Accounting for Income Taxes
Quarterly Hot Topics

In this issue:

Accounting Developments

Heads Up—FASB makes targeted changes to guidance on accounting for certain financial instruments with down-round features

On July 13, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standard Updates (ASU) 2017-11, which makes limited changes to the Board's guidance on classifying certain financial instruments as either liabilities or equity. The ASU's objective is to improve (1) the accounting for instruments with "down-round" provisions and (2) the readability of the guidance in ASC 4802 on distinguishing liabilities from equity by replacing the indefinite deferral of certain pending content with scope exceptions.

The ASU's guidance differs in some respects from that in the proposed ASU released in December 2016. In particular, the proposed requirement to recognize the value transferred upon the trigger of a down-round feature now applies only to equity-classified instruments for entities that disclose earnings per share (EPS).

See Deloitte's July 21, 2017, Heads Up for additional information.

US Federal

Disgorgement payments made by defendants in enforcement actions brought by the U.S. Securities and Exchange Commission

The U.S. Supreme Court held in *Kokesh v. SEC, 137 S. Ct. 810* that disgorgement payments made by defendants in enforcement actions brought by the U.S. Securities and Exchange Commission (SEC) operate as "penalties." The issue addressed in *Kokesh* was whether a five-year statute of limitations applies (under 28 U.S.C. section 2462), such that the SEC is required to commence an action seeking disgorgement of profits from a wrongdoing party within five years of the alleged misconduct. Viewing disgorgement payments to the SEC as "punitive" rather than merely "compensatory" in nature, the Supreme Court unanimously concluded that the five-year statute of limitations applies. Although the tax treatment of disgorgement payments was not directly at issue in *Kokesh*, the Supreme Court's decision could impact the analysis of whether a disgorgement payment made to the SEC constitutes a nondeductible "fine or similar penalty" for purposes of section 162(f) of the Internal Revenue Code.

Notice 2017-36 delays application of Section 385 documentation regulations

On July 27, 2017, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) issued Notice 2017-36, which states the intent of Treasury and the IRS to delay the application of the documentation rules set forth in the Treas. Reg. § 1.385-2 (the "Documentation Regulations") for 12 months such that the rules would apply only to certain interests issued or deemed issued on or after January 1, 2019. Taxpayers may rely on the delay pending the issuance of implementing regulations.

Please see United States Tax Alert dated August 2, 2017.

Federal research tax credit safe-harbor based on ASC 730 costs

The IRS recently issued internal Directive LB&I-04-0917-005, dated September 11, 2017 (the "Directive"), providing guidance to the IRS examiners regarding federal research tax credit claims made under IRC section 41 by LB&I taxpayers (i.e., taxpayers with assets equal to or greater than $10 million). With the stated objective of more efficiently managing audit resources, the Directive effectively creates an administrative safe-harbor by presuming that the amount of expenses indicated by a taxpayer in a certification statement as its "Adjusted ASC 730 Financial Statement R&D" and for which documentation is maintained by the taxpayer (e.g., a list of certain cost centers, GL accounts and W-2 wages paid to researchers) constitutes credit-eligible qualified research expenses for IRC section 41 purposes.

For purposes of this safe-harbor Directive, "Adjusted ASC 730 Financial Statement R&D" means the amount of research and development costs currently expensed on a taxpayer's certified audited financial statements pursuant to ASC 730 for US GAAP purposes (provided that this amount is shown as a separate line item on the income statement or in a separately stated note), but with certain specified adjustments required to be made to reflect the different definitions of qualifying "research expenditures" for US GAAP and federal income tax purposes.

If a taxpayer either voluntarily attaches a certification statement (signed under penalty of perjury) and related appendices to its federal income tax return demonstrating its eligibility under the Directive or, instead, provides such a certification statement and related appendices to the IRS audit team at the beginning of an examination of an IRC section 41 credit claim, then IRS examiners will not challenge claimed qualified research expenditures which are Adjusted ASC 730 Financial Statement R&D costs, provided that the taxpayer makes available upon request by the IRS exam team the underlying documentation to support the adjustments in the appendices.

The Directive applies prospectively to original tax returns timely filed on or after September 11, 2017.

US Multistate

California

On April 7, 2017, the California Franchise Tax Board ("FTB") released Chief Counsel Ruling 2017-01 ("Ruling"), in which a subcontractor ("Taxpayer") to health plans sought a ruling in connection with three issues related to the proper sourcing under California Revenue & Taxation Code Section 25136 and California Code of Regulations Section 25136-2 of sales derived from the Taxpayer's performance of certain management and administrative services that the health plans were contractually obligated to perform for its customers. The Ruling explains how the taxpayer must determine where the benefit of "non-marketing" services are received under California Code of Regulations section 25136-2, and applies the rationale set forth under Chief Counsel Ruling 2015-03 where the FTB made a distinction between "marketing" and "non-marketing" services and applied a treatment to these service sales that was similar to the treatment provided under this regulation for "marketing" and "non-marketing" intangibles. For details on the Ruling, see Deloitte's July 21, 2017 issue of State Tax Matters as well as Deloitte's Multistate Tax Alert dated August 2, 2017.

On July 27, 2017, a California Court of Appeal ("Court") partially affirmed a trial court's decision in a case involving whether capital gains from a taxpayer's sale of stock in another entity constituted apportionable business income for purpose of the California franchise tax, holding that such determination under the functional test must be made by examining the entire relationship between the taxpayer (a financial technology processor for banks) and the other entity (an information technology services provider) rather than only the taxpayer's acquisition of such stock in isolation. However, the Court disagreed with the trial court's determination that it did not need to apply the functional test at specific moments in time, remanding the case back to the trial court and noting that the trial court "will likely conclude" that such stock was still integral to the taxpayer's business at the time it was sold. For additional details, including a link to the case, see Deloitte's August 4, 2017 issue of State Tax Matters.

Illinois

On July 6, 2017, the Illinois Legislature, through an override of Governor Bruce Rauner's veto, enacted S.B. 009; the newly enacted budget (Public Act 100-0022), includes the following modifications to Illinois law:

- Increases the corporate income tax rate from 5.25 percent to 7 percent (combined income and replacement tax is 9.5 percent), effective July 1, 2017
- Reinstates the research and development credit through tax years ending prior to January 1, 2022, effective immediately
- Requires an addition modification for any IRC §199 deductions, effective for tax years ending on or after December 31, 2017
- Expands the definition of "United States" for determining a unitary business group, effective for tax years ending on or after December 31, 2017
- Repeals the unitary business group "non-combination rule", effective for tax years ending on or after December 31, 2017

For details on the above modifications, see Deloitte's Multistate Tax Alert issued on July 11, 2017.

On August 3, 2017, the Illinois Department of Revenue ("Department") has issued amended apportionment rules that eliminate the "double throwback" rule provisions, expand the "occasional sales" rule to include gross receipts from the sale of stock in a subsidiary, and revise alternative apportionment provisions to allow or require such use when the standard statutory formula does not fairly represent the "market" for the taxpayer's goods and services in Illinois (rather than the extent of the taxpayer's business activities in Illinois under prior law). The amendments also reflect other current Department policies related to apportionment of business income. For more details, see Deloitte's August 25, 2017 issue of State Tax Matters.

New Hampshire

Effective July 1, 2019, and applicable to taxable periods ending on or after December 31, 2019, new law that was enacted on June 28, 2017, decreases the tax rates of New Hampshire's business profits tax ("BPT") and business enterprise tax ("BET") from 8.2% and 0.72% to 7.7% and 0.6%, respectively. Effective July 1, 2021, and applicable to taxable periods ending on or after December 31, 2021, the tax rates for the BPT and BET will be further reduced to 7.5% and 0.5%, respectively. For additional details, see Deloitte's July 14, 2017 issue of State Tax Matters. See Deloitte's July 28, 2017 issue of State Tax Matters for details on a Technical Information Release, issued on July 21, 2017, which discusses the recently enacted business tax law changes.

North Carolina

Effective for taxable years beginning on or after January 1, 2019, a new law was enacted on June 28, 2017 which includes a state corporate income tax rate reduction—from a rate of 3% to a rate of 2.5%. For additional details, see Deloitte's June 30, 2017 issue of State Tax Matters and Deloitte's Multistate Tax Alert issued on July 28, 2017.

Applicable for taxable years beginning on or after January 1, 2017, a new law was enacted on August 11, 2017 that makes some revisions to computing North Carolina's related member interest expense "addback" for state corporate income tax purposes, including a provision stating that for purposes of determining whether a nominal debt instrument creates allowable deductible interest, the North Carolina Department of Revenue "will not apply the covered debt instrument rules contained in the regulations promulgated" under IRC Section 385. Applicable for taxable years beginning on or after January 1, 2020, and applicable to the calculation of state franchise tax reported on the 2019 and later state corporate income tax returns, the new law also allows some taxpayers a deduction from their North Carolina tangible property tax base for any indebtedness specifically incurred, and existing solely for, and as the result of the purchase of any real estate and any permanent improvements made on the real estate. In addition, applicable for taxable years beginning on or after January 1, 2017, this new law also defines "apportionable income" as all income that is apportionable under the US Constitution. For additional details, see Deloitte's Multistate Tax Alert issued on July 28, 2017 and the August 18, 2017 issue of State Tax Matters.

Texas

On June 30, 2017, the Texas Comptroller of Public Accounts ("Comptroller") released a letter discussing two policies to be revised concerning the state franchise (margin) tax temporary credit for business loss carryforwards. Under its first described revised policy, the Comptroller states that once a taxable entity has preserved the temporary credit for business loss carryforwards and has taken this credit on a timely filed report, the taxable entity may claim this credit on any subsequent report, even if the subsequent report is not timely filed. Under the second described revised policy, the Comptroller explains that if a member entity leaves a combined group during the accounting period on which a report is based, the combined group may claim, subject to credit limitations, the departing member's entire amount of credit and the member's entire available credit carryover for that report year. For subsequent reports, the departed member's credit is no longer available to the combined group, and the combined group's credit carryover must be adjusted to remove the portion of carryover related to the departed member. For more details on the Comptroller letter, see Deloitte's Multistate Tax Alert dated August 4, 2017.

On July 7, 2017, the Texas Comptroller of Public Accounts ("Comptroller") released a letter discussing its revised policy regarding the treatment of net losses from the sale of investments and capital assets in calculating "gross receipts" for apportionment purposes under the state franchise (margin) tax. In doing so, the Comptroller references the Texas Supreme Court's 2016 decision (see previously issued Multistate Tax Alert for more details on this ruling), which held that state law does not require taxpayers to include a net loss from the sale of investments and capital assets in its apportionment factor denominator for Texas franchise tax purposes—explaining that it will also apply this decision to the calculation of Texas receipts as there must be “symmetry between Texas receipts and gross receipts everywhere.” Accordingly, under its revised policy, the Comptroller explains that net loss from the sale of all investments and capital assets is not included in a taxpayer’s gross receipts everywhere and a net loss from the sale of all Texas investments and Texas capital assets is not included in a taxpayer’s Texas receipts for apportionment purposes. For more details, see Deloitte’s August 4, 2017 issue of State Tax Matters.

On August 11, 2017, a Texas Court of Appeals (“Court”) recently upheld a trial court decision permitting a taxpayer primarily engaged in the business of surveying, manufacturing, upgrading, and repairing drilling rigs to exclude subcontractor payments from its revenue for Texas franchise tax purposes. However, the Court reversed and remanded on the issue of allowable Texas cost of goods sold (“COGS”) items based on the taxpayer’s use of federal COGS as its starting point for its Texas franchise tax COGS deduction. Instead, the taxpayer was required to use a cost-by-cost analysis to determine whether a cost was eligible for inclusion in the Texas COGS deduction. For more details, including a background on the case, see Deloitte’s August 28, 2017 Multistate Tax Alert.

Amnesty / Voluntary Disclosure

The Multistate Tax Commission (“MTC”)

The MTC National Nexus Program is currently providing a voluntary disclosure initiative that will run from August 17, 2017 through October 17, 2017, and generally will be made available to online sellers that have nexus with a participating state as a result of having inventory located in a fulfillment center or warehouse in that state operated by a defined “marketplace provider/facilitator” or from other nexus-creating activities of a marketplace provider/facilitator in the state. For details of the program, a list of states participating in the program, and eligibility criteria, see Deloitte’s August 11, 2017 issue of State Tax Matters. For an updated list of states participating in the program, see Deloitte’s August 18, 2017 and August 25, 2017 issues of State Tax Matters.

Ohio

On June 30, 2017, new law was enacted that provides for a tax amnesty program to be administered from January 1, 2018 through February 15, 2018 for certain qualifying delinquent taxes. For additional details, see Deloitte’s July 7, 2017 issue of State Tax Matters.

Rhode Island

On August 8, 2017, a new law was enacted to establish a tax amnesty program and the Rhode Island Division of Taxation will begin accepting applications on December 1, 2017 through February 15, 2018, which generally will be open to eligible taxpayers owing any tax imposed by the division. For additional details, see Deloitte’s August 18, 2017 issue of State Tax Matters.

Texas

On June 12, 2017, new law was enacted that becomes effective September 1, 2017, which requires the Texas Comptroller of Public Accounts (“Comptroller”) to establish a tax amnesty program “for a limited duration” that is designed to encourage voluntary reporting by "delinquent taxpayers that do not hold a permit, or are otherwise not registered for a tax or fee administered by the Comptroller, or those permitted taxpayers that may have underreported or owe additional taxes or fees." For additional details on the program, see Deloitte's August 25, 2017 issue of State Tax Matters.

Virginia

On September 5, 2017, the Virginia Department of Taxation issued some additional guidance on its administration of the 2018 fiscal year tax amnesty program—announcing that the program will run for a 62-day period beginning on September 13, 2017, and ending on November 14, 2017. This program generally will be open to any taxpayer that is required but has failed to file a return or pay any tax administered by the Department. For additional information, see Deloitte's September 8, 2017 issue of State Tax Matters.

IRC Conformity

Recently, the following states passed legislation to update their conformity to the current federal Internal Revenue Code. For additional details on each state's tax law change, including the effective dates and instances where the state decouples from certain federal provisions, see Deloitte's issue of State Tax Matters provided below:

- **Hawaii** — July 14, 2017 issue of State Tax Matters
- **New Hampshire** — July 14, 2017 issue of State Tax Matters
- **North Carolina** — June 30, 2017 issue of State Tax Matters
- **Oregon** – July 7, 2017 issue of State Tax Matters
- **Vermont** — June 23, 2017 issue of State Tax Matters

International

Germany: Restriction on deductibility of royalty payments enacted

On June 2, 2017, Germany's upper house of parliament passed a bill that limits the deductibility of certain related party royalty payments. The law targets royalty payments made to nonresidents that result in "low taxation" of the royalty income at the level of the recipient due to the application of an intellectual property (IP) regime (i.e. IP box, patent box, license box, etc.), where the IP regime is not based on the "nexus approach" as described in Action 5 of the OECD's BEPS project.

Refer to the Tax@Hand article dated June 9, 2017 for more details.

Australia: Chevron withdraws appeal to the High Court in Australia in landmark transfer pricing case

On August 18, 2017, Chevron Australia Holdings Pty Ltd withdrew its appeal to the High Court in Australia, following the rejection of its appeal by the Full Federal Court on April 21, 2017, summarized in Deloitte's Tax Insights publication, dated May 3, 2017. Therefore, the decision in favor of the Australian Taxation Office (ATO) at the Full Federal Court now stands as the final decision.

In a subsequent media release, The Hon Kelly O'Dwyer, Australia's Minister for Revenue and Financial Services, stated,

> *"The Turnbull Government welcomes the withdrawal of Chevron's appeal to the High Court over the Australian Taxation Office's assessment of $340 million in tax and penalties for interest payments made to related offshore parties. Chevron sought to challenge Australia's transfer pricing rules and the appropriate method for establishing an arms-length interest rate for a related party loan … The withdrawal of the appeal means that the decision is now final."*

The Minister went on to emphasize the significance of the win for the Australian community, and provided an initial estimate of the additional tax revenue that the decision may create in the future.

> *"The ATO's initial estimates are that the Chevron decision will bring in more than $10 billion dollars of additional revenue over the next ten years in relation to transfer pricing of related party financing alone."*

This statement, combined with senior ATO leadership describing intra-group financing as the number one risk it is focused on with regard to multinational taxation means taxpayers should, at a minimum, be reviewing their cross-border financing arrangements with Australia in light of this decision—in particular the arm's length nature of the terms on which the arrangements are set.

Subsequent to the FFC decision, the ATO also released a related draft Practical Compliance Guideline, PCG 2017/D4. The draft PCG includes a matrix system under which businesses can self-assess their risk profile against pre-determined ATO criteria. This matrix can be used to determine the likelihood of an ATO review based on the system that allocates points to particular features of the arrangements. It is expected that further drafts of the PCG with additional other related material will be released in the next few weeks.

Refer to the Tax@Hand article dated August 20, 2017 and the Deloitte World Tax Advisor article dated September 8, 2017 for more details.

On the Horizon

Multistate Tax Commission

On August 1, 2017, the Uniformity Committee of the Multistate Tax Commission ("MTC") agreed that its partnership work group should move forward with drafting a proposed model statute and regulation that would address how states may respond to changes in the federal partnership audit and adjustment process, and which possibly may be based upon a draft proposal that was submitted for its consideration by representatives of several interested parties—including the Council On State Taxation, Tax Executives Institute, Inc., Institute for Professionals in Taxation, American Bar Association, and American Institute of CPAs. This submitted draft proposal suggests amending the MTC's "Model Uniform Statute for Reporting Federal Tax Adjustments with Accompanying Model Regulation" that was adopted in 2003, by also incorporating changes that address the underlying new partnership audit and adjustment issues. For more information, including the link to the draft proposal, see Deloitte's August 4, 2017 issue of State Tax Matters.

State Conformity to Federal Provisions—Exploring the Variances

See the August 11, 2017 edition of Inside Deloitte, where the potential for federal tax reform serves as a backdrop for a discussion of the various degrees in which state income tax regimes conform to or diverge from the federal income tax regime, and consequently, how the state tax implications of a transaction may differ significantly from the federal income tax characterization.

Oregon

S.B. 28 was signed by the governor on July 3, 2017 and is applicable to tax years beginning on or after January 1, 2018. S.B. 28 replaces the state's current cost-of-performance apportionment methodology for sales of items other than tangible personal property with market-based sourcing for state corporate income tax purposes. Oregon's market-sourcing legislation closely follows the model provisions as adopted by the Multistate Tax Commission ("MTC"). In general, Oregon will source sales of items other than tangible personal property to Oregon "if the taxpayer's market for sales is in" Oregon. For sales of services, Oregon provides that the sales will be sourced to Oregon "if and to the extent the service is delivered to a location" in Oregon. For additional details on the market-sourcing legislation, see Deloitte's July 5, 2017 Multistate Tax Alert.

H.B. 2273 was signed by the governor on August 2, 2017 and is applicable to tax years beginning on or after January 1, 2018. H.B. 2273 provides that for purposes of calculating the sales factor for state corporate income tax purposes, the term "sales" not only refers to non-allocated amounts under Or. Rev. Stat. Secs. 314.615 through 314.645, but must also constitute gross receipts received from transactions and activity occurring in the regular course of the taxpayer's trade or business. For additional details on the new law, see Deloitte's August 4, 2017 issue of State Tax Matters.

S.B. 28 and H.B. 2273 are not considered enacted at the time the governor signs the bill, as Oregon law requires a 90-day waiting period after the date on which the 2017 session of the 79th Legislative Assembly adjourns sine die in order to provide Oregon voters the opportunity to file a petition to have the new tax law ratified into law by Oregon voters via an election. The Legislative Assembly adjourned sine die on July 10, 2017, accordingly, these bills will not be considered effective law until the 91st day after July 10, 2017 (i.e., October 9, 2017).

France: Supreme Administrative Court (SAC) issued two preliminary decisions involving the application of the foreign tax credit

On June 26 2017, the Supreme Administrative Court (SAC) issued two decisions involving the application of the foreign tax credit. In one case, the SAC requested a preliminary ruling from the French Constitutional Court on whether the rules that deny French companies in loss-making situations the ability to carry forward unused foreign tax credits are in conformity with the constitution. The Constitutional Court must issue its preliminary ruling within three months of the SAC's request.

In the second case, in a change of position, the SAC allowed foreign tax credits to reduce the corporate income tax owed on foreign income that was subject to French tax at a rate that was less than the standard 33.33% rate in France.

Refer to the Tax@Hand article dated July 11, 2017 for more details.

OECD: Draft of 2017 update to model tax treaty released

On July 11, 2017, the OECD announced the release of a draft of the 2017 update to the OECD model tax treaty (last updated in 2014), and requested comments on certain provisions of the update by 10 August 2017. A significant portion of the update already has been approved as part of the BEPS project, and the OECD has not requested comments on these changes or on other changes that previously have been released for public comments. The update will be submitted to the Committee on Fiscal Affairs and the OECD Council for approval later in 2017.

The update also includes changes to reflect the mutual agreement procedure arbitration provision of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) adopted on November 24, 2016.

For more information, please refer to the July 21, 2017 edition of World Tax Advisor.

Did You Know?

Financial Reporting Alert 17-6: Financial reporting implications of disasters

This *Financial Reporting Alert* highlights some of the financial reporting implications of disasters for entities reporting under U.S. GAAP. North America has been affected by a series of natural disasters in recent weeks, including Hurricanes Harvey, Irma and Maria, and two significant earthquakes that struck Mexico within a span of 12 days.

A number of financial reporting implications can arise as a result of a disaster. This *Financial Reporting Alert* identifies potential implication and applicable authoritative guidance. The financial reporting implications discussed in this *Financial Reporting Alert* are not meant to be all-inclusive but as a starting point for thinking about the issues that might arise.

State Enterprise Zone Programs

The September column of Credits & Incentives talk with Deloitte discusses the comparisons of the Enterprise Zone (“EZ”) programs in Illinois, Indiana and Wisconsin. EZs are locations where states seek to attract businesses to specific, economically depressed areas in their respective states to improve the local economy. These distressed areas are often designated as “zones” and state EZ programs typically offer tax credits and operating cost deductions to incentivize businesses to invest in those specific geographic areas. The manner in which Illinois, Indiana, and Wisconsin aim to attract new business and retain existing businesses within their EZ programs varies considerably. The first step in a comparative analysis of the states' EZ programs is to understand how each state designates an EZ. See the September 2017 edition of Credits and Incentives talk with Deloitte for more details on the Illinois, Indiana, and Wisconsin EZ programs.

Learn More

Financial Reporting for Taxes Training

Deloitte's Financial Reporting for Taxes Training features interactive courses taught by experienced professionals who will explain applicable guidance as well as share real-world experiences and leading practices. Take advantage of registration discounts. Register today for the upcoming session (December 4 – 8, 2017) in Las Vegas, Nevada.

A Roadmap to Accounting for Income Taxes

The 2016 edition of A Roadmap to Accounting for Income Taxes was released on December 16, 2016. This Roadmap includes all of Deloitte's interpretive guidance on the accounting for income taxes, combining the income tax accounting requirements and implementation guidance from ASC 740 with Deloitte's interpretations and examples in a comprehensive, reader-friendly format. The Roadmap also contains appendixes that provide:

- Specific disclosure examples.
- Samples of recent SEC comments on income tax matters.
- A broad-based discussion of the income tax accounting guidance under International Financial Reporting Standards.

We hope that you find our Roadmap useful and informative.

Additional resources that you may find helpful

- Accounting for Income Taxes – Quarterly Hot Topics Archive
- Deloitte Tax Accounting & Provision Services Home Page
- Deloitte Tax Accounting & Provisions Dbriefs Webcasts Series
- Deloitte Heads Up Newsletter Archive

As always, we are interested in your comments on our publications. Please take a moment to tell us what you think by sending us an e-mail.

Talk to Us

If you have any questions or comments about the ASC 740 implications described above or other content of Accounting for Income Taxes Quarterly Hot Topics, contact the Deloitte Washington National Tax Accounting for Income Taxes Group at:
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