Case 13-10

LOL – Income Taxes

LOL (the "Company"), an SEC registrant with a calendar year-end, is a manufacturer and distributor of sports equipment. The Company was created in 1989 and is headquartered in Southern California. The Company has manufacturing operations and numerous sales and administrative locations in the United States. LOL files a consolidated U.S. federal tax return. (This case will not consider the evaluation of the state jurisdictions; it will only consider the federal jurisdiction.)

As LOL's auditors, you are now performing the Company's year-end audit for the fiscal year ended December 31, 2010, and have the following information available to you:

- LOL draft income statement and excerpt from tax footnote as of December 31, 2010 (Handout 1).
- A deferred tax asset realization analysis showing pre-tax book income projections (Handout 2).
- The projected income schedule (realization analysis above) projects organic growth beginning in 2012 after stemming the decrease in pre-tax book income.
- LOL does not have the ability to carryback any losses to prior periods.
- A significant customer declared bankruptcy in 2010; therefore, the Company wrote off all accounts receivable from this customer. The Company is considering the exclusion of such expense when evaluating if future income is objectively verifiable.
- The Company does not have a history of operating losses or tax credit carryforwards expiring unused.
- The Company has identified the following possible tax-planning strategies:
    - Selling and leasing back manufacturing equipment that would result in a taxable gain of $20 million.
    - Selling the primary manufacturing facility at a gain to offset existing capital loss carryforwards.

Required:

- Question 1 — What are the four possible sources of taxable income according to ASC 740?
- Question 2 — How much of the reversing taxable temporary differences may be considered in estimating future taxable income?

- Question 3a — In evaluating the income that LOL is projecting related to future operations, is LOL in a cumulative loss position (assuming LOL considers 3 years as the period over which to evaluate pretax accounting income or loss from continuing operations for cumulative losses)?
- Question 3b — In evaluating the income that LOL is projecting related to future operations, may LOL exclude the impact of the impairment of the nondeductible goodwill when estimating future taxable income?
- Question 3c — In evaluating the income that LOL is projecting related to future operations, may LOL exclude the expense from writing off the accounts receivable from the customer who declared bankruptcy when evaluating the projections of future income?
- Question 3d — In evaluating the income that LOL is projecting related to future operations, the Company has projected growth in its future projections. Does the evidence of historic losses affect our ability to accept the Company's estimate of future growth?
- Question 3e — In evaluating the income that LOL is projecting related to future operations, in an effort to satisfy your appropriate professional skepticism, what evidence might you ask for to support the Company's projections?
- Question 4 — Would the tax-planning strategy to sell and lease back manufacturing equipment be a tax-planning strategy that is considered prudent and feasible? Why or why not?
- Question 5 — Would the tax-planning strategy to sell but not lease back the primary manufacturing facility be a tax-planning strategy that is prudent and feasible? Why or why not?

Additional Facts- Intraperiod Allocation Consideration

Assume a valuation allowance of $105 million is recorded in Issue 1 as of December 31, 2010 ($150 million deferred tax asset (DTA) less $45 million reversing deferred tax liabilities (DTL)).

Further assume that during 2010, the Company recognized a loss of $50 million in accumulated other comprehensive income (AOCI) related to a pension adjustment from a loss in investment value.

The Company's effective tax rate absent the recognition of a valuation allowance is 37 percent.

Required:

- Question 6 — Calculate the tax effect on the loss of $50 million recognized in AOCI in 2010.

Additional Facts

Assume a valuation allowance of $105 million is recorded in Issue 1 as of December 31, 2010 ($150 million DTA less $45 million reversing DTLs).

Further assume that the Company's projection for 2011 pre-tax book income of $0 is accurate, but the Company sells a component of the business and recognizes the component as a discontinued operation.

The discontinued operations earn $20 million before tax, and the continuing operations lose $20 million before tax for a net pre-tax book income of $0.

As described above, the Company has a full valuation allowance.

Required:

- Question 7a — Is there a tax benefit on the loss of $20 million from continuing operations?
- Question 7b — Is there a tax provision on the $20 million of income from discontinued operations?

Additional Facts – Interim Reporting

Assume a valuation allowance of $105 million is recorded in Issue 1 as of December 31, 2010 ($150 million DTA less $45 million reversing DTLs).

Further assume that the actual 2011 net income before tax was $0 as projected at the end of 2010. In calculating the 2012 annual effective tax rate (AETR) at the beginning of the year, the Company projected income before taxes of $40 million ($10 million per quarter). Using the effective tax rate of 37 percent, the $40 million of income would result in a tax provision of $14.8 million during 2012 ($3.7 million per quarter) before considering the release of the valuation allowance.

In addition, assume the net operating loss carryforward will be used as income is generated during the year resulting in annual estimated tax of $0 and an annual estimated effective tax rate of 0 percent. Absent a release of the valuation allowance during 2012 from a change in estimate, the end of the year valuation allowance would be $90.2 million ($105 million less $14.8 million) as a result of the income earned in 2012.

In the second quarter of 2012, LOL determined that there was sufficient evidence of future taxable income to satisfy the valuation assertion of the DTA.

Required:

- Question 8 — Calculate the tax provision (benefit) that would be recognized in the second quarter of 2012.