

## Multistate Impact of the American Taxpayer Relief Act of 2012

March 5, 2013

### Overview

On January 2, 2013, President Barack Obama signed into law the American Taxpayer Relief Act of 2012 (“the Act”).<sup>1</sup> Among the various federal tax law changes contained in the Act are extensions of certain expired or expiring tax provisions, including a retroactive extension of the credit for certain research and experimentation expenses; an extension of 50 percent bonus depreciation for qualified property; a retroactive extension of a cost recovery provision that applies to certain leasehold, restaurant, and retail improvements and restaurant buildings; retroactive extensions of the active financing income exception and the controlled foreign corporation look-through; and a retroactive extension of the capital gain exclusion on Qualified Small Business Stock. Also, the Act provides a temporary election to accelerate some alternative minimum tax credits in lieu of bonus depreciation, increases the maximum amount and phase-out threshold for small business expensing under Internal Revenue Code (“IRC”) Sec. 179, and reduces the holding period for the S-corporation built-in gains tax. These federal law changes may have an effect on state taxes, depending on each state’s adoption of the IRC and each state’s decoupling provisions.

In general, states with automatic or “rolling” IRC conformity will adopt the provisions of the Act, unless specific state legislative action is taken to decouple from some or all of the federal law changes. Some states effectively adopt the IRC by referencing federal taxable income as the state income starting point. Although these states do not specifically adopt the IRC in whole or in part, they would generally be viewed as following provisions of the Act that affect federal taxable income. Other states adopt the IRC as of a specific date, do not adopt the IRC provisions in totality, or provide for modifications or exceptions to certain adopted IRC provisions. For these states, further analysis is needed to determine the extent to which certain provisions of the Act are followed (*i.e.*, does the state adopt the IRC as of January 2, 2013, or include the specific provisions in the state’s code?).

In this Tax Alert we summarize the extent to which California, Florida, Illinois, New York and Texas conform to the federal law changes described above.

### Summary of State IRC Conformity Generally

As noted previously, the various states approach IRC conformity in different ways. The following table outlines how California, Florida, Illinois, New York and Texas conform to the IRC generally:

STATE:	IRC Conformity:
California	Conforms to the IRC as of January 1, 2009, <sup>2</sup> with certain modifications and exceptions.
Florida	Presently conforms to the IRC as of January 1, 2012. <sup>3</sup> Each year the Florida legislature must consider adoption of the current IRC and could conceivably pass legislation to retroactively adopt the IRC as of January 2, 2013.
Illinois	Provides for rolling conformity to the IRC, <sup>4</sup> with certain modifications and exceptions.
New York	Effectively provides for rolling conformity to the IRC through reference to federal taxable income as the state income starting point, <sup>5</sup> with certain modifications and exceptions.
Texas	Conforms to the IRC as of January 1, 2007, <sup>6</sup> with modifications for the “margin” tax.

<sup>1</sup> American Taxpayer Relief Act of 2012; P.L. 112-240; 2013 Enacted H.R. 8.

<sup>2</sup> Cal. Rev. & Tax code § 23051.5(a)(1) & §17024.5(a).

<sup>3</sup> Fla. Stat. ch 220.03(1)(n) & (3).

<sup>4</sup> 35 ILCS 5/102.

<sup>5</sup> N.Y. Tax Law §208.9.

<sup>6</sup> Tex. Tax Code Ann. §171.0001(9).

## Conformity Treatment of the Act by the Enumerated States – Corporate Overview

**Research and experimentation credit** — *The credit under IRC Sec. 41 for certain research and experimentation expenses expired at the end of 2011. The Act retroactively extends the credit through the end of 2013 and modifies the rules for: (1) calculating the credit when there is a change of ownership for a portion of the trade or business, and (2) aggregation of research expenses within a controlled group.*

State Analysis:

States with rolling or automatic conformity and that do not have other specific provisions addressing the research credit will continue to follow the provisions of the Act relating to this credit. States with specific date conformity will continue to follow the federal rule in effect on that date (*i.e.*, if the conformity date is before January 2, 2013, the new federal provisions will not apply to the state). Finally, states that refer to the rules of IRC Sec. 41 without regard to a specific date will automatically incorporate the changes in the rule and/or may have their own state modifications that may not be impacted. The chart that follows summarizes these principles as applied to the enumerated states:

STATE:	Research Credit Conformity:
California	In general, California decouples from all corporate federal credits. <sup>7</sup> However, California refers to IRC Sec. 41, modifies its provisions and does not follow any termination dates. Thus, the California modified research credit continues to be available. <sup>8</sup>
Florida	Florida refers to IRC Sec. 41 and modifies its provisions. The Florida modified research credit continues to be available for years beginning on or after January 1, 2012. <sup>9</sup>
Illinois	Illinois refers to IRC Sec. 41 but the Illinois research credit specifically ends prior to January 1, 2016. <sup>10</sup>
New York	New York offers its own research and development tax credit to qualified participants in New York's Excelsior Jobs Program, which specifically refers to IRC Sec. 41. <sup>11</sup> If the federal research credit had expired, the New York research credit would have continued under the federal provisions in effect for tax year 2009. However, since the federal research credit was extended, New York follows this provision of the Act. <sup>12</sup>
Texas	Texas does not allow a research credit. <sup>13</sup>

**Bonus depreciation** — *The Act extends for one year the 50 percent bonus depreciation for qualified property. The provision applies to qualified property placed in service before January 1, 2014 (before January 1, 2015, for certain longer-lived and transportation assets).*

State Analysis:

A handful of states that have rolling conformity and that incorporate bonus depreciation without modification will likewise follow this change. States with a specific date of conformity will continue to follow the IRC rules as of that date and therefore may or may not include bonus depreciation. Many states never conformed to bonus depreciation and will continue to follow their own modification provisions and not be affected by this provision of the Act absent additional state legislation. The chart that follows summarizes these principles as applied to the enumerated states:

STATE:	Bonus Depreciation Conformity:
California	California codified its own depreciation methods that do not incorporate bonus depreciation provisions. <sup>14</sup> Thus, California does not conform to the new bonus depreciation rules.

<sup>7</sup> Cal. Rev. & Tax Code §23051.5(b)(8).

<sup>8</sup> Cal. Rev. & Tax Code §23609(i).

<sup>9</sup> Fla. Stat. ch 220.196(2).

<sup>10</sup> 35 ILCS 5/201(k).

<sup>11</sup> N.Y. Tax Law sections 210.41 and 31(a)(3); N.Y. Econ. Dev. Law §355.5; N.Y. Econ. Dev. Law sections 352.17 and 355.3.

<sup>12</sup> Also, New York's investment tax credit is available for investments in qualified tangible personal property, including certain research and development property. See, N.Y. Tax Law §210.12(b)(i).

<sup>13</sup> Note, Texas Cost of Goods Sold provides for a deduction related to "costs attributable to research, experimental, engineering, and design activities directly related to the production of goods, including all research or experimental expenditures described by IRC §174." 34 Tex. Admin. Code §3.588(d)(9).

<sup>14</sup> Cal. Rev. & Tax Code §24349.

Florida	Florida has a modification for bonus depreciation relating to specific federal legislation, not including the Act, for property placed in service before January 1, 2013. <sup>15</sup> Accordingly, Florida follows the bonus depreciation provisions of the IRC as of January 1, 2012, subject to the above-mentioned modifications, and does not follow the Act's one-year extension absent additional state legislation.
Illinois	Illinois requires an addback modification of bonus depreciation claimed under IRC Sec. 168 (k) (i.e., 50% bonus depreciation). <sup>16</sup> Because Illinois does not conform to IRC Sec. 168 (k), its extension by the Act will not have an Illinois impact. It should be noted that Illinois does not require an addback modification for 100% bonus depreciation claimed (i.e., Illinois conforms to 100% bonus depreciation permitted under the IRC). <sup>17</sup> 100% bonus depreciation was unaffected by the Act.
New York	New York has a general state modification for bonus depreciation allowed by the IRC. <sup>18</sup> Therefore, New York does not follow the bonus depreciation provisions of the Act.
Texas	Texas follows the depreciation rules of the IRC as of January 1, 2007 (which did not include any bonus depreciation provisions) and thus does not follow the bonus depreciation provisions of the Act. <sup>19</sup>

**AMT credit in lieu of bonus depreciation** — *The Act provides for another temporary election to accelerate some alternative minimum tax (“AMT”) credits in lieu of bonus depreciation for property placed in service in 2013. This election allows corporations to effectively “monetize” a portion of their AMT credits in lieu of claiming bonus depreciation.*

State Analysis:

In general, states with rolling conformity will follow this change. States with specific date conformity will continue to follow the date of conformity currently in effect and would thus not follow this change. Finally, some states may not conform to the federal AMT provisions or have state modifications to such provisions and would not be impacted. The chart that follows summarizes these principles as applied to the enumerated states:

STATE:	AMT Credit in Lieu of Bonus Conformity:
California	California has adopted modified AMT rules. <sup>20</sup> Therefore, California does not conform to the new AMT credit rules.
Florida	Florida has adopted modified AMT and AMT credit rules. <sup>21</sup> Therefore, Florida does not conform to the new AMT credit rules.
Illinois	Illinois does not have AMT and is therefore not affected by this change.
New York	New York has adopted modified AMT rules. <sup>22</sup> Therefore, New York does not conform to the new AMT credit rules.
Texas	Texas does not have AMT and is therefore not affected by this change.

**Leasehold improvements** — *The Act retroactively extends 15-year straight-line cost recovery for certain leasehold, restaurant, and retail improvements, as well as for new restaurant buildings that are placed in service before January 1, 2014. The provision had originally expired at the end of 2011.*

State Analysis:

In general, states with rolling conformity would follow this change. States with specific date conformity would continue to follow the date of conformity currently in effect and would not follow the change. A few states may have their own depreciation rules and thus would not conform to or be impacted by this provision. The chart that follows summarizes these principles as applied to the enumerated states:

<sup>15</sup> Fla. Stat. ch 220.13(1)(e)1.

<sup>16</sup> 35 ILCS 5/203(b)(2)(E-10).

<sup>17</sup> Instructions, IL-4562 Special Depreciation.

<sup>18</sup> N.Y. Tax Law §208.9(b)(17).

<sup>19</sup> Tex. Tax Code Ann. § 171.102(c)(6); see also, Franchise Tax Frequently Asked Questions – Cost of Goods Sold, Texas Comptroller of Public Accounts, Question 18 (Updated April 4, 2012).

<sup>20</sup> Cal. Rev. & Tax Code §23453.

<sup>21</sup> Fla. Stat. ch 220.13(2)(k) & 220.186.

<sup>22</sup> N.Y. Tax Law §210.1(c).

<b>STATE:</b>	<b>Leasehold Improvements Conformity:</b>
California	California codified its own depreciation and amortization methods that do not incorporate any federal leasehold improvement provisions. <sup>23</sup> Therefore, California is not affected by this change.
Florida	Due to its fixed date conformity of January 1, 2012, Florida does not follow the Act's extension of this provision and, thus, continues to follow the rule as of January 1, 2012 ( <i>i.e.</i> , the provision applies for property placed in service before January 1, 2012), absent additional state legislation.
Illinois	Due to its rolling conformity, Illinois follows this provision of the Act.
New York	Due to its adoption of federal taxable income as the starting point for state taxable income, New York follows this provision of the Act.
Texas	Due to its fixed date conformity of January 1, 2007, Texas does not follow the Act's extension of this provision and, thus, continues to follow the rule as of January 1, 2007 ( <i>i.e.</i> , the provision applies for property placed in service before January 1, 2008).

**Active financing income exception and controlled foreign corporation (“CFC”) look-through** — *The federal exception in Subpart F allowing deferral of the active financing income of a CFC engaged predominantly in banking, financing, or similar business activity expired at the end of 2011. The Act retroactively extends the exception through the end of 2013. Similarly, the Internal Revenue Service rules for look-through treatment for payments between related CFCs expired in 2011. The Act retroactively extends that treatment through 2013.*

State Analysis:

States that start with Federal Taxable Income would automatically follow the federal impact. However, there will be little or no impact to states that require an adjustment or do not follow the federal provisions for Subpart F income. Finally, a few states, such as California, generally have distinct rules that might require a separate calculation altogether. The chart that follows summarizes these principles as applied to the enumerated states:

<b>STATE:</b>	<b>Active Financing Income Exception and CFC Look-Through Conformity:</b>
California	Rather than follow the federal rules, California requires partial combination of CFCs with Subpart F income with the water's edge combined group and thus picks up a portion of Subpart F income. Despite its general conformity to the IRC in effect as of January 1, 2009, California automatically conforms to most amendments to the definition of Subpart F income, with certain modifications and, thus, follows the active financing income exception and CFC look-through provisions extended by the Act. <sup>24</sup>
Florida	Foreign dividends are excluded from taxable income. <sup>25</sup> Therefore, this provision of the Act has no effect in Florida.
Illinois	Illinois requires a subtraction modification for foreign dividends. <sup>26</sup> Therefore, this provision of the Act has no effect in Illinois.
New York	In New York, if a taxpayer is the owner of more than 50% of the voting stock of a CFC, the taxpayer's pro rata share of such CFC's Subpart F income is deemed to be a dividend from the CFC and is considered as being in the nature of a dividend from subsidiary capital. When computing entire net income, 100% of the dividend may be deducted from the taxpayer's federal taxable income. <sup>27</sup> If the taxpayer is the owner of 50% or less of the voting stock of a CFC, the taxpayer's pro rata share of such CFC's Subpart F income is deemed to be a dividend that is attributable to the stock of such CFC, 50% of which is deductible from the taxpayer's federal taxable income so long as the stock is not subsidiary capital or stock in a domestic international sales corporation (“DISC”) and IRC Sec. 246(c) (relating to holding period) is satisfied. <sup>28</sup> Therefore, this provision of the Act is modified as described above in New York.

<sup>23</sup> Cal. Rev. & Tax Code §24349.

<sup>24</sup> Cal. Rev. & Tax code §24402, 24411, and 25116.

<sup>25</sup> Fla. Stat. ch 220.13(1)(b)2.a & b.

<sup>26</sup> 35 ILCS 5/203(b)(2)(O).

<sup>27</sup> N.Y. Tax Law §208.9(a)(1) and NY Comm'r. of Tax. and Fin. TSB-A-02 (5)C (May 2011).

<sup>28</sup> N.Y. Tax Law §208.9(a)(2) and NY Comm'r. of Tax. and Fin. TSB-A-02 (5)C (May 2011).

Texas	Foreign dividends are excluded from gross receipts in Texas. <sup>29</sup> Therefore, this provision of the Act has no effect in Texas.
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## Conformity Treatment of the Act by the Enumerated States – Overview for Small Business and Individuals

**Section 179 expensing limitation** – The Act increases the maximum amount and phase-out threshold in 2012 and 2013 for small business expensing under IRC Sec. 179 to the levels in effect in 2010 and 2011. For tax years beginning in 2013, the limitation is raised to \$500,000 and would be reduced if the cost of IRC Sec. 179 property placed in service exceeds \$2 million. Within those thresholds, the Act allows a taxpayer to expense up to \$250,000 of the cost of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. Those limitation amounts will return to \$25,000 to \$200,000, respectively, after 2013.

### State Analysis:

A handful of states that have rolling conformity and that incorporate Section 179 expensing without modification will follow this change. States with specific date conformity will continue to follow the IRC rules as of that date and therefore may or may not include bonus depreciation. Many states never conformed to Section 179 expensing and will continue to follow their own modification provisions and not be impacted by this provision of the Act absent additional state legislation. The chart that follows summarizes these principles as applied to the enumerated states:

STATE:	Section 179 Expensing Limitation Conformity:
California	California refers to IRC Sec. 179 and modifies its provisions. The California modified Section 179 expensing continues to be in effect and, thus, is not impacted by this provision of the Act. <sup>30</sup>
Florida	Florida has a modification (i.e., expense limited to \$128,000 with 7-year expensing for the excess <sup>31</sup> ) for Section 179 for property placed in service before January 1, 2013 <sup>32</sup> and currently follows that modified provision for tax year 2012.
Illinois	Under Illinois' rolling conformity, the state follows the Section 179 provisions of the Act. <sup>33</sup>
New York	With one limited modification, New York generally conforms to Section 179 expensing and follows the Section 179 provisions of the Act. <sup>34</sup>
Texas	The Texas Cost of Goods Sold deduction may include Section 179 expenses under the IRC as of January 1, 2007 that are related specifically to equipment used in the production of goods. <sup>35</sup> The provisions of the Act are not otherwise incorporated by Texas.

**QSBS exclusion** – The Act retroactively extends the 100% tax exclusion for capital gains on Qualified Small Business Stock (“QSBS”) held by non-corporate taxpayers. If certain holding period and other requirements are met, the Act extends the exclusion for capital gains from the sale of QSBS acquired on or before December 31, 2013. The provision had originally expired at the end of 2011.

### State Analysis:

In general, states with rolling conformity will follow this change. States with specific date conformity will continue to follow the date of conformity currently in effect and will not follow the change. A few states may have their own QSBS rules and will not conform to or be impacted by this provision of the Act. The chart that follows summarizes these principles as applied to the enumerated states:

<sup>29</sup> 34 Tex. Admin. Code §3.587(d)(1)(B)(ii).

<sup>30</sup> Cal. Rev. & Tax Code §24356(b).

<sup>31</sup> Fla. Stat. ch 220.13(1)(e)2.

<sup>32</sup> Fla. Stat. ch 220.13(1)(e)1.

<sup>33</sup> 35 ILCS 5/102.

<sup>34</sup> Per N.Y. Tax Law §208.9(b)(16), the limited modification for New York is for “a taxpayer which is not an eligible farmer as defined in paragraph (b) of subdivision twenty-two of section two hundred ten of this article, the amount of any deduction claimed pursuant to section 179 of the internal revenue code with respect to a sport utility vehicle which is not a passenger automobile as defined in paragraph 5 of subsection (d) of section 280f of the internal revenue code.”

<sup>35</sup> Tex. Tax Code Ann. §17.0001(9) ; see also, Frequently Asked Questions – Cost of Goods Sold, Texas Comptroller of Public Accounts, Question 18 (Updated April 4, 2012).



<b>STATE:</b>	<b>QSBS Exclusion Conformity:</b>
California	California statutes refer to the IRC QSBS provisions but modify and limit their applicability, and would not be impacted by this provision of the Act. <sup>36</sup> However, California's provisions were ruled unconstitutional in recent litigation <sup>37</sup> and the California Franchise Tax Board has recently taken the position that gain exclusions and deferrals will be denied for all open tax years. <sup>38</sup>
Florida	Florida does not impose an income tax on individuals and therefore this provision of the Act is inapplicable and will have no impact.
Illinois	Due to its rolling conformity, Illinois follows this provision of the Act.
New York	Because New York effectively provides for rolling conformity to the IRC, through reference to federal adjusted gross income as the state starting point, New York effectively follows this provision of the Act.
Texas	Texas does not impose an income tax on individuals and therefore this provision of the Act is inapplicable and will have no impact.

**S Corp BIG exclusion, reduced period** – *The Act, for taxable years beginning in 2012 and 2013, provides a reduction in the holding period for recognition of the S corporation built-in gains tax from 10 years to 5 years.*

State Analysis:

In general, states with rolling conformity that recognize S corporations will follow the change. States with specific date conformity that recognize S corporations will continue to follow the date of conformity currently in effect and will not follow the change. A few states do not recognize S corporations and/or do not incorporate the tax on built-in gains and will not be impacted by this provision of the Act. The chart that follows summarizes these principles as applied to the enumerated states:

<b>STATE:</b>	<b>S Corp BIG Exclusion Conformity:</b>
California	Due to California's fixed date conformity as of January 1, 2009, the state is not affected by this provision of the Act. <sup>39</sup>
Florida	Due to its fixed date conformity and its specific adoption of the IRC S corporation built-in gain rules, <sup>40</sup> Florida follows the IRC built-in gain rules as of January 1, 2012, absent additional state legislation. <sup>41</sup>
Illinois	Illinois does not impose an S corporation built-in gains tax <sup>42</sup> and therefore is not affected by this provision of the Act.
New York	New York requires S corporations to make a New York election in order to be recognized as an S corporation. <sup>43</sup> New York does not impose an S corporation built-in gains tax and therefore is not affected by this provision.
Texas	In Texas, S corporations are subject to the Margin Tax <sup>44</sup> ( <i>i.e.</i> , franchise tax), therefore, federal S corporation provisions do not apply and Texas is not affected by this provision of the Act.

<sup>36</sup> Cal. Rev. & Tax Code §18152 & 18152.5.

<sup>37</sup> The California Court of Appeals recently ruled California's QSBS provisions, which attempted to limit qualification of QSBS to require at least 80% payroll and property of the business be attributable to California, are unconstitutional and invalid. *Cutler v. Franchise Tax Board*, (2012) 208 Cal. App. 4th 1247.

<sup>38</sup> FTB Notice 2012-03, accessible at:

[https://www.ftb.ca.gov/law/notices/2012/2012\\_03.pdf?WT.mc\\_id=News\\_Content\\_Announcements\\_FTbnotice2012\\_03](https://www.ftb.ca.gov/law/notices/2012/2012_03.pdf?WT.mc_id=News_Content_Announcements_FTbnotice2012_03).

<sup>39</sup> Cal. Rev. & Tax Code §23800, §23051.5(a)(1) & §17024.5(a).

<sup>40</sup> Fla. Stat. ch 220.12(2)(i).

<sup>41</sup> Absent an S corporation federal income tax filing requirement (*e.g.*, as a result of built-in gains), there is generally no S corporation filing requirement in Florida since Florida does not impose an individual income tax. Fla. Stat. ch 220.22(4)F.S.

<sup>42</sup> 35 ILCS 5/205(c).

<sup>43</sup> N.Y. Tax Law §660(a).

<sup>44</sup> Tex. Tax Code Ann. §171.0002.

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