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Rounding up recent tax developments

In today's difficult economic environment, managing cash flow and liquidity is key to survival for many companies. Fortunately, the IRS and lawmakers are helping with tax breaks. Some recent legislative and regulatory changes may provide your company with relief.

Relaxed CFC credit rules

Many companies are searching for alternative sources of liquidity and late last year the IRS provided some assistance by temporarily relaxing the controlled foreign corporation (CFC) credit rules. Notice 2008-91 made it a little easier for companies to access cash from a CFC under its control.

Ordinarily, when a CFC with earnings and profits loans money to a controlling U.S. shareholder, the shareholder must include a deemed dividend in its income. There's an exception, however, for loans repaid within 30 days — provided the CFC doesn't hold obligations that are considered "investments in U.S. property" for 60 or more days during that taxable year.

Companies that wouldn't benefit from bonus depreciation can accelerate refundable research and alternative minimum tax credits.

To "facilitate liquidity in the near term," the IRS notice temporarily extends these periods to 60 days and 180 days, respectively. The expanded exclusion applies to a CFC's first two tax years ending after Oct. 3, 2008 — in other words, through the end of 2009 for a calendar-year corporation.

Helping companies restructure debt

With interest rates at record lows, companies restructuring existing debt obligations risk triggering deduction limits for applicable high-yield discount obligations (AHYDO). These limits defer — and in some cases disallow entirely — original issue discount

(OID) deductions for corporate debt instruments with a term of more than five years and a yield to maturity that's at least 5% above the AFR.

To help companies restructure debt without triggering AHYDO deduction limits, the recently enacted American Recovery and Reinvestment Act of 2009 (ARRA) temporarily suspends those limits. This relief applies to debt instruments issued between Sept. 1, 2008, and Dec. 31, 2009, in exchange for existing non-AHYDO debt instruments, so long as the issuer of both debt instruments is the same.

"Exchange" includes modification of an existing debt instrument that's deemed to be an exchange. For debt instruments issued after 2009, ARRA authorizes the U.S. Treasury Secretary to use a rate higher than the AFR to determine whether AHYDO rules apply. ARRA also provides companies with some relief from cancellation of debt (COD) income. (See the sidebar "Stimulus package delivers COD relief" on page 3.)

Expanded NOL carrybacks

For companies suffering net operating losses (NOLs), the ability to use those losses to offset income in

previous or future years can be a great way to boost cash flow. Ordinarily, a company can carry back NOLs up to two years, but ARRA expanded the carryback period to up to five years for losses in tax years beginning or ending in 2008. Unfortunately, this benefit currently is limited to small businesses — companies with average annual gross receipts of $15 million or less.

An earlier version of ARRA would have expanded the NOL carryback period to up to five years for companies of *any* size, but the small business limitation was added to the bill that was ultimately signed into law. However, separate legislation that would extend the benefit to larger companies might be introduced in the future.

Encouraging small public company investment

An enhanced tax break for qualified small-business stock may make it easier for small public companies to attract investors. Ordinarily, this tax break allows individual investors to exclude 50% of their capital gains on the sale of original issue stock in a qualifying C corporation held for more than five years. ARRA increases the exclusion to 75% for stock issued after Feb. 17, 2009, and before Jan. 1, 2011. Because this exclusion is based on old capital gains rates of 28%, the effective rate on such gains is now 7%.

To qualify, a company must have aggregate capital of $50 million or less immediately before the stock is issued and meet several other requirements.

Bonus from Uncle Sam

ARRA also extends last year's 50% first-year bonus depreciation allowance to property acquired and placed in service in 2009 (through 2010 for certain transportation equipment, aircraft and other property). This benefit is available for depreciable assets with a recovery period of 20 years or less, as well as to purchased computer software, water utility property and qualified leasehold improvements.

Companies that wouldn't benefit from bonus depreciation — because they aren't planning any significant capital expenditures this year — can accelerate refundable research and alternative minimum tax credits in lieu of claiming bonus depreciation. This option was also available last year, and ARRA extended it through 2009.

Keep an eye on Congress

Lawmakers are expected to continue to introduce new tax and financial measures to help companies cope with the troubled economy. By monitoring legislative developments, your company will be better prepared to take advantage of benefits that can boost your cash flow and slash your tax bill.

Stimulus package delivers COD relief

Companies looking to restructure debt received a welcome gift from Congress earlier this year. The American Recovery and Reinvestment Act of 2009 (ARRA) provides companies with relief from certain cancellation of debt (COD) income. Ordinarily, when debt is forgiven or is reacquired for less than its adjusted issue price, the issuer is taxed immediately on COD income equal to the excess of the original debt's adjusted issue price over the repurchase price.

ARRA provides that COD income triggered by reacquisition of a debt instrument in 2009 or 2010 may be deferred until 2014 and then included in income ratably over a five-year period. This relief is available for cash repurchases, debt-for-debt exchanges (including modifications that are deemed to be an exchange), debt-for-equity exchanges, capital contributions and complete forgiveness of the debt.

Pros and cons of adopting a clawback policy

In the current economic climate, investors and the public are justifiably concerned about executive compensation. This is particularly true of company leaders receiving generous bonuses or other performance-based awards while their companies are struggling financially.

The Sarbanes-Oxley Act (SOX) and the American Recovery and Reinvestment Act of 2009 (ARRA) contain "clawback" provisions, which allow companies to recover, under certain circumstances, performance-based compensation that's based on inaccurate financial information. Some companies, however, are voluntarily adopting broader clawback provisions than are required by law.

The basics

The specific terms of clawback provisions vary. But, in general, clawbacks allow a company to recover performance-based compensation from executives when it discovers that the performance goals supporting the compensation weren't, in fact, achieved.

> *It may be easier to enforce a clawback provision if it's incorporated into compensation programs, individual employment contracts and other employee agreements.*

The law may require forfeiture of compensation under certain circumstances. Section 304 of SOX requires a company's CEO and CFO to reimburse the company for bonuses, other incentive- or equity-based compensation, and profits from the sale of company stock if the company is required to restate its financial results as a result of material noncompliance — because of misconduct — with SEC reporting requirements. The provision applies to compensation or profits received within 12 months after the relevant financial reports are first issued publicly or filed, whichever occurs first.

Sec. 304 is somewhat ambiguous. It doesn't define "misconduct," for example, or specify whether misconduct by someone other than the CEO or CFO is grounds for recovery. Also, the provision doesn't say whether the company or its shareholders can sue to enforce its terms, though some courts have held that an action can be brought only by the SEC. And, late last year, a federal judge ruled that CEOs and CFOs can't be forced to return compensation if the company doesn't actually restate its financial results — even if it should have done so.

ARRA contains a clawback provision for companies that receive assistance under the government's Troubled Asset Relief Program (TARP). The provision provides for recovery of bonuses and other incentive compensation paid to top executives, as well as the next 20 most highly compensated employees, if such compensation is based on financial criteria later found to be "materially inaccurate."

Voluntary provisions

Although legally mandated clawback provisions cover only CEOs and CFOs and companies receiving

TARP funds, an increasing number of businesses are adopting additional clawback policies. But before you take this step, think about its potential impact on your company's ability to attract and retain executive talent.

While it tries to strike the proper balance, your board should consider several questions, including:

How should we implement the clawback requirement? Adopting a general policy is the simplest approach during implementation. But it may be easier to enforce a clawback provision if it's incorporated into compensation programs, individual employment contracts and other employee agreements.

Who should be covered by the policy? Just the CEO and CFO? All executives? All employees? Only employees who have some influence over the company's financial reporting?

Under what circumstances should employees be required to forfeit compensation? Any time financial information is discovered to be inaccurate? Any time financial results are restated? Only in the event of a "material" restatement? And should misconduct be required for forfeiture? If so, does the clawback provision apply to all covered employees or only to the employee who committed the misconduct?

Such decisions can have far-reaching consequences. On the one hand, a broad clawback policy that allows your company to recover incentive compensation that was based on inaccurate financial results — regardless of fault — may send a positive message to shareholders and appeal to a general sense of fairness. On the other hand, it may be difficult to attract employees if they risk forfeiting compensation as a result of innocent mistakes or someone else's wrongful conduct.

A balancing act

Executive compensation is always a sensitive issue, but in today's struggling economy it's even more so. But you must balance the need to show your commitment to preventing unreasonable compensation against maintaining a management team that can navigate your company through treacherous waters.

Will IFRS squeeze the life out of LIFO?

Near the end of 2008, the SEC published its long-awaited "roadmap" for converting U.S. companies from Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS) over the next several years. Recently, the SEC extended the comment period for this roadmap, which may signal its intent to slow the pace of conversion. But the destination remains the same: In the not-too-distant future, IFRS will replace GAAP.

Get ready for FIFO

GAAP and IFRS have many important differences. One of the most significant — and potentially costly for U.S. companies — involves accounting for inventories.

Many U.S. companies use the last-in, first-out (LIFO) method of inventory accounting to reduce taxable income. LIFO bases the cost of sales on more recent (generally higher) prices, resulting in lower income. LIFO, however, is disallowed under IFRS, which instead accepts other methods such as first-in, first-out (FIFO) and weighted average cost.

At first glance, disallowing LIFO for financial reporting purposes may not seem like such a bad thing. The problem is the IRS's "conformity rule," which requires companies to use the same inventory accounting method for financial statement purposes as they do for tax purposes. Unless the IRS eliminates or modifies the conformity rule, companies that switch to IFRS will also have to change from LIFO to another method — generally FIFO — for federal income tax purposes.

That usually means recognizing income equal to the LIFO reserve (the excess of FIFO inventory values over LIFO inventory values). In most cases, however, this income can be spread out over a four-year period.

The cost of switching from LIFO to FIFO can be substantial. According to a recent study by the Georgia Tech Financial Analysis Lab, the 2007 pretax income

of the 30 U.S. companies with the greatest LIFO exposure would have been almost 12% higher if they had used FIFO.

Review your options

If your company currently uses LIFO for tax and financial reporting purposes, talk to your tax advisors about your options for dealing with the conversion to IFRS. It's possible that the IRS will eliminate or relax the conformity rule, allowing you to use LIFO for tax purposes and FIFO for financial reporting purposes. This may be an appealing outcome, but keep in mind that the need to keep two sets of records — one for federal income tax and one for financial reporting — will increase your administrative expenses.

Another possibility is that the government will extend the period over which additional taxes must be reported to more than four years. This would soften the blow of eliminating LIFO for tax purposes.

If your company has substantial LIFO exposure, you might consider reducing your inventories and LIFO reserves gradually before the mandatory switch to IFRS takes effect. Alternatively, if you have net operating losses or other tax attributes you can use to minimize or eliminate the tax impact of recapturing your LIFO reserve, you may want to change your inventory accounting method sooner.

Costly and complex

Depending on your company's size, the switch to IFRS may be several years away. But given the potential tax cost and complexity of conversion, it's a good idea to begin planning now.

Complying with the FCPA's bribery provision

Over the last five years, the SEC and U.S. Department of Justice have been cracking down on violations of the Foreign Corrupt Practices Act of 1977 (FCPA), and the cost of noncompliance can be staggering. In one case, a company charged with making a $50,000 bribe to a foreign government official ended up paying $1.5 million in penalties. Some corporate officers and employees have even served jail time for FCPA transgressions.

If your company does business abroad, you need to have policies, procedures and controls in place to prevent and detect FCPA violations.

Prohibited activities

The FCPA's antibribery provision is broad. It generally makes it unlawful for a U.S. person or certain foreign issuers of securities to pay or offer to pay — directly or through an intermediary — money or anything of value to a foreign official for the purpose of obtaining or retaining business. The provision also applies to foreign companies or persons who violate the act while in the United States.

Further, corporations whose securities are listed in the United States must also comply with the FCPA's accounting provisions. These require corporations to keep accurate books and records and maintain adequate internal accounting controls.

No excuses

It's possible to violate the FCPA even if payments are legal or culturally accepted in the country where they're made. What's more, the government generally finds it easier to prove an accounting violation than bribery. Companies have been penalized for keeping inaccurate books and records, or inadequate controls, even without sufficient evidence of an unlawful bribe. In addition to civil and criminal penalties, violators may be subject to ongoing — and costly — compliance monitoring obligations and be forced to disgorge any profits flowing from an FCPA violation.

To avoid potentially disastrous consequences — for your company's reputation as well as its bottom line — familiarize yourself with the FCPA's requirements and evaluate your company's exposure. Ensure that you have systems in place to prevent and detect violations. If you discover unlawful or suspicious activity, the consequences will generally be less harsh if you investigate it yourself and report it to the authorities.

Fair value accounting gains momentum

After months of controversy and calls by some for the suspension of fair value accounting rules, two things are becoming clear. First, fair value accounting, which includes so-called "mark-to-market" accounting, seems to be here to stay. And, second, at least in the government's view, fair value isn't to blame for our current economic woes. Regulators do acknowledge, however, that additional guidance is needed.

Pinpointing the source of controversy

Much of the fair value controversy has surrounded the Financial Accounting Standards Board's (FASB's) Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. But that statement doesn't itself require any new fair value measurements.

Those requirements actually are found in various other accounting standards. SFAS 157 provides a uniform definition of fair value, creates a framework for measuring it and requires expanded disclosures about those measurements.

Financial failures: Not guilty

Last year, Congress asked the SEC to conduct a study of fair value accounting and its impact on financial institutions. According to the SEC's report, critics claimed that fair value accounting under SFAS 157 contributed to instability in the financial markets. The fair value rules, they argued, required "inappropriate write-downs" based on "inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities."

Proponents of fair value accounting countered that the rules enhanced financial transparency and that suspending them would weaken investor confidence, leading to further instability. Accounting rules weren't responsible for the crisis, they argued, but were merely a reflection of the root causes of the crisis.

The SEC found that fair value measurements didn't significantly affect financial institutions' reported income last year, nor did they play a meaningful role in bank failures occurring during 2008. For failed banks that did recognize sizable fair value losses, the SEC concluded, "it does not appear that the reporting of these losses was the reason the bank failed." It also found that investors generally support fair value as providing the most transparent method of financial reporting for investments, and that suspending SFAS 157 would lead to "inconsistent and sometimes conflicting guidance on fair value measurements."

Further guidance provided

Although the SEC concluded that fair value accounting is basically sound, it recommended several modifications and improvements to the current guidance. In response, FASB recently finalized several FASB Staff Positions (FSPs) designed to clarify and improve fair value accounting:

1. FSP FAS 157-4 provides guidance on determining fair value when the market for an asset or liability is inactive or when price inputs being used represent distressed sales. It reaffirms the need to use judgment in determining whether a market has become inactive and, if it has, determining fair value.

The SEC found that fair value measurements didn't significantly affect financial institutions' reported income last year.

2. FSP FAS 115-2 and FAS 124-2 provides guidance on accounting for impairment losses related to debt securities if a company doesn't intend to sell the securities and is unlikely to be forced to sell them before the market recovers. Under those circumstances, if an "other than temporary impairment" exists, only the portion of the impairment charge attributable to credit losses is recognized in earnings.

3. FSP FAS 107-1 and Accounting Principles Board Opinion 28-1 apply only to publicly traded companies and require additional disclosures regarding financial instruments not currently reflected on the balance sheet at fair value. Previously, the fair values of these instruments were disclosed annually, but the FSP requires quarterly disclosures.

Stay tuned

FASB will likely continue to address fair value accounting issues in the future. Because new developments occur on an almost-weekly basis, check with your CPA for the latest fair value news.

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