Deferred Tax Assets and the Disclosure of Tax-planning Strategies

Executive Summary

Citigroup, Inc. and American International Group, Inc. have two very disparate views on the realizability of their deferred tax assets. Important to each company’s decision is the assessed availability or lack of tax-planning strategies needed to generate future taxable income. Yet, notwithstanding the importance of such strategies to these firms and others generally, little is known about them. Further, we find that companies are often not forthcoming in their disclosures of what tax-planning strategies are available to them and how they might be used. Investors and analysts could use this information in assessing the likelihood of future taxable income and the need for a valuation allowance against reported deferred tax assets.

In this research report we look closely at tax-planning strategies and the details, or lack thereof, provided by firms in describing them. From a sample of 34 firms drawn from recent filings with the SEC, we identify and categorize tax-planning strategies currently being used. We find that investment-related tax-planning strategies, e.g., selling appreciated securities or switching tax-exempt securities to taxable ones are the most common strategy in use, comprising 47% of our sample. Planned sales of other assets comprise 16% and transactions related to sale and leaseback transactions and other income-acceleration transactions constitute 13% of the sample. Five percent of the sample each employ a permanent reinvestment of foreign subsidiary earnings or capitalizing R&D costs for tax purposes. The remaining sample firms use a host of other miscellaneous practices, including the purchase of replacement properties, the merging of subsidiaries, or the shifting of entities to lower tax-rate jurisdictions. Given the general lack of disclosures observed, the FASB may wish to consider requiring more disclosure of tax-planning strategies by reporting firms.
Georgia Tech Financial Analysis Lab
College of Management
Georgia Institute of Technology
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Georgia Tech Financial Analysis Lab
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A recurring theme in Lab’s work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. It defines earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, the Lab research may look into reporting practices that affect either earnings or cash flow, or both. At times, its research may look at stock prices generally, though from a fundamental and not technical point of view.

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Deferred Tax Assets and the Disclosure of Tax-planning Strategies

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<td>51. Valley National Bancorp</td>
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<td>52. Western Liberty Bancorp</td>
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<td>53. II-VI Incorporated</td>
<td>16</td>
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Deferred Tax Assets and the Disclosure of Tax-planning Strategies
by Eugene E. Comiskey and Charles W. Mulford


Introduction
Among its $1.9 trillion in assets held at December 31, 2010, Citigroup, Inc. reports a gross deferred tax asset of $56.4 billion. The company provides no valuation allowance against this asset, indicating that it expects to be able to realize it fully by using the tax deductions it represents to reduce future taxable income. The company maintains that if future taxable income generated by operations is insufficient to absorb its future tax deductions then it has at its disposal certain tax-planning strategies, in particular, “. . . potential sales of businesses and assets . . .” that it can use to generate that taxable income.1

American International Group, Inc. provides a counter example. While the company reports a gross deferred tax asset of $37.4 billion, the company reduces that asset by a valuation allowance of $25.8 billion, which, when combined with its deferred tax liabilities, reduces its net deferred tax assets to a deferred tax liability balance of $1.2 billion. Total assets at the time were $683.4 billion. The company indicates that the valuation allowance is necessary because of, “. . . recent negative evidence of cumulative operating losses and a lack of predictable profits.”2 The company did note, however, that if it demonstrates consistent profitability or, “. . . develops prudent and feasible tax-planning strategies,” the valuation allowance might be reduced or removed.3

Citigroup and AIG are two large financial companies with two very disparate views regarding the realizability of an important tax-related asset. As an important part of the viewpoints taken, both companies mention either the existence or lack of tax-planning strategies in determining whether a deferred tax asset valuation allowance is necessary.

The clear importance of these tax-planning strategies notwithstanding, little is generally known about them. The purpose of this research report is to look at tax-planning strategies in the context of the valuation allowance for deferred tax assets. We look at what they are, how they work, and, when disclosed, we provide insight into the specific strategies used by firms to mitigate the need for a deferred tax valuation allowance.

3 Ibid.
Background
An important and challenging feature of GAAP tax-accounting is the requirement that firms assess the likelihood that deferred-tax assets (DTAs) will be realized.\textsuperscript{4} Deferred tax assets reflect the tax savings associated with future tax deductions. They arise primarily from deductible temporary differences, where expenses are recognized on a firm’s books prior to their recognition on the tax return. For example, a warranty expense might be accrued on the books that is not yet deductible on the tax return. The tax-saving potential of this accrual (the expense times the tax rate) is recorded as a deferred tax asset, along with an offsetting reduction in income-tax expense. The deferred tax asset will be realized in the future when a deduction for the warranty accrual is taken against future taxable income. The expense deduction reduces taxable income and with it income-tax payments. Other common examples of expenses or losses that give rise to deductible temporary differences include loan loss provisions and bad debt expense, the unrealized portion of restructuring charges, investment writedowns and impairment charges. While less common, the recognition of revenue on the tax return, before it is recorded on the books, can also create a deferred tax asset. Beyond temporary differences, deferred tax assets are also associated with net operating losses (NOLs), capital losses, and various tax-credit carryforwards.

Once on the balance sheet, deferred tax assets are subject to periodic impairment tests, as noted by the FASB below,

"Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized."\textsuperscript{5}

The key requirement for the realization of deferred tax assets is future taxable income. In the absence of future taxable income, future tax deductions provide no tax savings to the firm. Nathan’s Famous highlights the importance of future taxable income to the realization of deferred tax assets,

"The ultimate realizations of deferred tax assets is dependent upon the generation of future taxable income in those periods in which temporary differences become deductible."\textsuperscript{6}

\textsuperscript{5} Ibid., subsection 30-5.
\textsuperscript{6} Nathan’s Famous, Inc., Form 10-K Annual Report to the SEC, March 27, 2011, p. F-18. The Nathan’s Famous statement does not reference capital losses, net operating losses or tax credits because they currently do not have deferred tax assets associated with these items. However, their realization is also dependent upon sufficient taxable income being generated prior to the expiration of their carryforward periods.
When the likelihood that realization of some or all of a firm's deferred tax assets falls below the 50 percent threshold, valuation allowances are required. This calls for recording a deferred tax expense and an offsetting valuation allowance (a contra account to the deferred tax asset). Examples of valuation allowances taken against deferred tax assets are presented in Exhibit 1.
Exhibit 1: Deferred Tax Asset Valuation Allowances (in $thousands)

<table>
<thead>
<tr>
<th>Booze Allen Hamilton Corp.:</th>
<th>March 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>2010</td>
</tr>
<tr>
<td><strong>Deferred income tax assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>$53,675</td>
</tr>
<tr>
<td>Stock-based compensation</td>
<td>56,114</td>
</tr>
<tr>
<td>Pension and postretirement insurance</td>
<td>22,785</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>31,982</td>
</tr>
<tr>
<td>Net operating loss carryforwards</td>
<td>57,124</td>
</tr>
<tr>
<td>Capital loss carry forward</td>
<td>42,379</td>
</tr>
<tr>
<td>AMT</td>
<td>8,353</td>
</tr>
<tr>
<td>Deferred rent and tenant allowance</td>
<td>18,101</td>
</tr>
<tr>
<td>Other</td>
<td>12,440</td>
</tr>
<tr>
<td>Total gross deferred income taxes</td>
<td>302,953</td>
</tr>
<tr>
<td><strong>Less: Valuation allowance</strong></td>
<td>(42,379)</td>
</tr>
<tr>
<td><strong>Total net deferred income tax assets</strong></td>
<td>260,574</td>
</tr>
</tbody>
</table>


**Western Liberty Bancorp.:**

The cumulative tax effects of the primary temporary difference as of December 31 are as follows:

<table>
<thead>
<tr>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax assets:</td>
<td></td>
</tr>
<tr>
<td>Net operating loss carryforward</td>
<td>$5,889</td>
</tr>
<tr>
<td>Organization costs and start up costs</td>
<td>5,576</td>
</tr>
<tr>
<td>Allowance for loan losses, unfunded commitments and loan discounts</td>
<td>4,250</td>
</tr>
<tr>
<td>Stock warrants and stock options</td>
<td>2,331</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>769</td>
</tr>
<tr>
<td>Premises and equipment</td>
<td>76</td>
</tr>
<tr>
<td>Total deferred tax asset</td>
<td>18,891</td>
</tr>
<tr>
<td>Deferred tax liabilities:</td>
<td></td>
</tr>
<tr>
<td>Cored Deposit Intangible</td>
<td>(261)</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>(122)</td>
</tr>
<tr>
<td>Deferred loan costs</td>
<td>(109)</td>
</tr>
<tr>
<td>Net deferred tax asset</td>
<td>18,399</td>
</tr>
<tr>
<td><strong>Valuation allowance</strong></td>
<td>(18,399)</td>
</tr>
<tr>
<td>$—</td>
<td>$—</td>
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</tbody>
</table>

Western Liberty Bancorp, Form 10-K, Annual Report to the SEC, December 31, 2010, p. 139
The data in Exhibit 1, reveal that Booz Allen Hamilton Corp. determined that all of the deferred tax assets associated with its capital-loss carryforwards failed the realization test. That is, in the view of management, the $42,379,000 of deferred tax assets related to the capital-loss carryforwards fall below the fifty percent threshold. However, all of the remaining deferred tax assets make it over the fifty percent threshold and remain on the balance sheet. Booz Allen Hamilton also disclosed deferred tax liabilities, but they are not shown here.

Some important tax-law features can help explain the 100 percent valuation allowance of Booze Hamilton against its $42,379,000 million capital-loss carryforward deferred tax asset. First, capital gains must be produced in order to offset against capital losses. That is, capital-loss carryforwards cannot be used against ordinary operating taxable income. Second, the carryforward period for capital losses is only five years. In contrast, there is no valuation allowance in the case of the company’s net operating loss carryforwards. In this case, the net operating loss carryforwards can be used against operating income, which is less restrictive than in the case of capital losses. Moreover, the net operating loss carryforward period is twenty years, helping to ensure that the firm will be able to generate the taxable income needed to realize the net operating loss deduction.

There is a notable realization in fiscal 2011 of the deferred tax assets related to Booze Hamilton’s net operating loss carryforwards. The sharp decline in the NOL-related deferred tax asset is consistent with the NOL carryforwards being used to reduce taxable income. This observation is supported by the partial Booze Hamilton footnote provided below:

"In addition, our tax payments were reduced by $99.8 million in fiscal 2011 due to the utilization of our NOL. We believe that it is more likely than not that the company will generate sufficient taxable income to fully realize the tax benefit of our NOL carryforwards over the next two years, which had a remaining balance of $148.8 million as of March 31, 2011."\(^7\)

Earlier, when the company incurred the net operating losses, their tax-savings potential was reported as a deferred tax asset and the tax benefit was recognized as a reduction in income tax expense. Then, later, when the net operating losses were realized as deductions against taxable income in 2011, the company’s tax payments were reduced by the $99.8 million. Upon realization, the deferred tax asset was removed from the balance sheet.

The deferred tax assets of Western Liberty Bancorp, also in Exhibit 1, are fully offset by a valuation allowance at the end of both December 31, 2010 and 2009. This valuation

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\(^7\) Booz Allen Hamilton Corp., Form 10-K, Annual Report to the SEC, March 31, 2011, p. 51
allowance may be somewhat conservative since the firm has operating loss carryforwards of $17,321,000, which do not begin to expire until 2027. Note that the Western Liberty 2010 deferred tax asset of $5,889,000, is equal to the 2010 operating loss carryforward of $17,321,000 times a Federal tax rate of 34 percent ($17,321,000 x .34 = $5,889,000).

The identification of potential sources of future taxable income is central to the deferred tax asset impairment test as in the cases above. That is, no reduction in the carrying value of the deferred tax asset is required if sufficient taxable income, within the necessary time frame and of the appropriate matching character, is produced in the future. Examples of appropriate matching character would include: a capital gain to offset against a capital loss; a net operating profit to offset a net operating loss; and a Georgia capital gain to offset a Georgia capital loss.

**Taxable Income Sources**

Examples of potential taxable-income sources are provided by the FASB and presented in Exhibit 2.

**Exhibit 2: Taxable Income Sources for Deferred-Tax-Asset Realization**

Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences  
b. Future taxable income exclusive of reversing temporary differences and carryforwards  
c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law  
d. Tax-planning strategies that would, if necessary, be implemented to, for example:
   1. Accelerate taxable amounts to utilize expiring carryforwards  
   2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss  
   3. Switch from tax-exempt to taxable investments.


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8 Western Liberty Bancorp, Form 10-K, Annual Report to the SEC, December 31, 2010, p. 139
The first three taxable-income sources listed in Exhibit 2 (a, b, and c) are largely the product of the management and operations of the firm. The most common "a" source would be the reversal of depreciation temporary differences. With straight-line depreciation used on the books and accelerated depreciation on the tax return, book income will initially exceed taxable income. However, over time, as accelerated depreciation declines on the tax return, the depreciation on the books will exceed that reported on the tax return. The reversal of this taxable temporary difference will increase taxable income, or reduce a loss. Item "b" is simply all other taxable (tax return) income produced by the operations of the firm, exclusive of that resulting from the reversal of taxable temporary differences. Item "c" refers to taxable income earned within a carryback period. A deferred tax asset can be realized with taxable income earned in a preceding carryback period. For example, the carryback period for net operating losses is two years. It is three years for capital loss carrybacks.

Tax-planning strategies are the last potential source of taxable income listed in Exhibit 2. Unlike the other sources of taxable income listed in the Exhibit, tax-planning strategies require active management participation. For example, a switch from tax-exempt investments to taxable ones would require a plan to sell holdings of tax-exempt investments and the purchase of taxable investments so that income generated would be taxable, boosting future taxable income.

The tax-planning strategies identified in Exhibit 2, along with their disclosure, are the focus of this Report. Tax-planning strategies can play an important role in efforts to determine if a valuation allowance is necessary. However, little work has been done on identifying the tax-planning strategies developed by firms as methods to both ensure the realization of deferred tax assets and avoid the need to record valuation allowances.

The balance of this report is organized as follows: In the next section, Tax-planning Strategies, we provide additional information on the character of tax-planning strategies – how they are typically structured and how they function to help generate future taxable income. That section is followed with the section, Paucity of Tax-planning Strategy Descriptions, which provides examples of firms disclosing their use of tax-planning strategies but not detailing the nature of those strategies. We provide a summary of firms that do both declare their reliance on tax-planning strategies and also detail their character in the section titled, Tax-planning Strategies Identified. The paper concludes with Discussion and Conclusions, where we provide potential reasons for the reluctance of firms to provide details of their tax-planning strategies and some suggestions about changes in disclosures surrounding those strategies.
Tax-planning Strategies
Exhibit 2 provides some general examples of tax-planning strategies. More information is provided in ASC Topic 740, *Income Taxes* about the distinction between tax-planning strategies and other sources of taxable income. Key characteristics of qualifying tax-planning strategies are also presented, as described below.

*Distinctions between Tax-planning Strategies and Other Sources of Taxable Income*
ASC Topic 740 provides an example that distinguishes between tax-planning strategies and other sources of taxable income:

“For example, an enterprise may have a practice of deferring taxable income whenever possible by structuring sales to qualify as installment sales for tax purposes. Actions such as that are not tax-planning strategies, as that term is used in this Statement, because they are actions that management would take in the normal courses of business.”

The Statement then follows with an example that would be considered to be a tax-planning strategy:

“For purposes of applying the requirements of this Statement, a tax-planning strategy is an action that management ordinarily might not take but would take, if necessary, to realize a tax benefit for a carryforward before it expires. For example, a strategy to sell property and lease it back for the expressed purpose of generating taxable income to utilize a carryforward before it expires is not an action that management takes in the normal course of business.”

In this same subsection, the Statement characterizes a qualifying tax-planning strategy as an action that:

a) Is prudent and feasible

b) An enterprise ordinarily might not take, but would to prevent an operating loss or tax credit carryforward from expiring unused

c) Would result in realization of deferred tax assets.

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10 Ibid.
11 Ibid.
It is common for firms to reference the prudent and feasible characteristics in a rather
boilerplate fashion, without providing further detail. H. J. Heinz Co. is typical:

"The Company records valuation allowances to reduce deferred tax assets to
the amount that is more likely than not to be realized. When assessing the need
for valuation allowances, the Company considers future taxable income and
ongoing prudent and feasible tax planning strategies." 12

**Paucity of Tax-Planning Strategy Descriptions**

Firms frequently make references to tax-planning strategies in disclosures dealing with
defered tax assets. A search of 10-K filings on the SEC Website for the period 02/01/2010 to
1/30/2011 identified 1,700 firms that included references to tax-planning strategies. Our
analysis would suggest that almost all of such disclosures are rather generic in nature, and
they simply discuss the role of potential tax-planning strategies in assessing the need for
valuation allowances against their deferred tax assets. In many cases these disclosures appear
to be leading up to a disclosure of the specific nature of the tax-planning strategies they
believe that they could or would employ, but in most cases the reader is left hanging--no
detailed disclosure is provided. An example, of this practice, provided by Valley National
Bancorp. is found below. Several more are provided in Exhibit 3:

"A valuation allowance for deferred tax assets decreased $6.5 million in 2008
as a result of management’s identification of a qualifying tax-planning strategy
allowing the use of Valley’s capital-loss carryforwards. The qualifying tax
planning strategy identified by management was 1) prudent and feasible, 2) a
strategy that Valley had the intent and ability to implement, and 3) a strategy
that would result in the future realization of the capital loss carryforwards." 13

The absence of a description of the tax-planning strategy, which could be provided with the
addition of a descriptive sentence or two, leaves the financial statement reader with no ability
to make an assessment as to the likely effectiveness of the tax-planning strategy.

In contrast, consider the example provided by Regeneron Pharmaceuticals found below:

"During 2008, the Company implemented a tax planning strategy to utilize net
operating loss carry-forwards (which were otherwise due to expire in 2008
through 2012) on its 2007 U.S. federal and New York State income tax returns
that were filed in September 2008. The tax planning strategy included
electing, for tax purposes only, to capitalize $142.1 million of 2007 research
and development (“R&D”) costs and amortize these costs over ten years for
tax purposes. By capitalizing these R&D costs, the Company was able to

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Regeneron Pharmaceuticals created taxable income in its 2007 tax returns by the capitalization R&D costs in its tax return of the same year. This income could then be offset by operating loss carryforwards that otherwise might have expired unused.

The disclosure of tax-planning strategies would seem to be helpful to analysts, investors, regulators, auditors and others. That is, such disclosures should help financial statement readers make their own assessments of the likelihood that the deferred tax assets will be realized – particularly when those tax-planning strategies have yet to be implemented. However, our reviews of 10-K filings revealed very limited disclosures of the nature of tax-planning strategies. The most typical disclosure simply indicates that tax-planning strategies are available, which could ensure realization of some or all of the deferred tax assets—trust us! Some additional examples of these non-disclosures are presented in Exhibit 3.

**Exhibit 3: Tax-Planning Strategies Referenced but Not Disclosed**

1. **Ameron International Corp.** 11/30/2010, p. 48
   Included in this decrease was a release that reduced tax expense of $1,300,000 in 2009 and $1,100,000 in 2008 of valuation allowance related to the Company’s subsidiary in the Netherlands due to profitability in 2008 and projected profitability in the future due in part to a tax planning strategy that is being implemented to prevent the net operating loss carry-overs from expiring unutilized.

2. **Bluelinx Holdings, Inc.** 1/2/2010, p. 54
   Considering the weight of this evidence, we recorded tax benefits in the states where the tax planning strategy was executable. Therefore, we recorded a valuation allowance of $1.1 million for those states where we would not be able to execute the strategy as of the end of fiscal 2008.

3. **First Financial Northwest, Inc.** 12/31/2009, p. 119
   In the past, we have relied on two primary tax strategies that we had documented throughout 2008 to offset the capital loss with a capital gain. At December 31, 2008, after thoroughly evaluating these two strategies, we determined that neither of them would be viable to offset the capital loss resulting from the future potential sale of the AMF Ultra Short Mutual Fund.

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Exhibit 3 (continued) Tax-Planning Strategies Referenced but Not Disclosed

Also in 2009, the Company recorded a reduction of $0.8 million in the valuation allowance associated with deferred tax assets primarily related to Canadian losses recorded in prior years. The reduction was based on the Company’s identification of a tax planning strategy that it considered in connection with its ongoing assessment of the realizability of future benefits.

As to positive evidence which would outweigh the foregoing negative evidence, expectations as to future taxable income are generally considered insufficient to overcome the negative evidence of recent cumulative losses, even if supported by detailed forecasts and projections. This would have resulted in a complete valuation allowance on all U.S. deferred tax assets. However, we were able to recognize $2.6 million of deferred tax assets based upon a reasonable tax planning strategy.

Following a European Union Court of Justice decision and subsequent proceedings which concluded in the second quarter of 2007 that we believe may favorably impact us, we initiated a new tax planning strategy.

7. Mercado Libre, Inc. 12/31/2010, p. 53
Our valuation allowance is based on our assessment that it is more likely than not that the deferred tax asset will not be realized. The fluctuations in the valuation allowance will depend on the capacity of each country operation to generate taxable income or our execution of future tax planning strategies that allow us to use the aforementioned deferred tax assets.

The Company recognized cash tax savings of $10.0 million on the utilization of the Swiss tax losses during the year, and released an additional $4.2 million valuation allowance, primarily due to the Company’s decision to implement a tax planning strategy. . . . In addition, Management has considered a tax planning strategy that is both prudent and feasible that will be implemented in a timely manner, if necessary, which will allow the Company to recognize the future tax attributes by increasing taxable income in the United States.

We can restore a significant amount of the deferred tax asset for these credits by executing a certain tax planning strategy that involves filing amended tax returns.
Exhibit 3 (continued): Tax-Planning Strategies Referenced but Not Disclosed

Consequently, beginning in 2008, given our historical losses, we concluded that our ability to fully utilize our NOLs was limited due to projecting the continuation of the negative economic environment and the impact of the negative operating environment on our tax planning strategies. As a result of our tax planning strategies which have not yet been implemented and which do not depend upon generating future taxable income, we carry deferred tax assets in the U.S. of $90 million relating to the expected utilization of those NOLs.

In 2009 we implemented a tax planning strategy in order to take advantage of certain tax loss carrybacks which expire in 2009. During 2010, we received $67.7 million in tax refunds due to the tax planning strategy we implemented in 2009 in order to take advantage of certain tax loss carrybacks which expired in 2009.

During the year ended June 30, 2009, the Company decided to adopt a tax planning strategy which should enable the utilization of foreign tax credit carryforwards. As a result, a deferred tax valuation allowance of $1.1 million was reversed to income and the Company recorded the benefit of the current year foreign tax credits generated.

Based upon our preliminary anecdotal results, we expanded upon our initial investigation by conducting searches of 10-K filings for the period 2007 through the first quarter of 2011. These searches supported our earlier searches and reveal that many firms declare that they are relying to some extent on tax-planning strategies to realize their deferred tax assets, but very few disclose the nature of these tax-planning strategies.

Tax-planning Strategies Identified
The companies listed in Exhibit 4 are the examples of companies found through our SEC search that provided descriptions of their tax-planning strategies. There are a total of 34 firms that we could locate that identified the nature of their tax-planning strategies.

GAAP Tax-planning Strategies
Exhibit 2 listed three tax-planning strategies: (1) accelerate taxable amounts; (2) change taxable income or deductible amounts from ordinary income or loss to capital gain or loss; and (3) switch from tax-exempt to taxable investments. Beyond these three, ASC 740 lists...
several additional potential tax-planning strategies: (4) the election to file a consolidated tax return; (5) the election to claim either a deduction or a tax credit for foreign taxes paid; and (6) the election to forgo carryback and only carry forward a net operating loss. Other tax-planning strategies involve (7) increasing the recognition of taxable income by structuring sales so that they do not qualify for installment-sale treatment; (8) shifting taxable income by changing depreciation methods; (9) selling installment sale receivables to accelerate the reversal of associated taxable temporary differences; (10) accelerating the reversal of deductible temporary differences; and (11) entering into a sale and leaseback transaction for the sole purpose of boosting taxable income.\(^{15}\)

Examples of tax-planning strategies disclosed by the firms in our sample are provided in Exhibit 4. Most of the companies included in the Exhibit disclose only a single tax-planning strategy, though it was common for their disclosures to imply that there were others available to them that were not disclosed. The tax-planning strategies reported include those that have been implemented as well as those that would be used if necessary to achieve the realization of deferred tax assets. We classify the strategies into nine general categories in Exhibit 5.

\(^{15}\) Refer to Financial Accounting Standards Board, ASC 740-10-55.
Exhibit 4  Identified Tax-planning Strategies

1. Ace Limited, 12/31/2010, p. 69
At December 31, 2010, our investment portfolios held by U.S. legal entities included approximately $151 million of gross unrealized losses on fixed income investments. Our tax planning strategy related to these losses is based on our view that we will hold these fixed income investments until they recover their cost. As such, we have recognized a deferred tax asset of approximately $53 million related to these fixed income investments. This strategy allows us to recognize the associated deferred tax asset related to these fixed income investments as we do not believe these losses will ever be realized.

The Company implemented a tax planning strategy during the first quarter of 2009 that resulted in the realization of taxable profits in the United Kingdom from the sale of intellectual property and other intangible assets to Airvana, Inc. As a result of this sale, there was a $3,299,000 reduction in the valuation allowance against the Company’s U.K. net operating loss carryforwards which were used to offset the taxable profit realized on this transaction.

Although Ambac has a significant tax exempt portfolio, under SFAS 109, a tax planning strategy is available to switch the portfolio into taxable securities.

This decrease (in effective tax rate) was primarily due to current year taxable income from capital gain sources which resulted from the recognition of net realized gains on available for sale fixed maturity and equity securities that were sold as part of a tax planning strategy to generate capital gains to offset capital losses as discussed above.

We have not provided a full valuation allowance against our deferred tax assets due to a tax planning strategy that provides us the opportunity to sell certain appreciated investments. We have the intent and ability to sell such investments with unrealized gains prior to the expiration of the net operating loss and related deferred tax assets.

6. Andrew Corp., 1/30/2007, p. 67
In addition, the company also concluded during the fourth quarter of fiscal 2006, that tax planning strategies to generate future taxable income through transfers of intellectual property to foreign affiliates were not longer feasible due to uncertainties regarding the ability of foreign affiliates to efficiently utilize and finance the intellectual property.
Exhibit 4 (continued) Identified Tax-Planning Strategies

The company is dependent upon having capital gain income in the foreseeable future to use the capital loss carryforward in its entirety. To support the capital deferred tax asset, the Company is able to rely on future taxable capital gain income from gross unrealized gains in its investment portfolio. The Company is also able to rely on the use of various tax planning strategies to forecast taxable gains in the foreseeable future.

We have identified certain prudent and feasible strategies which could generate taxable future capital gain income . . . Examples include, but are not limited to, changing the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss or accelerating taxable amounts. While no commitments to implement any strategy have been made, these strategies have been considered in the analysis of the recoverability of the Company’s deferred tax assets and the reduction of the valuation allowance.

Although the Company has a significant tax exempt portfolio, this can be converted to taxable securities as permitted as a tax planning strategy under GAAP.

During October 2009, we received from the Internal Revenue Service a final extension until December 31, 2010 to obtain replacement property to defer the entire payment of income taxes. It is our intention to acquire replacement property by December 31, 2010. It is possible that we may not identify and purchase adequate replacement property within the required time period, which would require us to make this income tax payment plus interest as of December 31, 2010. We believe the tax planning strategy is prudent and feasible, and we have the ability and intent to purchase and sell, if necessary, replacement property to realize these deferred tax assets.

BFC’s shift in business strategy, coupled with more recent economic developments, caused BFC to reconsider its previously disclosed tax planning strategy wherein BFC had intended to sell BankAtlantic Bancorp’s Class A Common Stock in order to generate sufficient taxable income to utilize expiring NOLs. Because BFC believes that its best long term potential is more likely to occur through the growth of the companies it controls, BFC’s current business strategy is to hold its investment in BankAtlantic Bancorp indefinitely and no longer intends to pursue such a tax planning strategy.
Exhibit 4 (continued) Identified Tax-Planning Strategies


In December 2009, by implementing a tax planning strategy, which was to allocate sufficient future taxable income to Medicine before the expiration of its tax loss carryforwards, Management concluded that it was more likely than not that the correspondent deferred tax assets would be realized and therefore decreased the beginning-of-the-year balance of valuation allowance.


Based on management's current estimate of book and taxable income for the near future, as well as our tax planning strategy currently being implemented where deferred revenue as of the beginning of the year, related to maintenance contracts, will be taken into taxable income on a cash basis (full inclusion method) beginning with the current year over a four year period, it was determined that it is more likely than not that we will be able to generate enough taxable income in the respective carryforward periods and will utilize the respective net operating losses.


We also must consider any prudent and feasible tax planning strategies that would minimize the amount of deferred tax liabilities recognized or the amount of any valuation allowance recognized against deferred tax assets. For example, a tax planning strategy that we employ is the permanent reinvestment of the earnings of foreign subsidiaries.

14. FBL Financial Group 12/31/2009, p. 79

Our tax planning strategy is to sell various appreciated securities and other capital assets that if sold would result in sufficient capital gains to realize the deferred tax assets, thus minimizing the need for a valuation allowance.


Subsequent to December 31, 2007 the Company elected to make a one-time transfer of its entire investments held-to-maturity portfolio to investments available-for-sale portfolio as a tax planning strategy. During January 2008, a portion of the tax-exempt municipal bond portfolio was sold. Gross proceeds from the sales were $62,551 with gross gains of $1,429 and gross losses of $56.
Exhibit 4 (continued) Identified Tax-Planning Strategies

In fiscal 2008, we recorded an increase to the deferred tax asset of $2.4 million with a corresponding benefit for income taxes. The primary reason for this increase was a greater expected realizable gain from the possible repurchase of the remaining 6% convertible trust preferred securities at a discount to their book value of $50 per share. The increase was partially offset by the exclusion of unrealized gains on certain real estate properties that were no longer available as part of our tax planning strategy following a decision to market these properties for sale.

Further, we have considered limited prudent and feasible tax-planning strategies, such as, sale-leaseback of certain branches/buildings and divestiture of separately chartered banking subsidiary, that are available to accelerate taxable income.

The fiscal year 2010 effective tax rate was (81.0)% compared to the effective tax rate for fiscal year 2009 of 31.6%. Relatively low pre-tax income coupled with a tax benefit due to the Company's tax planning strategy related to the sale of its Poland facility and land and the favorable impact of the Company's earnings mix resulted in a tax benefit in fiscal year 2010 despite the Company's pre-tax income.

19. KVH Industries, Inc, 12/31/2009, p. 21
We rely upon a tax planning strategy to support the realizability of certain of our deferred tax assets. The strategy represents an action that we ordinarily would not take, but would take, if necessary, to realize an estimated $3.3 million in U.S. deferred tax assets. The strategy depends upon our ability to sell our Middletown, Rhode Island headquarters facility in order to generate taxable income for the purpose of utilizing our U.S. net operating tax loss carry-forwards before they expire.

The principal tax planning strategy available to us relates to the permanent reinvestment of the earnings of our foreign subsidiaries. Assumptions related to the permanent reinvestment of the earnings of our foreign subsidiaries are reconsidered quarterly to give effect to changes in our portfolio of producing properties and in our tax profile.
Exhibit 4 (continued) Identified Tax-Planning Strategies

21. MF Global Holdings LTD, 3/31/2011, p. 23
Third, in certain of our key operating jurisdictions, we have a sufficient tax planning strategy which includes potential shifts in investment policies, which should permit realization of our deferred tax assets. Management believes this strategy is both prudent and feasible. The amount of the deferred tax asset considered realizable, however, could be significantly reduced in the near term if our actual results are significantly less than forecast. If this were to occur, it is likely that we would record a material increase in our valuation allowance. Loss carryforwards giving rise to a portion of the overall net deferred tax asset either do not expire or expire no earlier than fiscal 2031.

22. National Atlantic Holdings, 12/31/2007, p. 58
Pursuant to our tax planning strategy, we invested the $40.6 million received from the OCIC replacement carrier transaction in long-term bonds in accordance with Treasury Ruling Regulation 1.362-2, which allows us to defer the payment of income taxes on the associated replacement carrier revenue until the underlying securities are either sold or mature.

The other tax strategy was the transfer of a profitable line of business from BPPR to BPNA. Although that strategy is still feasible, given the reduced profitability levels in the BPPR operations, which were reduced in the fourth quarter due to significant increased credit losses, management is less certain as to whether it is prudent to transfer a profitable business to the U.S. operations at this time.

Our tax planning strategy is to sell various appreciated securities and other capital assets that if sold would result in sufficient capital gains to realize the deferred tax assets, thus minimizing the need for a valuation allowance.

In evaluating the need for a valuation allowance on deferred tax assets, management determined that assets related to capital losses on investments would be realized through a tax planning strategy of selling investments with built in gains.

During 2009, we implemented a tax planning strategy to elect and capitalize, for tax purposes only, a total of $70.0 million of 2008 and 2009 research and development ("R&D") costs and amortize these costs over ten years for tax purposes. This strategy had the effect of decreasing deferred taxes for net operating losses and increasing deferred taxes for capitalized R&D.
**Exhibit 4 (continued) Identified Tax-Planning Strategies**

27. Radian Group, Inc. 12/31/2009, p. 88

Future realization of our DTA (deferred tax asset) will ultimately depend on the existence of sufficient taxable income of the appropriate character (ordinary income or capital gains) within the applicable carryforward period provided under the tax law. Among the more significant positive evidence that we considered in determining the amount of valuation allowance needed is our tax planning strategy, which was partially implemented during 2009, of converting the investment portfolio from tax exempt securities to securities that provide fully taxable interest.


For the year ended December 31, 2008, the Company incurred a net loss for tax purposes and recognized a full valuation allowance against deferred taxes. During 2008, the Company implemented a tax planning strategy to utilize net operating loss carry-forwards (which were otherwise due to expire in 2008 through 2012) on its 2007 U.S. federal and New York State income tax returns that were filed in September 2008. The tax planning strategy included electing, for tax purposes only, to capitalize $142.1 million of 2007 research and development (“R&D”) costs and amortize these costs over ten years for tax purposes.

29. Regions Financial Corp. 12/31/2010, p. 70

The Company has the ability to implement tax planning strategies to maximize the realization of deferred tax assets, such as the sale of appreciated assets. As an example, during 2010, the Company reported net pre-tax gains of $394 million from the sale of securities available for sale. At December 31, 2010, the Company’s portfolio of securities available for sale had $283 million of gross unrealized pre-tax gains which could absorb $108 million of deferred tax assets, which management would consider being a tax planning strategy to maximize the realization of the deferred tax assets.

30. Ronson Corp., 12/31/2007, p. 66

A portion of the deferred income tax assets is the result of a tax planning strategy for state income tax purposes of merging certain of the Company's subsidiaries resulting in realization of net operating loss carryforwards.

31. Soko Fitness & Spa Ground, Inc. 5/31/2009, p. 28

The decrease in income tax provisions is largely due to execution of our tax planning strategy this year by separating our beauty and spa facilities from our fitness centers. Revenues from our fitness centers are usually taxed at a regular rate of 25% while revenues generated from our beauty and spa facilities are generally subject to a fixed tax system, which results in much lower taxes.
Exhibit 4 (continued) Identified Tax-Planning Strategies

32. Superior Bancorp. 12/31/2009, p. 32
The only tax planning strategy management considered involves the decision to hold any available-for-sale debt security in an unrealized loss position until they mature at which time our full investment will be recovered.

We evaluate our valuation allowance each quarter based on factors such as the mix of earnings in the jurisdictions in which we operate, prudent and feasible tax planning strategies, current taxable income and forecasted taxable income . . . To realize approximately $13.0 million of our foreign tax credit carryforwards, we included a tax planning strategy that we would implement a future cash dividend of approximately $40.0 million from our European group.

Availability of prudent and feasible tax-planning strategies, consisting primarily of a switch in a portion of Webster’s investment securities portfolio, from tax-exempt to taxable, and certain sale-leaseback transactions available to the Company.

Classification of Disclosed Tax-planning Strategies
The tax-planning strategies categorized in Exhibit 5 have been organized in the order of their frequency. Out of the total 38 disclosed tax-planning strategies, seventeen, or 45 percent, were related to the use of securities. The most common securities-related tax-planning strategies involved (1) held-to-maturity securities that were carried at less than face value, where the strategy was to hold them until maturity, at which time full face value would be recognized; (2) securities that were carried at less than fair value, where the strategy was to sell the securities at gains; and (3) tax-exempt securities that would be sold and replaced by securities yielding taxable income. For example, Ace Limited (Firm 1) disclosed the intent to hold its fixed income investments until their cost was recovered. American Equity Investment Life Holding Co. (Firm 4) planned the sale of fixed maturity and equity securities to generate capital gains. Radian Group, Inc. (Firm 27) planned the conversion of its investment portfolio from tax exempt securities to securities that provide fully taxable interest.

Next to securities, sales or transfers of other assets made up six or 16% of the total tax-planning strategies. For example, Airvana, Inc., (Firm 2) sold intellectual-property assets, which produced gains that offset the company’s loss carryforwards. Similarly, KVH Industries, Inc. (Firm 19) sold its headquarters facility in order to produce taxable income that
could be used to utilize an operating tax loss before it would expire. Popular, Inc., (Firm 23) transferred a profitable line of business to, apparently, an entity making losses.

The tax-planning strategies related to sale and leaseback and accelerated revenue transactions are similar in nature. The sale and leasebacks produce taxable income just as is the case with most of the investment-related strategies. However, it could also be seen as a method to accelerate the realization of taxable income. For example, Hampton Roads Bankshares, Inc. (Firm 17) characterized its sale and leaseback as "available to accelerate taxable income."

Exterran Holdings, Inc. (Firm 13) and Marathon Oil Corp. (Firm 20) identify the permanent reinvestment of the earnings of foreign subsidiaries as tax-planning strategies. Recovery of these foreign earnings would trigger an increase in taxable income and the payment of additional taxes.

The capitalization of R&D costs for income-tax purposes, as noted by Progenics Pharmaceuticals, Inc., (Firm 26) and Regeneron Pharmaceuticals, Inc., (Firm 28), increases current taxable income, which is the central theme of tax-planning strategies and the realization of deferred tax assets.

Several miscellaneous items, all of which are designed to increase taxable income, are included in the “Other” caption in Exhibit 5.
### Exhibit 5 Classification of Disclosed Tax-planning Strategies

<table>
<thead>
<tr>
<th>Area of Tax-planning Strategy</th>
<th>Numbers of Firms Using the Method</th>
<th>Number of Firms Using the Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments I: Hold to maturity or sell appreciated securities</td>
<td>1, 4, 5, 7, 10, 14, 15, 24, 25, 29, 32</td>
<td>11</td>
</tr>
<tr>
<td>Investments II: Switch tax-exempt securities to taxable securities to taxable</td>
<td>3, 8, 21, 27, 28, 34</td>
<td>6</td>
</tr>
<tr>
<td>Sale or transfer other assets</td>
<td>2, 6, 16, 18, 19, 23</td>
<td>6</td>
</tr>
<tr>
<td>Sale and leaseback</td>
<td>17, 34</td>
<td>2</td>
</tr>
<tr>
<td>Accelerate income or expense</td>
<td>7, 12, 17</td>
<td>3</td>
</tr>
<tr>
<td>Permanent reinvestment of foreign subsidiary earnings</td>
<td>13, 20</td>
<td>2</td>
</tr>
<tr>
<td>Capitalize (tax returns) R&amp;D costs</td>
<td>26, 28</td>
<td>2</td>
</tr>
<tr>
<td>Other:</td>
<td>11, 9, 22, 30, 31, 33, 33, 1</td>
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<tr>
<td>Allocate income to another entity</td>
<td>11</td>
<td>1</td>
</tr>
<tr>
<td>Buy replacement property</td>
<td>9</td>
<td>1</td>
</tr>
<tr>
<td>Defer tax payments</td>
<td>22</td>
<td>1</td>
</tr>
<tr>
<td>Merging subsidiaries</td>
<td>30</td>
<td>1</td>
</tr>
<tr>
<td>Shifting entities to lower tax rates</td>
<td>31</td>
<td>1</td>
</tr>
<tr>
<td>Obtain future dividend from one of its foreign subsidiaries</td>
<td>33</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>38</td>
<td>38*</td>
</tr>
</tbody>
</table>

*The 38 tax-planning strategies recorded above exceed the number of firms, 34, because four firms disclosed two tax-planning strategies.
Discussion and Conclusions
The Citigroup, Inc. and American International Group, Inc. disclosures that opened this research report demonstrate the importance of tax-planning strategies to the assessment of a need for a valuation allowance against deferred tax assets. Yet, the importance of these strategies notwithstanding, many firms identify the availability of tax-planning strategies but do not disclose what they are. Analysts and investors are left to wonder.

In this research report we review tax-planning strategies to better determine what disclosures are being provided about the strategies and to summarize what specific strategies are being used. We find that the practice of most firms is not to describe the tax-planning strategies that they reference in their tax notes. Our 10-K searches identified only 34 firms that both discussed tax planning strategies and also described them. Firms that identify sufficient tax planning strategies, whether or not they describe them, can reduce or avoid recording valuation allowances against their deferred tax assets. By so doing, both earnings and shareholders' equity are increased.

The disclosed tax-planning strategies provided in Exhibit 4 should be of value to financial statement readers, including analysts and investors. However, as things currently stand, firms seem to take the position that simply declaring that they have strategies available to them is sufficient. While their numbers are small, firms that identified their tax-planning strategies utilize a significant range of tax-planning actions, including selling appreciated securities or switching tax-exempt securities to taxable ones, planned sales of other assets, transactions related to sale and leaseback transactions and other income-acceleration transactions, the permanent reinvestment of foreign subsidiary earnings and capitalizing R&D costs for tax purposes.

While unclear from our data, one might conjecture that at least some of those who do not detail their referenced tax-planning strategies do so in order to reduce the possible scrutiny of tax authorities.

We think that analysts, investors and other readers of financial statements would be well served by the disclosure of the specific tax-planning strategies available to management. With that information, interested parties could draw their own inferences about the likely success or lack thereof in allowing a firm to realize its deferred tax assets. Such information would permit a more informed judgment regarding the sufficiency of any deferred tax asset valuation allowance. The FASB may wish to consider such a disclosure requirement.