Deloitte.

Accounting for Income Taxes
Quarterly Hot Topics

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Accounting Developments

Roadmap to Accounting for Income Taxes

A new release, **A Roadmap to Accounting for Income Taxes**, has been added to Deloitte's Roadmap series. This Roadmap includes all of Deloitte's interpretive guidance on the accounting for income taxes, combining the income tax accounting rules and implementation guidance from Accounting Standards Codification (ASC) 740 with Deloitte's interpretations and examples in a comprehensive, reader-friendly format.

The Roadmap also contains appendixes on the following topics:

- A comprehensive disclosure example.
- Samples of recent SEC comments on income tax matters.
- A comprehensive discussion of the income tax accounting guidance under International Financial Accounting Standards (IFRSs).

Federal

New guidance released on federal tax accounting for gift cards

On January 5, 2011, the Internal Revenue Service (IRS) released guidance regarding gift cards under Revenue Procedures ("Rev. Proc.") 2011-17 and 2011-18. Rev. Proc. 2011-17 provides a safe harbor method that allows taxpayers to treat the issuance of gift cards in exchange for returned goods as (1) the payment of a cash refund in the amount of the gift card and (2) the sale of a gift card in the amount of the gift card. Taxpayers may then account for the sale of the gift card under Treasury Regulations Section 1.451-5 or Rev. Proc. 2004-34, as appropriate.

If a taxpayer pays a customer an immediate cash refund for returned goods, a refund liability occurs and the taxpayer may reduce taxable gross receipts for the amount of the refund. If the customer then uses the refund to purchase a gift card, the taxpayer receives an advance payment from the sale of a gift card and may be able to defer the proceeds of the sale under a method of accounting that complies with either Treas. Reg. Section 1.451-5 or Rev. Proc. 2004-34. Prior to Rev. Proc. 2011-17, however, if a taxpayer only issued a gift card to a customer in exchange for returned goods, it is arguable that a fixed liability under Treas. Reg. Section 1.461-1(a)(2)(i) did not occur because it was conditioned on the future redemption of the gift card. By issuing Rev. Proc. 2011-17, the IRS has permitted a taxpayer within the scope of the revenue procedure to treat gift cards issued for returned goods as the payment of a cash refund and the subsequent sale of a gift card, regardless of whether the taxpayer's policy is to provide a cash refund or a gift card for returned goods.

A taxpayer generally must recognize advance payments (e.g., sale of a gift card) in taxable income in the year of receipt, because receipt satisfies the all events test of Treas. Reg. Section 1.451-1(a). Two exceptions to this general rule are provided by Treas. Reg. Section 1.451-5 and Rev. Proc. 2004-34:

- Treas. Reg. Section 1.451-5 generally allows an accrual method taxpayer to defer recognizing advance payments for goods as income until the taxable year the taxpayer recognizes the advance payments in revenue under the taxpayer's method of accounting for financial reporting purposes. However, the deferral of substantial advance payments for inventoriable goods is limited to the end of the second taxable year following the year the advance payment becomes substantial. In addition, Treas. Reg. Section 1.451-5 applies only to "an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."
- Rev. Proc. 2004-34 generally allows an accrual method taxpayer to defer recognizing advance payments received for goods, services, or a mixture of both, as income until the taxable year the taxpayer recognizes the advance payments in revenue under the taxpayer's method of accounting for financial reporting purposes. However, the deferral is limited to the end of the next succeeding taxable year following the year the taxpayer receives the payments.

The manner in which retailers market, sell to customers, and redeem (i.e., accept as payment for goods or services) gift cards has evolved over time. Historically, a single retailer would sell a gift certificate or gift card to a buyer and would redeem the card or certificate itself by providing goods or services to the holder. Provided all the requirements were otherwise met, a retailer could defer recognizing income pursuant to Rev. Proc. 2004-34. Today, however, gift cards are commonly sold by one retailer and redeemed either by that retailer or by others (related or unrelated to the selling entity) under a gift card service agreement.

Rev. Proc. 2011-18 extends the advance payment deferral method of accounting in Rev. Proc. 2004-34 (the "Deferral Method") to accrual method taxpayers who sell gift cards that may be redeemed by another entity under a gift card service agreement. The Deferral Method may be applied to the sale of a gift card (or gift certificate) if (1) the taxpayer is primarily liable to the customer for the value of the card until redemption or expiration and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment. Rev. Proc. 2011-18 also indicates that the deferral exception provided for by Treas. Reg. Section 1.451-5 would not be available in a situation where the goods are provided by entities other than the taxpayer as the goods are not "held by the taxpayer" for sale as required by Treas. Reg. Section 1.451-5.

Effective for taxable years ending on or after December 31, 2010, taxpayers changing to the Deferral Method as a result of the new guidance may do so as an automatic method change. A taxpayer that has a manual method change pending with the national office that was filed on or before January 5, 2011, related to gift cards issued in exchange for returned merchandise or advanced payments for gift cards that may be redeemed by another entity, may convert its application to an automatic method change, if otherwise eligible. The taxpayer must notify the national office of the conversion before the national office issues a letter ruling under Rev. Proc. 97-27.

Both Revenue Procedures provide that if a taxpayer was utilizing the method of accounting permitted under the Rev. Proc. in a taxable year beginning before December 31, 2010, the IRS will not challenge the use of that method of accounting, nor will it further pursue the use of such method to the extent it is currently an issue under consideration in an examination, in appeals, or before the U.S. Tax Court.

ASC 740 Implications: Taxpayers that had uncertain tax positions with respect to the situations addressed by the Rev. Procs. must determine the appropriate period to remeasure their tax position.

Taxpayers that were utilizing a method permitted by one of the Rev. Procs. in a tax year ending before December 31, 2010, should remeasure the benefit previously recorded for such tax position in their reporting period that includes January 5, 2011, the date the Rev. Procs. were issued. Accrued interest and penalties, if any, associated with such tax position should be similarly adjusted in such reporting period.

Taxpayers that qualify for and will change their method of accounting to one of the methods permitted in the Rev. Procs. via the automatic consent procedures provided for in the Rev. Procs. should remeasure the benefit previously recorded and adjust any related accrual for interest and penalties in the reporting period that the eligible taxpayer files its **Form 3115**, *Application for Change in Accounting Method*.

International

Puerto Rico excise tax

In the **December 2010 issue of Accounting for Income Taxes Hot Topics**, we reported *Puerto Rico Excise Tax Not an Income Tax* and addressed the issue of the Puerto Rico excise tax enacted on October 25, 2010, and subsequently amended on October 28, 2010.

In part due to concerns over the creditability of the tax for U.S. federal income tax purposes, Puerto Rico amended the law on January 31, 2011, to clarify the application of the rules. While the amendment does not change the conclusion that the excise tax is not an income tax under ASC 740, we believe the better position is that the excise tax is a creditable “in lieu of” tax under Section 903 and the regulations there under, given the description of the excise tax and the underlying regulations published to date.

For more information on the Puerto Rico tax changes, see **Deloitte’s October 29, 2010 International Tax Alert**.

ASC 740 implications: The new excise tax does not fall within the scope of ASC 740 because the tax is levied on gross purchases which are not a measure of income. This is the case irrespective of whether the tax is creditable for U.S. federal income tax purposes.

The foreign tax credit is within the scope of ASC 740 and is recorded in the income tax provision line, notwithstanding the fact that the excise tax is recorded “above the line.” Although the excise tax is recorded outside income tax expense, for example as a cost of goods sold, it is not capitalized under Section 263A if a taxpayer elects to claim a foreign tax credit with respect to the tax. Consider the following example:

A U.S. parent, P, conducts manufacturing operations in Puerto Rico through a wholly-owned subsidiary, S. Assume the following additional facts:

- S manufactures widgets and sells them to P for $100 million. S has a cost of goods sold (COGS) of $90 million.
- The excise tax is $4 million, which is computed at the 4 percent excise tax rate on $100 million of purchases by P.

- During the year, P sells all of the widgets to a third-party buyer for $110 million. P records the $4 million excise tax as an increase to COGS.
- The applicable statutory tax rate for P and S's business in both jurisdictions is 35 percent.
- P has sufficient foreign source income from other sources to utilize the excess foreign tax credit.

The consolidated accounts are as follows:

	P (U.S.)	S (PR)	Eliminations	Consolidated
Revenue	110	100	(100)	110
COGS	(104)	(90)	100	(94)
Pre-book tax income	6	10		16
Book/tax difference	4	0		4
Taxable income	10	10		20
Tax rate	35%	35%		
Tax expense (before FTC)	3.50	3.50		7.00
IRC Section 903 Credit	(4.00)			(4.00)
Net tax expense	(0.50)	3.50		3.0
Effective tax rate				18.75%

Multistate

Arizona tax law change

On February 17, 2011, Governor Jan Brewer signed Laws 2011, Ch. 1, 2nd Special Session (H.B. 2001), which includes the following modifications to the Arizona law:

- **Corporate income tax rate reduction** – H.B. 2011 maintains the current corporate income tax rate of 6.968% for taxable years beginning through December 31, 2013. Thereafter, H.B. 2001 provides the following four year phase-in of the corporate income tax rate reduction:

For taxable years beginning from and after:	Corporate income tax rate:
December 31, 2013 through December 31, 2014	6.5%
December 31, 2014 through December 31, 2015	6.0%
December 31, 2015 through December 31, 2016	5.5%
December 31, 2016	4.9%

- **Electable weighted sales factor** – Prior to H.B. 2001, for taxable years beginning from and after December 31, 2008, corporate taxpayers were required to elect either a 50 percent or 80 percent weighted sales factor. Pursuant to H.B. 2001, the current election will apply for taxable years beginning through December 31, 2013. Thereafter, H.B. 2001 provides the following changes to the electable weighted sales factor:

For taxable years beginning from and after:	Electable weighted sales factor of:
December 31, 2013 through December 31, 2014	50% or 85%
December 31, 2014 through December 31, 2015	50% or 90%
December 31, 2015 through December 31, 2016	50% or 95%
December 31, 2016	50% or 100%

New and modified tax credits – H.B. 2001 implements several new credits and modifies others, including:

- Credit for new employment
- Investment in small businesses credit
- University-related research credit

For additional details, please refer to **Multistate Tax: External Alert – February 23, 2011**.

ASC 740 implications: The Arizona tax law changes could result in the following financial reporting impacts:

***Deferred taxes*:**

- **Measurement** – Deferred tax assets and liabilities (DTAs and DTLs) should be measured using the applicable enacted tax rate expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. Companies may need to schedule the reversals of temporary differences in order to determine the applicable tax rate for measuring DTAs and DTLs considering the changes to the income tax rate and electable weighted sales factor that will be phased in over a number of years.
- **Net operating loss (NOL) carryforward** – Because Arizona NOL carryforwards are utilized on a post-apportionment basis, a change to the electable sales factor weighting does not require recalculation of the carryforward and remeasurement of the DTA; however, the NOL DTA might require a valuation allowance if such election is expected to reduce taxable income in the carryforward period significantly. However, companies do need to consider whether the income tax rate reduction impacts the measurement of DTAs for Arizona NOLs.
- **Intraperiod allocations** – Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations, in the period that includes the enactment date of the applicable law change, which is February 17, 2011. This is true even if the DTA or DTL was originally established through an item other than continuing operations – e.g., other comprehensive income, discontinued operations.
- **Interim** – ASC 740-270-25-5 provides that the effect of a change in tax law or rate on a DTA or DTL shall not be apportioned among interim periods through an adjustment of the annual effective tax rate (AETR). Rather, the tax effect is recorded as a discrete item in the period in which the enactment occurs.

***Current taxes*:**

- **Interim** – Pursuant to ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year should be recorded after the effective dates prescribed in the statutes and reflected in the computation of the AETR beginning no earlier than the first interim period that includes the enactment date of the new legislation. Companies should consider how the new and modified tax credits may impact their quarterly estimated AETR in the period they become effective.

Illinois tax law change

On January 13, 2011, Illinois Governor Pat Quinn signed into law Public Act (P.A.) 96-1496 amending the Illinois Income Tax Act. The new provisions include the following modification to Illinois tax law:

- **Corporate income tax rate modifications** – The changes to the corporation income tax rates under P.A 96-1496 are summarized below:

Calendar basis tax years	Illinois corporate income tax	Personal property replacement tax	Total combined corporate tax
2010	4.8%	2.5%	7.3%
2011-2014	7.0%	2.5%	9.5%
2015-2024	5.25%	2.5%	7.75%
2025-	4.8%	2.5%	7.3%

  The date on which each rate change occurs is January 1 – 2011, 2015, or 2025. This means that for fiscal year taxpayers, there will be two taxable periods to which two different rates apply in a single tax year that includes January 1 (in 2011, 2015, and 2025). Regarding the computation of liability for a year to which two different rates apply, P.A 96-1496 provides that a taxpayer may determine taxable income for each portion of the year either by (1) specific accounting, or (2) multiplying taxable income for the year by a ratio equal to the number of days in that short time period over total days in the year.

  If state spending for any fiscal year from June 30, 2012 to June 30, 2015 exceeds the State Spending Limitation for that fiscal year, the income tax rates revert to their pre-P.A. 96-1496 levels. For the purpose of reducing spending below the Spending Limitation, the Governor may place certain appropriated amounts into a “reserve.” The “reserve” amounts may be used by the legislature without constituting “spending” if the amount is used pursuant to a “fiscal emergency” as declared by the Governor. However, either the state Comptroller or state Treasurer may report to the legislature that they do not concur in the governor’s declaration, thus precluding the use of the “reserve” and effectively triggering the rate reversion to their pre-P.A. 96-1496 levels.

- **Net loss carryover suspended for C Corporations** – For tax years ending after December 31, 2010 and prior to December 31, 2014 (for calendar years 2011– 2013), P.A 96-1496 suspends the net loss carryover deduction for C Corporations. Any year for which the net loss carryover deduction is suspended does not count as a “taxable year” for purposes of calculating Illinois’ 12-year net loss carryover period.

- **Estimated tax safe harbor** – Illinois generally provides that estimated payments are measured by either (1) 90 percent of the tax shown on the return for the taxable year, or (2) 100 percent of the tax shown on the prior year return. For installments due after January 31, 2011 and prior to February 1, 2012, the 100 percent safe harbor amount is increased to 150 percent of the tax shown on the prior year return.

For additional details, please refer to **Multistate Tax: External Alert – January 13, 2011**.

ASC 740 implications: The Illinois tax law changes could result in the following financial reporting impacts:

Current Taxes

- **Interim** – Pursuant to ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year should be recorded after the effective dates prescribed in the statutes. Calendar year companies that have nexus in Illinois should consider this change in tax law when computing their first quarter AETR for 2011. Fiscal year filers should also consider the impact of the change in tax law and adjust their AETR to reflect their chosen tax return filing application (i.e., specific accounting or pro-ration) in the quarter in which the change was enacted.
- **Net loss carryover suspension** – Companies that previously intended to utilize NOLs to reduce their current year taxable income should adjust their income taxes payable and NOL DTA in the period that includes January 13, 2011 to reflect the suspension of NOL deductions for tax years ending after December 31, 2010 and prior to December 31, 2014.

Deferred Taxes

- **Measurement** – DTAs and DTLs should be measured using the applicable enacted tax rate expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. Companies may need to schedule the reversals of temporary differences in order to determine the applicable tax rate for measuring DTAs and DTLs considering the changes to the income tax rate. Since it is not probable that the state will exceed its spending limits given the fiscal consequences of doing so and the reserve mechanisms noted above, a company should not anticipate the rate reverting back to its historical level when computing its deferred taxes. Therefore, companies should measure DTAs and DTLs at the enacted tax rates above and continue to monitor developments related to the potential tax rate reduction.

- **Net loss carryover suspension** – Companies should assess whether the NOL utilization suspension and related potential impact to the 12-year carryover period results in a change to the amount of NOLs that are more likely than not to be realized, and record any related increase or decrease to the valuation allowance in the period of enactment in income from continuing operations pursuant to ASC 740-10-45. For example, a company may have relied on the existence of taxable temporary differences scheduled to reverse in tax years 2011 through 2014 as a source of taxable income to recognize the benefit of the NOLs. However, as a result of the NOL suspension, the current inventory of taxable temporary differences may no longer be an available source of taxable income.

- **Intraperiod allocations** – Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations, in the period that includes the enactment date of the applicable law change, which is January 13, 2011. This is true even if the DTA or DTL was originally established through an item other than continuing operations – e.g., other comprehensive income, discontinued operations.
- **Interim** – ASC 740-270-25-5 provides that the effect of a change in tax law or rate on a DTA or DTL shall not be apportioned among interim periods through an adjustment of the AETR. Rather, the tax effect is recorded as a discrete item in the period in which the enactment occurs.

Wisconsin administrative practice

On January 28, 2011, the Wisconsin Department of Revenue (DOR) issued a new ten-year Look-Back Policy applicable to certain Wisconsin income and franchise tax nonfilers. Prior to the issuance of this policy, the state did not have an established administrative practice concerning the number of prior tax periods for which the state would seek to collect tax, interest, and penalties for nonfilers with Wisconsin nexus.

Under the new policy, the DOR has adopted a maximum ten-year Look-Back period applicable to any "person"[1] that satisfies both of the following conditions:

1) The person must have nexus in the state currently, and
2) Must have filed timely Wisconsin income or franchise tax returns for at least the four most recent taxable years.

The policy will not apply to any person making a false representation of facts to the DOR.

For additional details, please refer to **Multistate Tax: External Alert – February 17, 2011**.

ASC 740 implications: The new administrative practice Look-Back period may allow a company that meets the requirements of the policy to derecognize unrecognized tax benefit (UTB) amounts recorded for years prior to the tenth preceding year.

- **UTB** – In the absence of a widely understood administrative practice or precedent, ASC 740 requires the accrual of a UTB for every period in which an entity is determined to more-likely-than-not have nexus in a specific taxing jurisdiction. A company that did not file a Wisconsin tax return in a year that it had nexus in Wisconsin may need to reassess its UTB considering the new information provided by the new DOR policy, and should account for any related change in its financial statements in the period in which the administrative practice was published.
- **Subsequent event disclosures** – As discussed in ASC 740-10-25-14 and 15, information received after the balance sheet date that affects the evaluation of a previous tax position should not be considered when evaluating that tax position as of the balance sheet date. However,

[1] Under Wisconsin law (Wis. Stat. Section 71.01(5)), Wisconsin adopts the Internal Revenue Code (IRC) definition of "person," unless otherwise defined or the context requires otherwise. The IRC defines "person" to mean and include an individual, a trust, estate, partnership, association, company, or corporation. 26 U.S.C. Section 7701(a)(1). Wisconsin explicitly includes fiduciaries within the definition of "person." Wis. Stat. Section 71.01(9). Additionally, Wisconsin Tax Bulletin 170 defines "person" as including an "individual, partnership, corporation, limited liability company, and fiduciary."

the entity should consider disclosure of the impact of the information received after period end and its effect on the financial statements (if material).

Controversy

Tax Controversy Update: 2011 Offshore Voluntary Disclosure Program

On February 8, 2011, the IRS issued IR-2011-14 announcing the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI). The 2011 OVDI is an opportunity for taxpayers with unreported income from undisclosed foreign accounts, foreign assets, or foreign entities to become current with their federal income tax obligations while avoiding potentially substantial civil penalties and generally eliminating the risk of criminal prosecution. The 2011 OVDI will be available through August 31, 2011.

Taxpayers currently under an IRS examination are ineligible for the 2011 OVDI, regardless of whether the examination is related to the undisclosed foreign accounts or entities.

In connection with IRS's announcement of 2011 OVDI, the IRS gave taxpayers the opportunity to file delinquent Forms 5471 (*Information Return of U.S. Persons With Respect To Certain Foreign Corporations*), Foreign Bank Account Reports, or other international information returns for tax years 2003 through 2010 without being subject to a delinquency penalty. This penalty relief is only available to taxpayers who properly reported and paid tax on all taxable income with respect to all transactions related to the foreign entities. To take advantage of this opportunity, taxpayers need to file, on or before August 31, 2011, the delinquent international information returns according to form instructions and attach a statement explaining why the information returns are being filed late. Generally, these forms should be filed as part of an amended return which shows no change.

It appears that the procedures and penalty protection afforded under this process may cover the following international information returns:

- **Forms 5471**, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*
- **Form 5472**, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*
- **Form 8858**, *Information Return of U.S. Persons With Respect To Foreign Disregarded Entities*
- **Form 8865**, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*
- **Form 926**, *Return by a U.S. Transferor of Property to a Foreign Corporation*
- **Forms 3520**, *Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*
- **Form 3520-A**, *Annual Information Return of Foreign Trust With a U.S. Owner*

For additional information on the 2011 OVDI, please refer to **IRS Insights, March 2011 issue.**

ASC 450 implications: Generally, a taxpayer should either accrue a liability (if under accrual accounting it is clearly a liability) or, more likely for the types of items above, consider whether a contingent liability should be recognized under ASC 450. It would not be appropriate to apply ASC 740, when determining whether a liability should be recognized for fixed-fee penalties associated with the untimely filing of information returns since the exposure does not relate to an income tax position. Companies need to consider this IRS initiative when determining the amount of penalties related to certain delinquent international information returns. Generally, adjustments to penalties as a result of participation in an the IRS initiative should be recorded in the period that an amended tax return, along with the relevant international information returns, is filed, and all necessary actions have been taken to obtain penalty relief.

Did You Know?

Income tax accounting for partnerships – Determining the appropriate tax basis (first in a series)

The taxable or deductible temporary difference that is attributable to an investment in a pass-through entity (i.e., the "outside" basis difference) represents the expected increase or decrease in taxable income (relative to book income) assuming that the investment is recovered for its financial reporting carrying amount.[2] Therefore, the measurement of the DTA or DTL, if any, is based on the difference between the tax basis of the investment (exclusive of allocable liabilities as discussed below) and its reported amount in the investor's statement of financial position (usually referred to as the "book basis"). This is true regardless of how the investor accounts for its interest in the pass-through entity (e.g., cost method, equity method, or consolidated).

For U.S. income tax purposes, the adjusted tax basis of a partnership investment is generally equal to the tax basis of property or cash initially contributed (or the amount paid if the partnership interest is purchased from an existing partner) and is adjusted each year for the partner's share of the partnership's taxable income or loss, any distributions, and additional contributions. For purposes of determining whether a partner can deduct its share of allocable losses, the basis described above is increased for the partner's share of recourse and nonrecourse partnership liabilities (section 752(a)). While the partner's share of nonrecourse partnership liabilities is relevant for the application of tax law in determining whether the partner has sufficient basis to claim losses, it is not relevant for purposes of determining the taxable or deductible temporary difference in the partnership. For purposes of measuring the outside basis difference in a partnership, the tax basis is determined without considering the partner's share of nonrecourse partnership liabilities and the resulting amount can be negative.

If the investor is accounting for its partnership interest under the equity method, then the investor's equity interest in losses cannot exceed the total amount of the equity method investment (i.e., not less than zero when the company has no obligations to make additional contributions to fund losses and has not guaranteed repayment of the debt). A larger loss may be recognized for income tax purposes because the partner's adjusted tax basis is increased by its share of nonrecourse liabilities.

If the investor is consolidating the partnership for U.S. GAAP financial reporting purposes, then the investor recognizes its share of the partnership's losses (this is reflected in the "book basis" which is equal to the assets and liabilities consolidated reduced by the noncontrolling interest – a net amount that can be negative). The financial reporting losses that are allocable to the noncontrolling interests will generally be based on the noncontrolling interest's percentage ownership, even as it relates to losses that were effectively financed by liabilities that are recourse to the consolidating partner and not to the noncontrolling interest holder.

[2] An investor should not recognize deferred taxes on the book and tax basis differences associated with the pass-through entity's assets and liabilities (i.e., "inside basis differences"), since the partnership itself is not a tax paying component (the exception being when the partnership is a tax paying component as it relates to certain states, etc.).

In summary, (a) the liabilities of the partnership may be considered differently (book versus tax) when determining the amount of loss that reduces the basis in the partnership interest and (b) when determining the appropriate tax basis for purposes of measuring the outside basis difference, a company should calculate the tax basis that does NOT include the partner's share of nonrecourse partnership liabilities.

Consider the following example:

X and Y form a partnership. X contributes $12,000 in exchange for a 60% partnership interest. X consolidates the partnership for financial statement purposes. Y contributes $8,000 in exchange for a 40 percent partnership interest. The partnership purchases property for $20,000 cash and an $80,000 nonrecourse note. X's share of the nonrecourse liabilities is $48,000. Immediately after the property purchase, X's adjusted tax basis in its partnership investment is $60,000 ($12,000 cash investment plus $48,000 of nonrecourse liabilities) and as such, could claim losses of $60,000 prior to being limited by its tax basis. However, if X were to sell its investment in the partnership for the book basis of $12,000, no gain or loss would be recognized for tax purposes because, for purposes of measuring its gain or loss, the partnership interest has a tax basis of $12,000 (i.e., that is the amount that it would compare to any proceeds received in an exchange).

Deloitte offers Financial Reporting for Taxes 2011 Training

Professionals continue to face significant challenges in financial accounting and reporting for income taxes. Deloitte's 2011 training program can help you stay informed. Five-day sessions with multiple course offerings allowing the registrant to choose the courses most appropriate for their needs are set for May 9-13 in Jersey City, New Jersey, and December 5-9 in Las Vegas, Nevada. Course offerings are open to clients and potential clients of Deloitte, not to other professional services organizations and consultants. We encourage you to **register** early due to limited meeting space, number of reserved hotel rooms, and to take advantage of early registration discounts.

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: **USNationalWNTActIncomeTaxesGrp@deloitte.com**.