

Tellabs, Inc.
Acquisition of Advanced Fibre Communications, Inc.
Deferred Tax Accounting and Future Effective Tax Rate Implications
May 2004

This paper is intended to provide information on Tellabs' current deferred tax position and the impact of the pending acquisition of Advanced Fibre Communications, Inc. (AFCI) on our prospective effective tax rate.

Executive Summary

Tellabs' acquisition of AFCI is expected to result in AFCI recording additional deferred tax liabilities. Such deferred tax liabilities will, in consolidation, offset the deferred tax assets of Tellabs and result in a reduction in Tellabs valuation allowance. These adjustments will occur in accounting for the purchase of AFCI and may have the effect of increasing Tellabs' future effective tax rate for financial reporting purposes. The underlying deductions, losses and tax credit carry forwards of Tellabs will continue to be available to reduce cash taxes payable on future pretax income.

Background

Deferred tax assets arise when a company's financial statements recognize charges or expenses that for income tax purposes, will not be allowed as deductions until future periods. For example, when a corporation incurs an expense in its financial statements, such as certain restructuring type charges, that it is not allowed to deduct on its federal tax return until paid in the future, the future tax benefit of that expense is generally recorded in the income statement as a reduction of income tax expense and in the balance sheet as a tax asset. The same general treatment applies to the carry forward of unused net operating losses and unused tax credits. Deferred tax assets are often netted with deferred tax liabilities when presented in the balance sheet and are referred to as *net* deferred tax assets.

Under FAS 109, *Accounting for Income Taxes*, a net deferred tax asset may only be carried on the balance sheet at its full value if it is *more likely than not* that the deductions, losses, or credits giving rise to such deferred tax asset will be used in the future. If the more likely than not test is not met, then a valuation allowance is required to be recorded against the net deferred tax asset. A valuation allowance creates a charge to income tax expense in the income statement and a reduction of an asset on the balance sheet, in the period it is recorded. Common practice would support a determination that a corporation with two or more consecutive years of significant losses is presumed to fail the more likely than not test. Because of Tellabs' losses in recent years the company examined the value of its deferred tax assets and felt it was appropriate to record a valuation allowance against a major portion of them. The valuation allowance essentially reduced our U.S.-based deferred tax asset to zero. The effect was to reverse the benefit of those deferred tax assets that were recorded in prior years' income statements and balance sheets. Consequently, these tax benefits will be available in the future to reduce our income tax expense when we have positive income in the U.S. against which to use the tax benefits, or we have sufficient deferred tax liabilities to absorb the tax assets (including deferred tax liabilities arising as a result of purchase accounting related to an acquisition, such as the pending acquisition of AFCI).

Current Position

During the first quarter of 2004, we reversed a small portion of our valuation allowance on deferred tax assets because of anticipated profitability in 2004. This reversal had the effect of significantly reducing our income tax expense on U.S.-based income thereby yielding an effective tax rate of less than 20%. That is, the low overall rate is the result of a very low tax rate on U.S.-based income and a tax rate on international income that was close to traditional statutory rates.

Acquisition Accounting Impact

Tellabs anticipates that it may record a potentially significant deferred tax liability in accounting for the AFCI acquisition. It is possible that the amount would be large enough that it would cause all of our existing valuation allowance to no longer be required. If the valuation allowance is reduced or eliminated in purchase accounting, the future income statement benefit of the underlying tax benefits would no longer be available to reduce our income tax expense from continuing operations. In other words, our effective tax rate could be higher after the acquisition of AFCI than it would have been otherwise.

Note: this summary deals only with the accounting impact of a change in our valuation allowance. The cash value of our deferred tax assets will be essentially unchanged because we continue to project that we will fully utilize the underlying tax benefits on tax returns in the current and future years.