduction to your deferred tax asset valuation allowance represents a significant component of your net income of $[X] million for the year ended September 30, 2012. Please enhance your disclosures in future filings to explain in further detail your consideration of ASC 740-10-30-16 through 30-25 in determining that as of September 30, 2012, it was more likely than not that these deferred tax assets are realizable. Please address the following:

- We note your discussion on pages [X] and [X] regarding the positive and negative evidence that you considered. Please disclose in more detail how this positive and negative evidence was weighted and how that evidence led you to determine it was appropriate to reverse the valuation allowance during the quarter ended June 30, 2012. Please discuss the significant estimates and assumptions used in your analysis, including the specific factors that changed during fiscal 2012 and led you to determine the reversal was appropriate at this time;
- Please discuss how you determined the amount of valuation allowance to reverse;
- Please disclose the amount of pre-tax income you need to generate to realize these deferred tax assets. Include an explanation of the anticipated future trends included in your projections of future taxable income. Confirm to us that the anticipated future trends included in your assessment of realizability of your deferred tax assets are the same anticipated future trends used in estimating the fair value of your reporting units for purposes of testing goodwill for impairment and any other assessment of your tangible and intangible assets for impairment; and
- If you are also relying on tax-planning strategies, please disclose the nature of your tax planning strategies, how each strategy supports the realization of deferred tax assets, the amount of the shortfall that each strategy covers, and any uncertainties, risks, or assumptions related to these tax-planning strategies.

Please show us in your supplemental response what your revisions to future filings will look like.
We note that you recorded a discrete tax benefit of approximately $[X] million from the write-off of the historical tax basis of an investment. Please tell us more about this tax benefit, the circumstances surrounding it and refer to any authoritative guidance you relied upon when determining your accounting. As part of your response, please tell us how you concluded that your current disclosures sufficiently explain the nature of this discrete tax benefit.

Please provide draft disclosure, to be included in future filings, of the components of income (loss) before income tax expense as either domestic or foreign for the periods presented pursuant to Rule 4-08(h) of Regulation S-X.

Please revise the notes to the financial statements to disclose the classification of interest and penalties within the income statement in accordance with ASC 740-10-45-25.

In future filings, please provide the required tax rate reconciliation.
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