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Accounting Developments

SEC issues staff paper to address incorporation of international standards into U.S. reporting system

On May 26, 2011, the Securities and Exchange Commission (SEC) issued a **staff paper**, "Exploring a Possible Method of Incorporation," that presents a possible framework for incorporating International Financial Reporting Standards (IFRS) into the U.S. financial reporting system. The framework is intended to accomplish the following:

- Provide the Financial Accounting Standards Board (FASB) and SEC with the ability to maintain authority over U.S. accounting standard setting.
- Facilitate the process of incorporating IFRS into U.S. GAAP.
- Allow U.S. financial statement issuers compliant with U.S. GAAP to also represent that they are compliant with IFRS.

The framework has been dubbed "condorsement" by the SEC staff and others, as it is perceived to be a combination of a convergence approach and an endorsement approach. Convergence refers to the ongoing joint efforts of the FASB and International Accounting Standards Board (IASB) to adopt substantially identical standards in specific areas, and would continue under the framework as a transitional phase. Endorsement refers to the FASB's adoption of individual IFRSs into GAAP, with the FASB and SEC maintaining the ability to supplement or modify IFRSs as part of the endorsement process when doing so would be in the public interest or necessary for the protection of investors. Although a timeline was not part of the scope of the SEC's paper, the framework suggested a gradual transition that could occur over a five to seven year period.

Although *income taxes* were identified as a joint project in the original memorandum of understanding between the IASB and FASB in 2006, there has not been any recent progress in arriving at a converged standard; therefore, it is unclear how differences between ASC 740 and IAS 12 may be addressed under the framework.

The SEC has requested comments on the **staff paper** by July 31, 2011. For additional information on the SEC staff paper, please see Deloitte's Heads Up newsletter issued June 1, 2011 – **IFRSs Anyone? SEC Staff Paper Explores Method of Incorporating International Standards Into U.S. Reporting System.**

Federal

Rev. Proc. 2011-35 – Establishing tax basis in the stock of a target corporation acquired in a "transferred basis transaction"

On May 31, 2011, the Internal Revenue Service (IRS) released a revenue procedure (Rev. Proc. 2011-35) providing guidelines an acquiring corporation may use to establish its tax basis in stock of a target corporation when it acquires the target stock in a transferred basis transaction, such as a reorganization described in Internal Revenue Code (IRC) Section 368(a)(1)(B). Rev. Proc. 2011-35 adopts the surveying and statistical sampling guidelines in Rev. Proc. 81-70, but updates and revises them to take current market practices into account. This revenue procedure also adopts the safe harbor methodologies described in Notice 2009-4 with some modification. Finally, Rev. Proc. 2011-35 expands the applicability of these provisions by permitting their use in any transferred basis transaction completed on or after June 20, 2011.

The IRS has set forth procedures in the Rev. Proc. for methodologies that taxpayers may use to determine basis in stock acquired in a transferred basis transaction, in the absence of actual knowledge of such basis, including: (1) surveying all surrendered shareholders to determine actual basis in surrendered shares, (2) statistical sampling when a full survey is not feasible, and (3) two estimation techniques that may be used when specified criteria are satisfied. Taxpayers may use one or more of these methodologies, with certain restrictions, in any combination. If a taxpayer cannot or does not use the methodologies prescribed in Rev. Proc. 2011-35, the basis in the acquired target company shares may be established by such other methodologies as agreed by the IRS and the acquiring corporation.

Rev. Proc. 2011-35 is effective with respect to transferred basis transactions completed on or after June 20, 2011. However, taxpayers may use this revenue procedure with respect to transferred basis transactions completed prior to June 20, 2011; in such cases, surveys will be considered timely if substantially completed, and reporting requirements will be considered satisfied if filed, on or before June 20, 2013. Rev. Proc. 81-70 and Notice 2009-4 are obsoleted with respect to transferred basis transactions completed on or after June 20, 2011.

For additional details, please refer to **Rev. Proc. 2011-35**.

ASC 740 implications: Although it is not expected that the release of Rev. Proc. 2011-35 will cause a significant impact to a company's financial statements for previously completed transferred basis transactions, companies should consider the effects it could have on future transactions and existing assertions related to outside basis differences.

The difference between a parent company's tax basis in an investment in a subsidiary and its financial reporting basis results in an outside basis difference. Deferred taxes are always recorded on taxable and deductible temporary differences, unless a specific exception applies. The exception that may apply under ASC 740 depends on whether the outside basis difference indicates taxable or deductible amounts. A deferred tax liability (DTL) is recorded for any outside basis difference that is a taxable temporary difference, unless one of the exceptions in ASC 740-10-25-3(a) or ASC 740-30-25-7 through 25-8 applies. Under ASC 740-30-25-9, a deferred tax asset (DTA) should not be recorded on an outside basis difference that is a deductible temporary difference unless it is apparent that the temporary difference will reverse in the foreseeable future (e.g., generally within the next 12 months).

Under ASC 740-30-25-7 through 25-8, outside basis differences in domestic entities (i.e., the holder of the investment is taxable in the same jurisdiction as the investee) would not be treated as taxable temporary differences if (1) the investment in the subsidiary "could" be recovered tax-free and (2) the parent expects to recover its investment in the subsidiary in such tax-free manner eliminating the outside basis difference either before or after a sale of the subsidiary's assets. In other words, the company is asserting that it would not sell the stock of the subsidiary (i.e., in a transaction that is treated for tax as a sale of shares rather than as a sale of assets).

Companies that are asserting that they will recover their investment in their domestic subsidiaries in a tax-free manner, and by such assertion have not recorded DTLs on any taxable outside basis differences, should have a full understanding of the tax basis of their domestic subsidiary's stock and the tax basis of the underlying assets in order to determine the reasonableness of their financial statement assertion.

For example, Parent company (Parent) acquires all of the stock of a target company (Target) in a transferred basis transaction (as defined in Rev. Proc. 2011-35). The financial reporting amount of the investment in Target is $120 million. Using a statistical sample, Parent determines that the tax basis in its Target stock is $100 million. The net assets of Target have a tax basis of $5 million. Parent owns 100 percent of Target and could recover its investment in Target in a tax-free manner and as such proposes to not record a DTL. Parent must determine whether it is reasonable to assert that it would recover its investment in Target in a tax-free manner (generally through actual or deemed tax-free liquidation) given the fact of relatively low tax basis in the Target assets. If Parent determines that it would expect to sell Target's stock, then the exception to recognizing outside basis differences contained in ASC 740-30-25-7 through 25-8 should not be applied.

Rev. Proc. 2011-29 – Safe harbor election for allocating success-based fees between facilitative and non-facilitative activities

The IRS recently released Rev. Proc. 2011-29, which provides a safe harbor election for allocating success-based fees paid in a business acquisition or reorganization described in Reg. Section1.263(a)-5(e)(3). This safe harbor permits electing taxpayers to treat 70 percent of any success-based fees as an amount that does not facilitate the transaction. This does not mean that the 70 percent amount is immediately deductible. It is still necessary to determine whether a deduction under Section 162, or amortization under Section 195, is appropriate. The remaining 30 percent must be capitalized as an amount that facilitates the transaction. Rev. Proc. 2011-29 is effective for success-based fees paid or incurred in taxable years ending on or after April 8, 2011.

Prior to the release of Rev. Proc. 2011-29, success-based fees were subject to being capitalized under the presumption that the costs were incurred to facilitate a business acquisition or reorganization transaction. However, a taxpayer could rebut that presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. Whether a taxpayer's documentation is sufficient to rebut the presumption continues to be the subject of controversy between taxpayers and the IRS. The IRS and the Treasury Department expect that much of this controversy can be eliminated by providing taxpayers this simplified method for allocating a success-based fee between facilitative and non-facilitative activities.

The IRS will not challenge a taxpayer's allocation of success-based fee if the taxpayer:

1. Treats 70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction;
2. Capitalizes the remaining 30 percent as an amount that does facilitate the transaction; and
3. Attaches a statement to its original federal income tax return for the taxable year the success-based fee is paid or incurred, stating that the taxpayer is (1) electing the safe harbor, (2) identifying the transaction, and (3) stating the success-based fee amounts that are deducted and capitalized.

An election under Rev. Proc. 2011-29 applies only to the transaction for which the election is made and, once made, is irrevocable.

For additional details, please refer to **Rev. Proc. 2011-29**.

ASC 740 implications: Because of its prospective effective date, Rev. Proc. 2011-29 is not expected to impact previously recorded DTA arising from success-based fees incurred and paid prior to the effective date (April 8, 2011). However, acquiring companies that anticipate paying or incurring success-based fees in tax years ending after the effective date should consider the application of Rev. Proc. 2011-29 when determining the amount of acquisition related costs that can be benefited (either immediately deducted or capitalized and amortized) and the amount that cannot be benefited (if the transaction is a stock acquisition rather than an asset acquisition).

When an acquiring corporation acquires a target corporation in a business combination, pays a success-based fee, and applies the safe harbor election of Rev. Proc. 2011-29, then a tax benefit (i.e., current benefit or DTA) should be recognized for 70 percent of the success-based fee.[1] If the transaction is an asset acquisition, a tax benefit (i.e., DTA) should also be recognized for the remaining 30 percent of the success-based fee that will be deductible over time (most likely as tax deductible goodwill). If the transaction is a stock purchase, a tax benefit (i.e., DTA) would generally not be recognized for the remaining 30 percent of the success-based fee because the costs capitalized for tax purposes would generally cause the tax basis to exceed the financial reporting basis of the target corporation shares.

[1] Because success-based fees are acquisition-related costs and expensed for financial reporting purposes, the current and deferred tax benefits resulting from success-based fees are recorded as components of income tax expense and not included in the business combination accounting for the acquisition of the target corporation.

Pursuant to ASC 740-30-25-9, no DTA can be recognized for tax over financial reporting basis in the stock of a subsidiary unless that temporary difference is expected to reverse in the foreseeable future.

International

Puerto Rico excise tax

In the **December 2010** and **March 2011** issues of **Accounting for Income Taxes Hot Topics**, we reported on the Puerto Rico excise tax. The legislation was initially enacted in October 2010 and then amended in January 2011. We noted in the March 2011 issue that the tax (as amended) is likely to be treated as creditable for U.S. tax purposes, specifically as an "in lieu of" tax under Section 903. In addition, we illustrated the anticipated impact of the excise tax on the effective tax rate when the tax is recorded "above the line."

Most recently, the IRS has issued Notice 2011-29 to state that it "will not challenge a taxpayer's position that the excise tax is a tax in lieu of an income tax under Section 903" pending further review of certain legal and factual issues. Any future change (if any) to the IRS' position will be prospective.

ASC 740 implications: As we discussed in our March 2011 issue, the excise tax is not within the scope of ASC 740 (Income Taxes) because it is levied on the purchaser of goods (rather than the seller of goods) and is measured on gross purchases. While many “in lieu of” taxes are subject to ASC 740 with the reasoning partly being that only taxes on income are creditable for U.S. tax purposes and as such, by being creditable, the excise tax in question must be a tax on income. However, this particular “in lieu of” tax is unique because the payer is the purchaser and not the seller, and as such, is based on purchases (cost of goods sold) and not sales (the normal base used by “in lieu of” taxes).

Effect of Section 901(m) on the Section 338 election making process

During 2010, Congress enacted Section 901(m) which is generally effective with respect to "covered asset acquisitions" entered into on or after January 1, 2011. Section 901(m) can apply in numerous contexts. This discussion is limited to the effect of Section 901(m) on the acquisition of a foreign corporation when a Section 338(g) election is made.

In connection with the taxable purchase of foreign corporations, the seller and buyer will typically evaluate the making of an election under Section 338(g). This election has the effect of stepping up the basis in the assets of the foreign subsidiary (including tax amortizable goodwill – making it a “covered asset acquisition”) for the purpose of the prospective measurement of earnings and profits (E&P) that will be used in determining the U.S. tax treatment of future distributions from that entity. There is no change to the tax basis in the assets for local, in-country tax purposes. The election also eliminates the historical E&P, eliminating the need to for the buyer to compute that amount (which can be complicated if it is an older company or the records are not robust).

Parties to an eligible taxable stock purchase of a foreign corporation in 2011 and beyond will need to undertake the same analysis; however, purchasers should consider the effect of new Section 901(m) which generally will deny a foreign tax credit (FTC) for any in-country taxes paid on income that was effectively offset, for E&P purposes, by the step-up resulting from the Section 338(g) election. Any amount of FTC that is not allowed by this provision is excluded from the general requirement to include amounts claimed as FTCs as additional U.S. taxable income (the Section 78 gross-up). While the FTC is not allowed, the amortization resulting from the step-up remains deductible for U.S. E&P purposes.

ASC 740 implications: Prior to the enactment of Section 901(m), under certain facts, the acquiring corporation may have recognized a post-acquisition provision benefit on hypothetical or actual distributions from the acquired foreign subsidiary since the foreign subsidiary’s tax (which is being paid on income that is not reduced by any amortization) was often significant relative to U.S. E&P (which is being reduced by the amortization of the stepped-up basis).

When evaluating the after-tax economics of a "covered asset acquisition" in 2011 and beyond, purchasing corporations should consider the post-acquisition effect of claiming a deduction for foreign taxes paid that otherwise were creditable prior to the enactment of Section 901(m).

Consider the following example: A U.S. Parent, P, acquires the stock of Foreign Target, T, in a "qualified stock purchase." T makes a Section 338(g) election. Assume the following additional facts:

- The local country income tax rate is 30 percent, and the U.S. federal income tax rate is 35 percent.
- Local country taxable income is equal to U.S. GAAP pre-tax book income.
- During Year 1, T:
  - earns U.S. GAAP pre-tax book income equal to 7,000;
  - accrues and pays local country tax equal to 2,100; and
  - distributes 4,900 to P.
- "Book goodwill" is equal to tax goodwill and remains unimpaired under ASC 350 as of the end of Year 1.
- T has no U.S. E&P adjustments as compared to U.S. GAAP except for 1,000 of goodwill amortization that relates to the aggregate basis difference before and after the acquisition.

The effective tax rate (ETR) comparison (with and without Section 901(m)) is as follows:

U.S. P acquires the stock of controlled foreign corporation with a Section 338(g) election

T's local country tax	**Pre-§ 901(m)**	**Incl. § 901(m)**	
U.S. GAAP pre-tax book income/(loss)	7,000	7,000	
Local country tax rate	30.00%	30.00%	
Local country tax expense /(benefit)	2,100	2,100	
Net income/ (loss)	**4,900**	**4,900**	
P's U.S. shareholder tax and FTC			
E&P before goodwill amortization	4,900	4,900	
Goodwill amortization from "aggregate basis difference"	-1,000	-1,000	
§ 78 Gross-Up	2,100	1,800	[1]
Foreign source taxable income/(loss)	**6,000**	**5,700**	
U.S. tax rate	35.00%	35.00%	
U.S. tax (before FTC)	2,100	1,995	
FTC (assuming no FTC limitation)	-2,100	-1,800	
Net U.S. tax expense/(benefit)	**-**	**195**	
Worldwide tax expense/(benefit) and ETR			
Local country tax	2,100	2,100	
U.S. shareholder tax	2,100	1,995	
U.S. FTC	-2,100	-1,800	
Total tax expense /(benefit)	**2,100**	**2,295**	
Effective tax rate	**30.00%**	**32.79%**	
P's Disqualified FTC's Under § 901(m)			
Local country tax expense		2,100	
Disqualification % (from below)		14.29%	
Disqualified FTC's under § 901(m)		**300**	
Annual amortization from basis difference		1,000	
Local country taxable income		7,000	
Disqualification %		**14.29%**	

Note [1]: Only amounts claimed as a credit are treated as a dividend under Section 78. As a result, disqualified FTC's under § 901(m) reduce the Section 78 gross-up (here by 300).

The example illustrates that P's net U.S. tax liability increases by a net 195 as a result of:

1. An increase of 300 resulting from taxes that are non-creditable under Section 901;
2. Net of a benefit derived from the E&P deduction for non-creditable taxes multiplied by 35 percent (equal to 105).

Updated Form 8832 accommodates late classification elections

Rev. Proc. 2009-41 describes the process that taxpayers may follow to request relief for late entity classification elections. Taxpayers requesting relief under Rev. Proc. 2009-41 have been required to submit Form 8832 together with a statement declaring that certain eligibility requirements had been met (including that tax return filings were timely filed and consistent with the requested classification). In addition, taxpayers were required to include a "reasonable cause" statement in their request for relief. Once received, the IRS service center would determine whether the requirements were satisfied and would send notice as to the requested relief.

The IRS has revised Form 8832 to incorporate the requirements of Rev. Proc. 2009-41. Specifically, a "check-box" at the top of the form was added, as well as Part II to accommodate the request for late election relief. To the extent that relief is requested, once the Form 8832 is filed, a taxpayer will receive notice if such relief has been granted or denied, typically within 60 days.

ASC 740 implications: ASC 740-10-25-33 states that the "effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary..."

Often taxpayers consider the filing date of a timely-filed Form 8832 as the effective date, for financial statement purposes, based on the assertion that IRS approval of such an election is "perfunctory." For those who assert this view, the changes to streamline the process by which taxpayers obtain relief present an interesting conundrum. More specifically, given the requirements of Rev. Proc. 2009-41, taxpayers may yet conclude that acceptance is not perfunctory because the IRS must formally evaluate the taxpayer's eligibility for relief. As a result, those taxpayers who consider approval of such elections as not perfunctory may conclude it appropriate to maintain an uncertain tax position (UTP) liability pending acceptance of the Form 8832.

Multistate

New Jersey law change

On April 28, 2011, New Jersey Governor, Chris Christie, signed Senate Bill S-2753, which phases in a single sales factor generally applicable for corporate income tax purposes, and creates a modified sales factor (measured by revenue miles) for airlines.

- **Apportionment fraction changes** – Senate Bill S-2753 amends existing law by enacting a single sales factor apportionment formula, which will be phased in over a three-year period effective for the privilege periods beginning on or after January 1, 2012, as follows:

Privilege periods:	**Sales fraction weighting**	**Property fraction weighting**	**Payroll fraction weighting**
Current law	50%	25%	25%
January 1, 2012 – December 31, 2012	70%	15%	15%
January 1, 2013 – December 31, 2013	90%	5%	5%
January 1, 2014 -	100%	0%	0%

- **Modified sales factor for airlines** – Under the current regulations, the sales fraction for airlines is based on the ratio of departures in New Jersey to total departures weighted by cost or value of the aircraft. Pursuant to S-2753, effective for privilege periods beginning on or after January 1, 2012, the sales fraction for airlines will be determined as a ratio of revenue miles in New Jersey divided by total revenue miles.

For additional details, please refer to **Multistate Tax: External Alert – April 28, 2011**.

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

Deferred taxes

- **Measurement** – DTAs and DTLs should be measured using the applicable tax rate (the product of the apportionment rate and the enacted tax rate) expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. For purposes of most temporary differences, the applicable tax rate is used when measuring DTAs and DTLs. Companies should schedule the reversals of temporary differences in order to determine the applicable New Jersey tax rate for measuring DTAs and DTLs considering the changes to the apportionment that will be phased in over the next three years.
- **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 April 28, 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.

Michigan enacts Corporate Income Tax and eliminates three-factor apportionment election

On May 25, 2011, Michigan Governor, Rick Snyder, signed into law House Bills (H.B.) 4361, 4362, and 4479. These bills replaced the Michigan Business Tax (MBT) and imposed a six percent Corporate Income Tax (CIT), while eliminating the election of any equal-weighted three-factor apportionment formula.

Business tax replaced by Corporate Income Tax (H.B.s 4361 and 4362)

Effective January 1, 2012, the MBT will be replaced (except in limited instances discussed below) by the new 6 percent CIT levied upon C Corporations. The computation of the CIT will be similar in most respects to the computation of the Business Income Tax (BIT) element of the MBT and will retain similar rules related to:

- Generally following federal tax law with specific differences (such as not including IRC Sections 168(k) and 199) and providing for certain addition and subtraction modifications.
- Imposition of the CIT on a unitary business group basis.
- Application of a nexus standard based on either physical presence in Michigan greater than one day a year, or active solicitation of sales in Michigan combined with $350,000 or more in Michigan-sourced gross receipts.
- Apportionment based on a single-factor sales formula (effective 1/1/2011 see H.B. 4479 on the next page).
- Ten-year carryforward period for CIT net operating losses.

Significant changes under the CIT include:

- Flow-through entities will not be subject to the CIT.
- For taxpayers holding a direct or indirect (through one or more other flow-through entities) ownership interest or beneficial interest in a flow-through entity that has business activity in

Michigan, the taxpayer's business income that is directly attributable to the business activity of the flow-through entity shall be apportioned to Michigan using an apportionment factor determined based on the business activity of the flow-through entity.

- A C Corporation will have nexus for CIT purposes by virtue of ownership in a flow-through entity with the requisite business activities in Michigan.
- Any BIT tax losses being carried forward will not be available as a deduction against the CIT base.
- The "book-tax difference" BIT tax base deduction, which would have been eligible in 2015 through 2029 under the MBT, will not be available as a deduction against CIT base.
- Aside from a limited small business credit, none of the numerous MBT credits will be retained under the CIT.

Other considerations in transition from MBT to CIT include:

- Fiscal year taxpayers will need to prepare a final short period MBT return for periods ending December 31, 2011, and (if subject to the CIT) an initial short period CIT return for the period commencing January 1, 2012.
- Investment tax credits, whether claimed under the MBT or its predecessor, the Single Business Tax, will no longer be subject to recapture.

H.B. 4362

H.B. 4362 was passed by the Legislature contemporaneously with H.B. 4361, apparently to address the concerns of taxpayers that had been granted specific MBT credits with a negotiated term extending beyond 2011. H.B. 4361 allows taxpayers with certain "certificated credits" (a defined term under an amendment to the MBT Act), to make an election subjecting the taxpayer to the MBT (rather than the CIT) for purposes of allowing the taxpayer to apply the certificated credits and any carryforwards.

H.B. 4362 amends the MBT Act to provide new rules, beginning January 1, 2012, for taxpayers that make this election, including:

- Adding the definition for "certificated credits,"
- Amending the MBT definition of "taxpayer," and
- Adding a provision that subjects taxpayers making the election to a tax that is the greater of the MBT liability or a modified version of the liability they would have if they filed under the CIT.

H.B. 4362 will repeal the MBT Act once the Secretary of State receives a written notice from the Department of Treasury that all certificated credits have been exhausted. It should be pointed out that a flow-through entity that would otherwise not be subject to the CIT would be able to elect to be subject to the MBT if it wishes to take advantage of previously granted certificated credits.

Elimination of three-factor apportionment (H.B. 4479)

Effective January 1, 2011, H.B. 4479 amends Michigan Compiled Law Section 205.581 to eliminate the Multistate Tax Compact Act (MCT) Election under the Michigan Business Tax Act (MBT). Thus, taxpayers subject to the Business Income Tax (BIT) and Modified Gross Receipts Tax (MGRT) components of the MBT will be required to apportion their BIT and MGRT tax bases pursuant to a single sales factor. H.B. 4479 provides no explicit language regarding retroactive application.

For additional details, please refer to **Multistate Tax: External Alert – May 25, 2011**.

ASC 740 implications: The Michigan 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 and reflected in the computation of the annual effective tax rate (AETR) beginning no earlier than the first interim period that includes the enactment date of the new legislation. Since H.B. 4479, which modifies Michigan apportionment to a single sales factor, is retrospectively effective to January 1, 2011, companies should consider the impact on their quarterly estimated annual effective tax rate in the period it is enacted (the interim period that includes May 25, 2011).

Deferred taxes

- **Michigan tax attributes –** As discussed above, loss carryforwards and most tax credit carryforwards generated under the MBT will not be available to offset future CIT. Therefore, companies should schedule the amount of MBT attributes that will not be realized before the effective date of January 1, 2012, and de-recognize the associated DTA in the interim or annual period that includes the enactment date of H.B. 4361, which is May 25, 2011.
- **Michigan "book-tax difference" deduction –** The MBT included a deduction from a taxpayer's pre-apportioned BIT base. That deduction was based on a notional amount determined from the net DTL recognized when taxpayers accounted for the enactment of the MBT. For many companies, the DTA related to the "book-tax difference deduction" offset the establishment of a net DTL resulting from the enactment of the MBT. This DTA was to be recovered over 15 successive tax years beginning in 2015. As noted above, due to the tax regime change of H.B. 4361, this "book-tax difference deduction" will not be deductible against the CIT tax basis and therefore, the related DTA should be de-recognized in the annual or interim period which includes the date of enactment, May 25, 2011.
- **Measurement –** DTAs and DTLs should be measured using the applicable tax rate (the product of the apportionment factor and the enacted tax rate) expected to apply in the periods in which the temporary differences are expected to reverse. Companies should consider the effects of the Michigan law changes, which include both apportionment changes of H.B. 4479 as well as the significant modification of the Michigan tax regime from H.B. 4361. Further, companies that qualify for the MBT election under H.B. 4362 and expect to make such election should schedule the reversals of temporary differences in order to determine the appropriate inventory of temporary differences and applicable tax rate for measuring DTAs and DTLs based on the greater of MBT or CIT requirements in the Bill.
- **Flow-through entities –** Flow-through entities that do not intend to elect to be subject to the MBT should derecognize MBT deferred taxes related to temporary differences expected to reverse on or after January 1, 2012 in the annual or interim period that includes the date of enactment, May 25, 2011**.**
- **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 May 25, 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.

State programs

Recently, Colorado, Arizona, and California have implemented programs applicable to income taxes and non-income taxes.

Colorado – On June 3, 2011, Colorado governor John Hickenlooper signed Senate Bill 11-184, which establishes a tax amnesty program that will commence on October 1, 2011 and run through November 15, 2011. An eligible taxpayer who participates in the program and pays the full amount of the outstanding taxes plus one-half of the interest owed on or before November 15, 2011, will receive a waiver of the remaining one-half interest owed and a complete waiver of both criminal and civil penalties. The program also permits participation without payment of all taxes owed by November 15, 2011, provided that the taxpayer reports all taxes due and submits an amnesty application by that date, signs an "agreement to pay," and pays all taxes and 100 percent of the interest owed in accordance with the terms of the agreement. Participation in this manner results in the waiver of civil and criminal penalties, but does not result in any waiver of interest.

For additional details, please refer to **Multistate Tax: External Alert – June 3, 2011**.

Arizona – On April 6, 2011, Arizona Governor, Jan Brewer, signed Senate Bill 1616, which establishes new law effective July 20, 2011, that requires the department to establish a "tax recovery program" to run from September 1, 2011 through October 1, 2011 that will apply to most taxes administered by the department. The program will allow qualified participants to pay back taxes and reduced interest generally for periods beginning from and after December 31, 2003 and ending before January 1, 2010 (with some exceptions), in exchange for an abatement or waiver of all or part of the applicable civil penalties and interest "that have been or could be assessed or imposed for any taxable period during the applicable liability period without the need for the taxpayer to show reasonable cause or the absence of willful neglect."

California - On March 24, 2011, the state of California enacted the Voluntary Compliance Initiative II for "Abusive Tax Avoidance Transactions" and Offshore Financial Arrangements (VCI II), which will run from August 1, 2011 to October 31, 2011. Under the terms of this new initiative, qualified participating taxpayers that meet the following requirements will receive relief from most California tax penalties and criminal action for pre-2011 "abusive tax avoidance transactions" (ATATs) and underreported income from offshore financial arrangements:

1. File an amended return for each taxable year for which the taxpayer has previously filed a tax return using an ATAT or offshore financial arrangement,
2. Pay all tax and interest owed, and
3. Cooperate fully with any Franchise Tax Board inquiry into the facts and circumstances related to the use of the ATAT or offshore financial arrangement.

For additional details, please refer to **Multistate Tax: External Alert – March 25, 2011**.

ASC 740 and ASC 450 implications: Companies need to consider state programs when determining the amount of unrecognized tax benefits (UTBs) and the penalties and interest related to their UTBs recorded for income taxes accounted for pursuant to ASC 740-10. In the case of non-income taxes, a taxpayer must consider state programs when determining the amount of loss contingencies, including penalties and interest, accounted for under ASC 450.

Generally, adjustments to UTBs, contingencies, interest, and penalties, as a result of participation in state programs, should be recorded in the period that all necessary actions have been taken to participate in the program and obtain its benefits.

Controversy

Refund claim allows IRS to recalculate tax liability for all years necessary to determine whether there was an overpayment

In a recent case, the Court of Appeals for the Fourth Circuit held that the IRS could recalculate the taxpayer's liability for a taxable year after the statute of limitations had expired in order to determine whether excess tax credits were available to be carried back to previous years to support a claim for refund. *R.H. Donnelley Corporation v. U.S., 2011 U.S. App.* LEXIS 6606 (4th Cir. N.C. Mar. 31, 2011).

Background

Shortly before the statute of limitations on assessment expired for 1994, the taxpayer filed claims for refund for the 1991 and 1992 tax years as a result of tax credits carried back from 1994. The taxpayer had roughly $8 million in excess FTCs that it sought to carry back to 1991 and over $3 million in excess research credits that it sought to carry back to 1992. The IRS audited the taxpayer's 1994 federal income tax return and disallowed an unrelated deduction claimed by the taxpayer. As a result of the adjustment, the taxpayer would have owed approximately $43 million of additional tax for 1994; however, the IRS was unable to assess and collect the deficiency because the assessment statute of limitations had expired. Therefore, the IRS denied the refund claims based on its recalculation of the taxpayer's 1994 tax liability which resulted in no tax credits being available for the taxpayer to carry back to its 1991 and 1992 tax years. The taxpayer challenged the IRS' authority to deny its 1991 and 1992 refund claims based on the recalculation of the 1994 tax liability. As noted above, the IRS prevailed.

IRS cannot make assessment but can re-determine liability

While the IRS cannot make an assessment after the statute of limitations has expired, it may still re-determine the tax liability in a closed year because the taxpayer is not entitled to a refund unless the taxpayer has overpaid tax*. Lewis v. Reynolds*, 48 F.2d 515 (10th Cir. 1931). While acknowledging *Lewis v. Reynolds*, the taxpayer argued that *Lewis* only allows the IRS to raise issues arising in the same tax year as the refund claimed; therefore, according to the taxpayer, the IRS could only challenge deductions from the 1991 and 1992 tax years. The Court reasoned that the IRS could recalculate tax items from all relevant years to determine whether there was an overpayment in the year of the claimed refund. In this case, whether the taxpayer had overpaid its taxes in 1991 and 1992 depended upon whether the tax credits claimed in 1994 were available to be carried back. Accordingly, the IRS could examine the taxpayer's 1994 tax year to determine whether the taxpayer had any excess credits that could be carried back by the taxpayer to generate refunds of taxes for the 1991 and 1992 tax years.

Expiration of Statute of Limitations does not Extinguish Tax Liability

Next, the taxpayer argued, based upon *Estate of Michael v. Lullo*, 173 F.3d 503 (4th Cir.), that the expiration of the statute of limitations not only prevents the IRS from assessing time-barred taxes, but "extinguishes potential liability for all such time-barred taxes." The Court pointed out that the statute of limitations extinguishes liability only with respect to the IRS's ability to *collect* an outstanding tax liability after the statute of limitations has expired. However, when a taxpayer files a refund claim, the taxpayer is only entitled to a refund if he has overpaid his tax. The outstanding tax liability still exists with respect to determining whether the taxpayer has overpaid, regardless of whether the IRS can still collect on that liability. As a result, the IRS may review a tax liability for a specific year, even if it is a tax year whose statute of limitations has expired, in order to determine whether there was an overpayment in the tax year for which a refund claim was made.

The Court held that because the refund claims for the 1991 and 1992 tax years stemmed from the carry back of 1994 tax credits, the IRS had authority to re-determine the taxpayer's 1994 tax liability. As a result, there were no excess credits available to be carried back to the 1991 and 1992 tax years to generate a refund.

For additional information, please refer to **IRS Insights May 2011**.

ASC 740 implications: ASC 740-10-25-8 provides "If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions: (a) the more-likely-than-not recognition threshold is met by the reporting date, (b) the tax position is effectively settled through examination negotiation or litigation, or (c) the statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired".

When determining the amount of tax benefit to recognize for financial statement purposes related to a refund claim, companies should consider the UTPs taken in *all* relevant years to determine whether there is, in fact, an overpayment of taxes to be refunded. Similarly, *all* relevant years should be considered when determining the amount (i.e., on a more-likely-than-not basis) of an attribute coming from (or having passed through) periods that are statute barred for purposes of collection. Tax positions taken in these "closed" periods might reduce the amount of the attribute coming out of those periods resulting in UTBs in subsequent periods when the attribute was subsequently applied. Alternatively, those positions might result in an UTB that reduces the amount of the DTA for the remaining amount of the attribute that would become unavailable if the tax positions in the statute barred periods are not sustained.

Did You Know?

SEC comments – Income tax disclosures related to indefinitely reinvested foreign earnings

Most companies are aware of the ASC 740 – Income taxes disclosure requirement related to having an unrecorded DTL related to the investment in a foreign subsidiary when the earnings of that foreign subsidiary are indefinitely reinvested. That disclosure is either (a) the amount of the unrecorded deferred tax liability or (b) a statement that the determination of that liability is not practicable. When the determination of the DTL is not practicable, the gross amount of temporary difference for which no DTL has been recognized is required to be disclosed.[2] However, it is becoming clear that the SEC expects additional disclosures (discussion) to be included in Management Discussion and Analysis (MD&A).

In a speech made at the **2010 AICPA conference**, Ms. Davis, Associate Chief Accountant at the SEC, noted that registrants should consider disclosing in their MD&A the existence of the indefinite reinvestment assertion and its impact on the company's liquidity. The following example was used by Ms. Davis to explain the SEC's concern.

> "A registrant appears to have sufficient cash and short-term investments to satisfy its debt obligation. However, if a significant portion of the cash and short-term investments are in a foreign subsidiary for which deferred taxes have not been recognized because of the assertion that the subsidiary's earnings are reinvested indefinitely, the company should provide a discussion in MD&A to inform investors that if the entity were to repatriate the cash or short-term investments to satisfy the company's debt obligation, a significant tax liability may result."

Since the 2010 conference, numerous registrants have received SEC comments requesting that the registrant consider expanded disclosures. Below is an example of an SEC comment that many registrants have received on this topic.

> "Tell us what consideration you gave to providing disclosures to discuss the potential impact on liquidity associated with the repatriation of undistributed earnings of foreign subsidiaries. In this regard, consider disclosing the amount of cash and investments that are currently held by your foreign subsidiaries and the tax impact of repatriating the undistributed earnings of foreign subsidiaries."

Registrants have also received comments similar to the one below:

> "Please clarify why you believe it is not practicable to determine the amount of unrecognized DTL related to $XX in undistributed earnings."

This development of inquiring into why the computation is not practicable is recent and is consistent with the SEC's interest in greater transparency related to the potential impact on liquidity.

Based on recent SEC comments, some of the additional disclosures requested by the SEC might relate to:

- The amount of cash and other liquid assets in non-U.S. jurisdictions, or an assertion that such amounts are not material.
- A discussion of the registrant's ability to maintain sufficient liquidity while meeting its commitments without being dependent on the cash or other liquid assets held by foreign subsidiaries that are considered indefinitely reinvested (such disclosure might include the registrants expectation that it will incur debt (domestically) in a future period).
- The tax cost of repatriating foreign earnings.

Determining the tax liability on repatriating foreign earnings is often a complex calculation. The expected tax liability should reflect the expected manner and timing of recovering the foreign earnings. Partly on account of the inherent complexity in computing the DTL, the FASB provided an exception to the recognition of this DTL (the "impracticable exception") and allowed the disclosure of the temporary difference for which no DTL has been recognized. Therefore, the fact that the SEC is now seeking disclosure of the taxes that would be payable and the related impact of the assertion on liquidity represents new thinking on the part of the standard setters.

[2] It is fairly common to disclose the amount of unremitted foreign earnings instead of reporting the gross amount of the temporary difference in the stock of the foreign subsidiary (the latter being the required disclosure).

Income tax accounting for partnerships – Effective tax rate consequences of noncontrolling interests (second in a series)

Pass-through (or flow-through) entities such as partnerships are generally not taxable entities. Instead, their owners report their allocable portion of the entity's income, gain, loss, deduction, and credit in their tax return and pay any related tax. Deferred taxes are normally recognized for any book/tax basis differences in assets and liabilities, but that is not the case with pass-through entities, because they are not taxpayers. The owners of pass-through entities are generally taxable entities and recognize deferred taxes for any book/tax basis difference in the assets that they own including interests in pass-through entities.[3] The book/tax basis difference in the units or shares representing ownership of a pass-through entity is often referred to as an "outside" basis difference. The outside basis difference represents the expected increase or decrease in the taxable income (relative to book income) that will arise when the investment is recovered for its financial reporting carrying amount.[4]

A pass-through entity that is consolidated by a controlling entity (the "Parent") will include 100 percent of the pass-through entity's income or loss in pre-tax income, but will only record a current tax liability with respect to its interest in the entity's current taxable income and deferred taxes with respect to the book/tax basis difference in its interest in the pass-through entity. No current or deferred tax consequences are recognized with respect to any interest in the pass-through entity that is owned by an entity that is not consolidated (i.e., the owners of the noncontrolling interest) because the payer of that tax is outside of the consolidated financial statements. A consequence of consolidating 100 percent of the pre-tax income of the pass-through entity while only including the tax related to the Parent's interest in the tax provision is that a "rate reconciliation" item will be required to explain the relationship of the tax provision to the pre-tax income.

Example 1: Parent (P), a U.S. corporation consolidates Subsidiary (S), a domestic partnership with a 20 percent noncontrolling interest, for financial reporting purposes. S is not subject to income taxes in any jurisdiction in which it operates. S earns $1,000 in 20X0. Assume a federal statutory income tax rate of 35 percent.

For financial statement purposes, P's consolidated income statement is reported as follows:

	20X0
Pre-tax book income	$1,000
Income tax expense ($1,000 x 80% x 35%)	(280)
Consolidated net income	720
Less: Net income attributable to noncontrolling interest ($1,000 x 20%)	(200)
Net income attributable to Parent	$520

The reconciliation of the U.S. federal statutory income tax rate of 35 percent to the Company's effective tax rate of 28 percent is as follows:

	20X0
U.S. federal statutory income tax rate	35.0%
Income taxed to owners of noncontrolling interest	(7)
Effective income tax rate	28.0%

A rate reconciling item is required for the pre-tax book income allocated to the noncontrolling interest that is not subject to tax.

[3] A pass-through entity can be owned by another pass-through entity. In that case, the current and deferred tax would be recorded by the taxable owner of the upper-tier pass-though entity.

[4] 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.).

Example 2: Assume, S is a corporate subsidiary and not a partnership, and all other facts from example 1 are the same.

For financial statement purposes, P's income statement is reported as follows:

	20X0
Pre-tax book income	$1,000
Income tax expense ($1,000 x 35%)	(350)
Consolidated net income	650
Less: Net income attributable to noncontrolling Interest [($1,000 x 20%) – ($1,000 x 20% x 35%)]	(130)
Net income attributable to controlling interest	$520

No reconciling items are required in this instance, since the U.S. federal statutory income tax rate of 35 percent and the Company's effective tax rate of 35 percent are identical:

	20X0
U.S. federal statutory income tax rate	35.0%
Effective income tax rate	35.0%

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**.