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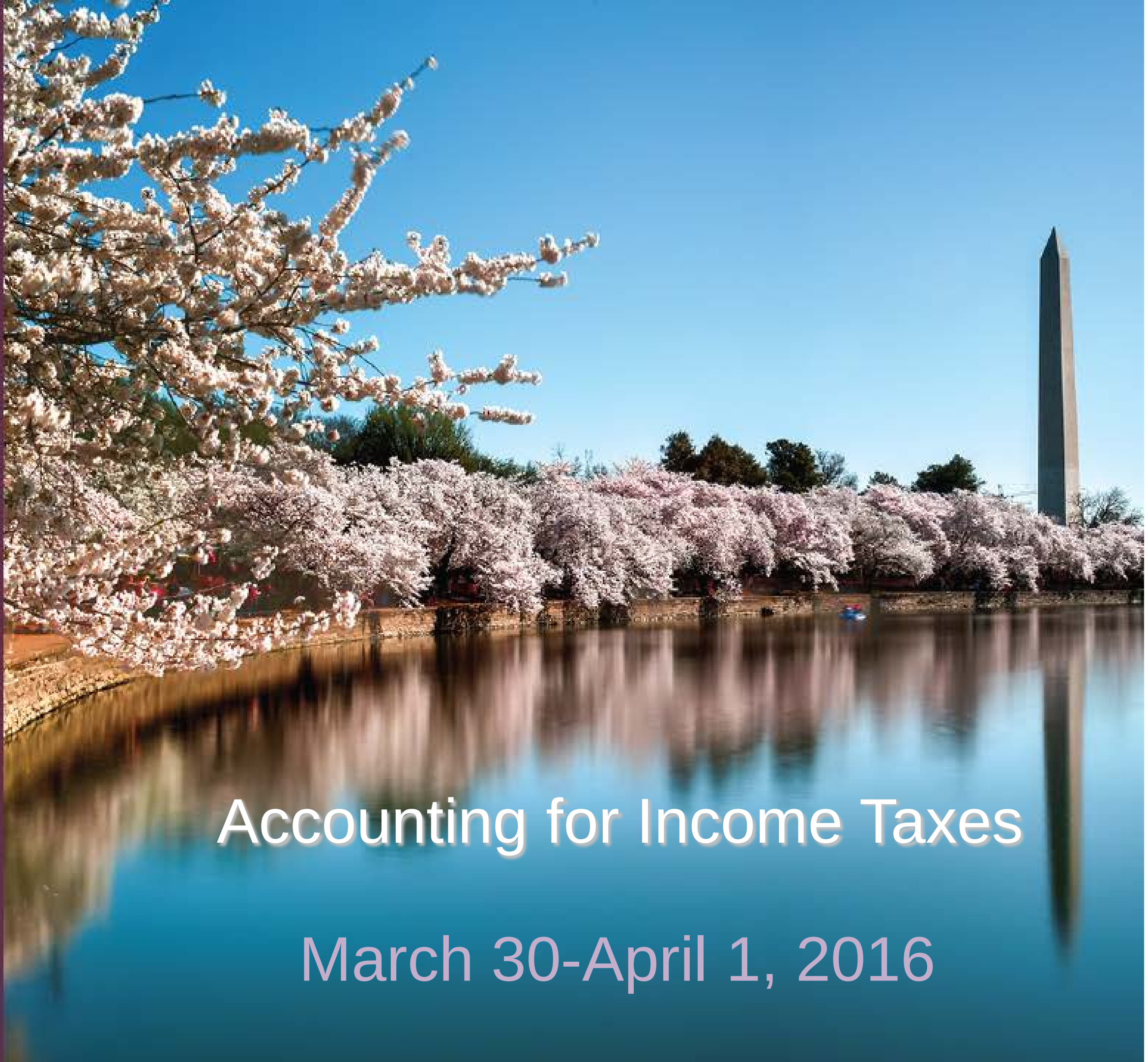

Accounting for Income Taxes

March 30-April 1, 2016

Speakers

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- James Finnerty, SVP-Tax, Forest City Realty Trust, Inc.
- Jack Miller, VP-Tax Planning, Ventas, Inc.

Agenda

- Overview
- Special issues
  - Valuation allowance
  - Interim reporting
  - Effective tax rate
  - REIT and TRS interaction
  - Purchase accounting
  - Foreign entities and investments
  - Uncertain tax positions
  - Footnotes

Scope of Income Taxes

- Federal income tax
- State and local income taxes (margin taxes)
- Foreign income tax
- Withholding taxes
- Special taxes
  - Section 857(b)(7)
  - Prohibited transaction
  - Foreclosure property
  - Section 1374

Separate Tax Calculations

- REIT
  - Treatment in calculation of Funds From Operations (“FFO”)
- Taxable subsidiaries
  - TRSs domestic and foreign
  - Foreign entities disregarded for US tax
  - Variable interest entities
  - Partnerships (with TRS or foreign entity as partner)
  - Noncontrolling interests

Basic Elements of Tax Expense or Benefit Calculation

- Annual reporting
  - Provision – Tax expense or benefit
    - Book income
    - Permanent items
    - Temporary differences
    - Valuation allowance adjustments
    - Discrete items
    - Uncertain tax position amounts
    - Tax rates
    - Foreign tax items
  - Balance sheet
    - Current income tax accrual or refund including liability for uncertain tax positions
    - Deferred tax assets (“DTA”) and liabilities (“DTL”) calculation
- Interim reporting
  - Effective tax rate calculation
  - Ordinary income or loss
  - Discrete items
- Auditor approach to documentation

Basic Approach

- Balance sheet or liability approach
- Current liability or refund
- Deferred tax on temporary differences between financial statement and tax basis
- Change in Net DTA or (DTL) for the Reporting Year = Deferred Income Tax Expense or Benefit +

  Change in Current Year Tax Accrual or Receivable (Before Payments and Refunds) =

  Current Year Income Tax Expense or Benefit
- Taxable difference = book over tax basis of asset or tax over book liability
- Deductible difference = tax over book basis of asset or book over tax liability

Primary Objectives related to Accounting for Income Taxes (ASC 740-10-10-1)

- To recognize the amount of taxes payable or refundable for the current year
- To recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns

Incremental Concept (ASC 740-10-10-3)

- A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year
- The difference between:
  - The amount of taxes that will be payable or refundable in the future years inclusive of reversing temporary differences and carryforwards
  - The amount of taxes that would be payable or refundable in future years exclusive of reversing temporary differences and carryforwards

Recognition (ASC 740-10-25-2)

- A tax liability or asset shall be recognized … for the estimated taxes payable or refundable on the tax returns for the current and prior years
- A deferred tax liability or asset shall be recognized for the estimated future tax effects attributable to temporary differences and carryforwards

Special Issues – Valuation Allowances

- Evaluating the need for a valuation allowance
  - Net operating losses
  - Deferred deductions
  - Other temporary differences
    - Book accruals
    - Reserves
    - Tax over book basis
  - Scheduling

Valuation Allowances - 4 Sources of Taxable Income

1. Future reversal of taxable temporary differences
   - Indefinite-lived assets and carryovers (Example 1)
   - Contingent liabilities and reserves
   - Indefinite-lived declining balance depreciable assets
2. Future taxable income exclusive of reversing temporary differences and carryforwards
   - Consistent with projections used for other purposes
3. Taxable income in carryback years
4. Tax planning strategies
   - Prudent & feasible
   - Would likely be implemented
   - Results in realization of DTA – not an increase in another DTA

Example 1 – Valuation Allowance

Tax Rate 40%	Tax Amount	Book Value
NOL	100	
Trademark (indefinite life)		100
Deferred tax asset (“DTA”)	40	
Deferred tax liability (“DTL”)		(40)

Since trademark has indefinite life and may never reverse, DTA may require a full valuation allowance, resulting in a net DTL.

Special Issues – Valuation Allowances (cont.)

- Negative evidence of need for valuation allowance – cumulative losses – current year and two proceeding years
- Impact on provision
  - Discrete item tax expense if related to deferred tax assets previously benefited
  - Increase in effective tax rate for current year impact or exclusion from calculation
- Release of valuation allowance
  - Period of positive income and gains
  - Current year reduction in effective rate or expense – future years impact discrete

Special Issues – Interim Reporting

- Multiple jurisdictions – consolidated ordinary income/loss and ETR
  - Exceptions
  - Multi-jurisdictional blended effective tax rate
- Exclusion of entities with full valuation allowance for the current year (exception for jurisdictions with tax benefit)
- Limitation on tax benefit in early quarters to full year benefit
- Valuation allowance in early quarters due to reversing taxable differences leaving net unrealizable DTA at year-end (Example 2)
- Use of cutoff or discrete method if ETR unreliable (e.g. unusual circumstances or significant permanent items) (Example 3)
- Unusual or extraordinary items exclusion that distort ETR (e.g. transaction costs)

Example 2 – Valuation Allowance

Tax Rate 40%	12/31/X1		Forecast 12/31/X2	
	Book/Tax Difference	DTA / (DTL)	Book/Tax Difference	DTA / (DTL)
NOL	250	100	250	100
Fixed asset	(250)	(100)	0	0

Fixed asset difference reverses in 12/X2. This may require a full valuation allowance and tax expense for the $100 NOL DTA in Q1 of 12/X2.

Example 3 – Effective Tax Rate

Forecast	Company 1	Company 2	Consolidated
Ordinary income	100	(110)	(10)
Permanent items		100	100
Book taxable income	100	(10)	90
Tax (40%)	40	(4)	36

Effective tax rate (ETR) =36/(10) = (360%)

Q1 ordinary income	50
ETR	(360)%
Q1 tax benefit	(180)

As the ETR is unreliable, discrete (or cut-off) method may be appropriate.

Special Issues – Effective Tax Rate

- Determination of effective tax rates – interim and annual
  - Federal tax rate
  - State tax rates
    - Apportionment and tax rates – prior tax returns
    - Changes due to merger or acquisition – discrete
    - Changes in rate or computation due to tax laws enacted - discrete impact
    - Deferred tax issues (Example 4)
  - Foreign tax rates – changes in law

Example 4 – State Deferred Tax

	Amount	DTA
Federal NOL	1000	400
State X NOL ($400 over Federal)	1400	2
State Y excess tax basis due to bonus disallowance	500	2
Total DTA		404

Federal and blended State rate	40%
State X rate times apportionment	10% * 5% = 0.5%
State Y rate times apportionment	4% * 10% = 0.4%

Special Issues – Effective Tax Rate (cont.)

- Special REIT / TRS Issues
  - Separate entity states
  - Unitary returns
    - Rate applicable to TRS
    - Allocation of NOL carryforwards and benefit
    - Utilization of unitary NOL by REIT
  - Combined TRS returns
    - Exception to overall valuation allowance for certain members of group (Example 5)
  - Tax sharing agreements amount REIT and TRSs

Example 5 – State Tax – Combined Return / Valuation Allowance

Current Year	
TRS A loss – State X	2,000
TRS B loss – State X	1,000
TRS C – deferred tax liability – State X	(50)

State rate * combined apportionment = 8% * 5% = 0.4%
TRS A and TRS B losses are otherwise subject to a full valuation allowance
TRS C has a DTL

Entry - TRS	DR(CR)
DTA (Note 1)	12
Tax benefit	(12)

Note 1: 3000 * 0.4%

Special Issues – REIT and TRS Interaction

- TRS sales or distributions of assets to REIT
  - Deferral of tax expense or benefit – prepaid or accrual (Example 6)
  - Release on ultimate sale to unconsolidated party
  - Valuation allowance issues
- Transfer of assets and liabilities to TRS by contribution to capital or sale
  - Book tax differences – impact on tax expense or benefit and DTAs and DTLs (Example 7)
  - Pursuant to a business combination
- Termination of TRS status by tax liquidation
  - Expense or benefit related to net deferred tax asset or liability (Example 8)
  - Built-in gains and NOL (Section 1374)

Example 6 – Sale by TRS to REIT

Tax Rate 40%	Tax Basis	Book Value	FMV
Asset	50	100	150

TRS sells asset to REIT at FMV

Entry-TRS	DR(CR)
DTL	20
Prepaid tax	20
Tax payable	(40)

Example 7 – Contribution by REIT to TRS / Sale by REIT to TRS

Tax Rate 40%	Tax Basis	Book Value	FMV
Depreciable Asset	50	100	200

REIT contributes asset to TRS as capital

Entry - TRS	DR(CR)
Fixed asset	100
Capital	(100)
DTL (40%)	(20)
Tax expense	20

REIT sells asset to TRS at FMV

Entry*	DR(CR)		
	TRS	REIT	Elim
Fixed asset	200	(100)	(100)
Cash	(200)	200	
Gain		(100)	100

* REIT Tax Rate deemed to be 0%

Example 8 – Voluntary Revocation of TRS Election to QRS

DTA/DTL Schedule (Tax) **Tax Rate 40%**	**Tax Basis**	**Book Value***	**DTA/ (DTL)**
Intangibles	0	100	(40)
Fixed assets	100	200	(40)
Land (to be sold within 5 years)	50	100	(20)
NOL	100	0	40
	250	400	(60)

- TRS terminates TRS status on 12/30/X1
- Deemed liquidation as QRS 100% owned by REIT
- Land DTL and equal amount of NOL DTA at REIT level

*Assume FMV exceeds book value

Entry - TRS	DR(CR)
DTL	80
DTA	(20)
Tax benefit	(60)

Special Issues – Purchase Accounting

- Business combinations involving REIT & TRS
- Impact on valuation allowances – benefit or expense
- Tax over book basis of indefinite-lived assets
- REIT conversions and mergers with non-REITS
  - Elimination of deferred tax assets and liabilities
  - Exceptions – Section 1374 and gains/income recognized within 5 years
  - UTP reserve for dispositions

Special Issues – Purchase Accounting (cont.)

- Goodwill – Tier 1 and Tier 2 deferred tax implications
  - Possible gain if substantial tax basis over book (Example 9)
  - Section 197 assets – Goodwill or other intangibles
- Single asset acquisitions - excess tax basis – simultaneous equation and adjustment to book value
- Noncontrolling interest in investees – book tax differences

Example 9 - Goodwill

	Section 197 Goodwill	Preliminary Book Goodwill	Difference
At acquisition	1000	100	900

GAAP only gain calculation (40% tax)

Initial calculation (40% / 1-40%) * 900 = 600
However, 600 exceeds 100 book value of goodwill

GAAP Gain Calculation
(40% / 1-40%) * X = 100 (Book goodwill)
(40% / 1-40%) * 150 = 100
(900-150) * 0.4 = 300 gain

Entry-TRS	DR/(CR)
DTA	400
Goodwill	(100)
Gain	(300)

Special Issues – Foreign Entities and Investments

- Tax rate changes and asset cost indexation
- APB 23 implications – US and Foreign taxes
  - TRS and REIT differences – foreign tax credit (Example 10)
- Foreign branches and Section 987 (foreign tax credit or deduction)
- Foreign operations with US$ functional currency
  - Historic cost for fixed assets and depreciation
  - Monetary assets and liabilities
- Foreign partnership outside basis differences
- Translation adjustment in OCI – deferred tax implications

Example 10 – APB 23

	Tax Amount	Book Value
Investment in Country X Sub	500	1000

Distribution in liquidation of excess book value is subject to 10% foreign country withholding tax. Subsidiary has history of distributing book earnings.

Entry – REIT	DR(CR)
DTL	(50)
Tax Expense	50

Special Issues – Uncertain Tax Positions

- Determination, recognition, measurement (REIT, TRSs and foreign entities)
- Subsequent adjustment and derecognition
- Tax indemnification agreements – on and after acquisition date
- Interest and penalties – tax expense or other expense
- Discrete items – not in ETR
- Current liability or offset to DTA
  - Utilization of NOL or other deductible differences
- Transfer pricing issues – Section 857
  - Recognition as deducted or reported

General Content of Footnote Disclosure

- Tax treatment of distribution
- Current and deferred income tax expense schedule
- Reconciliation of statutory rate to tax expense or benefit
- Deferred tax asset and liability schedule
- Roll forward of valuation allowances
- Tabular reconciliation of uncertain tax positions
- Other disclosures –
  - Year over year significant changes in accounts
  - Purchase accounting adjustments
  - Net operating loss carryforwards
  - Statute of limitations on examinations
  - Examination activity
  - Reason for tax expense or benefit

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