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September 2011

Accounting Developments

Lease accounting update

In August 2010, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (the "boards") issued an exposure draft (ED) that would fundamentally change the accounting for lease arrangements for both U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). On the basis of feedback received from comment letters, roundtables, and outreach sessions, significant changes to the proposals in the ED have been made. Given the changes, the boards have decided to re-expose the proposed lease accounting guidance for comment. We expect that the boards will attempt to complete their redeliberations of the lease project this fall, with a goal of issuing the revised ED in December for a 120-day comment period. A final standard is expected to be issued in mid to late 2012.

Although the boards have not discussed a potential effective date for the final lease standard, they did discuss effective dates pertaining to the revenue project and noted that such dates would not be earlier than January 1, 2015. We expect the timeline for the lease project to be similar.

Proposed accounting – Lessee

The boards reaffirmed the ED's overall model in which all leases are treated as a financing transaction and recognized on the balance sheet. In addition, they reaffirmed that lessees should apply a single model, the right-of-use model, to all leases that are within the scope of the proposed guidance. A lessee would recognize an asset for the right to use the underlying asset and a liability to make lease payments.

The two key factors in measuring the right-of-use asset and lease liability are the lease term and lease payments. The ED proposed that the lease term be measured as the "longest possible term that is more likely than not to occur," including options to renew and proposed the use of a probability-weighted expected outcome approach to estimate lease payments, including contingent rentals. Comment letters expressed almost unanimous opposition to both of these measurement methods. The boards agreed with many of the concerns raised in the comment letters and have proposed to simplify these measurements.

The proposed language would require the lease term to be the noncancelable period plus any renewal periods for which there is a significant economic incentive for the lessee to exercise the renewal option. These criteria would be generally consistent with the current guidance entities use today to evaluate renewal periods and lease term. The boards have also tentatively concluded that the initial measurement of lease payments should only include those variable payments (1) based on an index or rate (e.g. consumer price index (CPI)) or (2) that are in-substance fixed lease payments (e.g., the lease contains disguised fixed lease payments).

Proposed accounting – Lessor

The boards have also reconsidered the lessor model and have tentatively decided that a single lessor accounting model, the receivable and residual method, should apply to all leases. The only exceptions would be short-term leases and leases of investment property measured at fair value.

This model is similar to the derecognition model proposed in the ED. Under the receivable and residual method, a lessor would derecognize the underlying asset (or portion of the asset leased) and recognize:

- A lease receivable measured as the present value of the future lease payments.
- A residual asset measured on an allocated-cost basis.

The boards have also affirmed that the specialized accounting for leverage leases will not be retained. These leases will be accounted for under the proposed lessor model, including any leverage leases existing on the effective date.

ASC 740 implications: For many companies, the classification of leases for tax purposes has generally followed the financial accounting treatment as either a capital or an operating lease. Therefore, under current accounting guidance, an entity may have had operating leases for both book and tax, in which case there would be no existing temporary difference for those leases. The changes proposed in the ED will most likely give rise to new temporary differences for many entities involved in leasing transactions. Generally, entities will record assets and liabilities for financial accounting purposes that they will not record for tax purposes, which will create temporary differences.

Under U.S. tax law, the classification of leases is generally based on economic factors established by case law and Internal Revenue Service (IRS) administrative rulings, and therefore, many leases may require an independent analysis of specific facts and circumstances to establish the appropriate classification, particularly for complex transactions. Because the ED affects all outstanding leases as of the date of initial application, entities will need to be mindful of the significant temporary differences that may arise upon initial application of the final Accounting Standards Update, which may need to be accounted for on a lease by lease basis.

State taxes

Many states require that a taxpayer determine its state taxable income based on a multifactor apportionment formula, which may include a property factor. The property factor is often based on financial statement values for property, plant, and equipment plus an adjustment for leased property that is based on a multiple of annual lease payments (a multiple of eight times net annual rental rate is fairly common). What isn’t clear under the ED is whether the “right-to-use” asset is a component of tangible property, plant, and equipment or an intangible asset for financial reporting. There may be some ambiguity in many states regarding whether a taxpayer should utilize the "right-to-use" book asset or a multiple of the net annual rental rate for purposes of calculating the property factor. As the ambiguity is resolved (hopefully in advance of the first year that the new lease accounting applies) companies should assess whether the combined impact of the new lease accounting and the state’s approach to using that information for apportionment purposes has a material effect on the applicable state rate (i.e., the statutory rate times the apportionment factor) so as to require remeasurement of deferred taxes (i.e., prior to the first year the new lease accounting is applicable).

Similarly, certain states impose a franchise tax in addition to a corporate income tax. In states where the franchise tax is based on the amount of assets that a taxpayer has in the state (e.g., North Carolina, Tennessee), the taxpayer's franchise tax liability may be impacted by assets capitalized under the ED. State franchise taxes based on book net equity may also be impacted by the leased assets and liabilities that will be recorded under the ED.

The ED is unclear about whether or not the right-to-use asset is a component of property, plant, and equipment or an intangible asset. Thus, in some states it may be unclear how the ED would impact property taxes.

Tax departments will have to monitor the tax implications that result from the changes in the lease accounting standard to avoid any unintended consequences and plan for potential opportunities. Companies should review their current tax accounting methods related to the ED in anticipation of any changes, particularly those that have historically followed financial reporting, to better understand the potential impact on future cash flow. It is also important that tax departments collaborate with other financial reporting groups, including treasury and accounting, to understand the implications that may arise. Further, tax departments should stay attuned to changes in accounting data and systems modifications adopted to accommodate the new lease accounting standard that could be leveraged for tax reporting.

Federal

Guidance issued on the application of the economic substance doctrine

In the **June 2010 issue of the *Accounting for Income Taxes Quarterly Hot Topics*** newsletter, we discussed the amendment to Internal Revenue Code (IRC) Section 6662 in connection with the codification of the economic substance doctrine in the Health Care and Education Reconciliation Act of 2010. IRC Section 6662 was amended to impose a strict liability penalty for an underpayment of tax attributable to any disallowance of claimed tax benefits if a transaction lacks economic substance or fails to meet the requirements of any similar rule of law. The penalty rate is 20 percent of the underpayment, but increases to 40 percent if the taxpayer does not disclose the relevant facts on its return. As a strict liability penalty, there is no reasonable cause exception available to reduce the penalty. The provisions apply to transactions entered into after the date of enactment, March 30, 2010.

On July 15, 2011, the Large Business and International (LB&I) Division of the IRS issued a new directive, LB&I-4-0711-015, on the application of the economic substance doctrine ("the doctrine") and the associated strict liability penalty. The directive provides guidance to IRS examiners and managers not only on when to seek approval from an IRS Director of Field Operations (DFO), but also how to apply the doctrine and the related strict liability penalty in an examination. It also provides that until further guidance is issued, the application of the economic substance penalty will be limited to transactions that lack economic substance, and may not be imposed to deficiencies arising from the application of any other "similar rule of law" or judicial doctrine (e.g., the step transaction doctrine, substance over form, or sham transaction).

This LB&I directive outlines a four-step process examiners should follow when determining whether application of the economic substance doctrine is merited as well as guidance on how to request DFO approval. Each process step includes transaction fact and circumstance inquiries that will assist the examiner in determining the applicability of the economic substance doctrine. Generally, the term “transaction” refers to all of the interconnected steps taken with a common objective together. However, in certain circumstances, it may be appropriate to apply the guidance of the directive separately to one or more steps that are included within a series.

The directive also advises examiners to notify a taxpayer that the examiner is considering whether to apply the doctrine to a particular transaction as soon as possible, but not later than when the examiner begins the four-step process outlined in the directive.

For additional details, please refer to **IRS Insights – September 2011**.

ASC 740 implications: ASC 740-10-25-57 provides that if a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 740-10-25-7); an entity shall recognize an expense for the amount of the statutory penalty in the period in which the entity claims or expects to claim the position in the tax return. If penalties were not recognized when the position was initially taken, the expense shall be recognized in the period in which the entity's judgment about meeting the minimum statutory threshold changes.

When determining if a tax position does or does not meet the statutory threshold to avoid payment of penalties, companies should consider a taxing authority's widely understood administrative practices and precedents, such as IRS directives. Please note that for the LB&I directive to be applicable, the company must not yet be in front of Appeals for this issue – the LB&I directive applies to agents under LB&I supervision, but is not applicable to the Appeals Division.

Companies that are currently recording an income tax liability for penalties based on the application of the economic substance doctrine should review the directive and determine if the new information causes a change in judgment for which a remeasurement will be appropriate. Pursuant to ASC 740-10-25-15, a change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs.

Final regulations on accounting methods following IRC Section 381(a) transactions

IRC Section 381 provides rules with respect to the carryover of certain attributes following the tax-free acquisition of assets of one corporation (commonly referred to as the transferor or distributing corporation) by another corporation (commonly referred to as the acquiring corporation). One such attribute is the appropriate accounting methods to be used by the acquiring corporation.

On July 26, 2011, the IRS issued final regulations (T.D. 9534) providing rules for determining the methods of accounting to be used by an acquiring corporation following an IRC Section 381(a) transaction.

Specifically, the final regulations:

- Apply to transactions described in IRC Sections 368(a)(1)(A), (C), or (F); IRC Sections 368(a)(1)(D) or (G), provided the requirements of IRC Section 354(b) are met; and IRC Section 332.
- Provide that if acquiring and transferor/distributor are operated as separate trades or businesses following the transaction, then generally, the acquiring and transferor/distributor each continue to use their respective pretransaction accounting methods (i.e., the carryover methods).

- Provide that if one or more of the trades or businesses of acquiring and transferor/distributor are not operated as separate and distinct trades or businesses following the transaction (i.e., trades or businesses are integrated), a principal method must be determined. Such determination is made based on all facts and circumstances that reflect acquiring's ultimate plan of operation. The principal method is determined applying certain tests to the integrated trades or businesses.

- Provide that an acquiring corporation does not need the Commissioner's consent to use a principal method with respect to its trade or business or the distributor or transferor's trade or business, even if the use of a principal method is a change from the previous method used. Any change to a principal method, whether related to a trade or business of the acquiring corporation or the distributing or transferor corporation, must be reflected on the acquiring corporation's federal income tax return for the taxable year that includes the date of the distribution or transfer. Any IRC Section 481(a) adjustment required by the IRC or regulations must be determined by the acquiring corporation as of the beginning of the day that is immediately after the date of distribution or transfer, and is included on the acquiring corporation's federal income tax return that includes the date of the distribution or transfer and subsequent taxable years, as necessary.

- Provide that any party to an IRC Section 381(a) transaction may request permission under IRC Section 446(e) to change a method of accounting, if the principal method (or carryover method) is impermissible or to a method other than a principal method (or carryover method), for the tax year in which the transaction occurs or is expected to occur. However, if the trades or businesses will be integrated post-transaction, such change in method will be granted only if the requested method must be used after the transaction. A taxpayer must request an accounting method change consistent with the manner in which accounting method changes are requested under IRC Section 446(e) and Treas. Reg. Section 1.446-1(e), which generally requires the filing of Form 3115, *Application for Change in Accounting Method*. The Form 3115 must be labeled "Filed under IRC Section 381(c)(4)" at the top and must be filed with the IRS on or before the later of:

    1. the due date for filing a Form 3115 as specified in Treas. Reg. Section 1.446-1(e) or

    2. the earlier of (a) 180 days after the date of distribution or transfer, or (b) the date acquiring files its federal income tax return for the taxable year that includes the distribution or transfer.

- Clarify that, if a taxpayer is required to change to the last-in, first-out (LIFO) method under IRC Section 381(c)(5), the restoration to cost of any previous inventory write-downs to market value should be taken into account by the acquiring corporation ratably in each of the three taxable years beginning with the taxable year that includes the date of the distribution or transfer, consistent with IRC Section 472(d).

- Do not provide audit protection for use of or change to a principal method after the date of distribution or transfer; however, audit protection is provided for any voluntary change in method of accounting for which a party to an IRC Section 381(a) transaction obtains consent (i.e., a change from an impermissible principal method or a change to a method other than a principal method) under IRC Section 446(e) and the generally applicable administrative procedures.

The final regulations include numerous examples illustrating the provisions of the regulations. The final regulations are effective for transactions occurring on or after August 31, 2011.

ASC 740 implications: Taxpayers that acquire, distribute, or transfer the assets of other corporations in a transaction to which IRC Section 381(a) applies should consider the potential impact of recording deferred taxes in acquisition accounting and the potential effect on uncertain tax positions (UTPs) with respect to the guidance provided in the final regulations on both the acquiring corporation and the transferor/distributor corporation.

Certain IRC Section 381(a) transactions (e.g., corporate reorganizations pursuant to IRC Sections 368(a)(1)(A) or (a)(1)(C)) generally constitute nontaxable business combinations for financial reporting purposes. Any change to the transferor's method of accounting necessitated by a change to the principal method must be determined such that the appropriate deferred taxes are recorded through acquisition accounting. If the principal method requirement causes acquiring to change its method of accounting, the corresponding impact on acquiring's deferred taxes should be recorded in the quarter that the transaction occurs. Generally, this should not impact the statement of operations as deferred taxes should be adjusted for the change in the basis of the applicable asset or liability with a corresponding adjustment to deferred taxes for the IRC Section 481(a) adjustment. However, entities should consider the impact, if any, that such adjustments may have on scheduling the reversal of taxable and deductible temporary differences if they are relying on scheduling as part of their valuation allowance assessment.

The final regulations do not provide audit protection for use of or change to a principal method after the date of distribution or transfer. However, audit protection is provided for any voluntary change in method of accounting for which a party to an IRC Section 381(a) transaction obtains consent (i.e., a change from an impermissible principal method or a change to a method other than a principal method) under IRC Section 446(e) and the generally applicable administrative procedures. Companies should consider the impact on its UTPs, related interest and penalties, if any, of a change to a principal method if it is determined that the principal method is an impermissible method or if the principal method is a permissible method but the previous method of the transferor/distributor was not a permissible method. In addition, entities should consider the impact a change in method of accounting has on their UTPs, related interest and penalties, if any, and adjust accordingly.

International

UK Corporate Tax Rate Changes

On July 19, 2011 the Finance Act 2011 ("the Act") received Royal Assent. The Act promulgated a reduction to the UK corporate income tax rate from 28 percent to 26 percent and further to 25 percent. The reduced rates become effective April 1, 2011 and April 1, 2012, respectively. This rate change replaces an earlier 1 percent tax rate reduction which adjusted the tax rate from 28 percent to 27 percent under the Finance Act 2010. It is important to note that although the UK Budget 2011, which was introduced on March 23, 2011, discussed the further tax rate reduction to 24 percent in 2013 and 23 percent in 2014, these changes were not included in the Finance Act 2011; and, therefore, have not been enacted.

ASC 740 implications: Pursuant to ASC 740-10-45-15, a company with operations in the United Kingdom should adjust its deferred tax assets (DTAs) and deferred tax liabilities (DTLs) for the effect of the change in tax rate in the financial reporting period that includes the enactment date of July 19, 2011. In computing the effect of the tax rate change, a detailed scheduling of the timing of the reversals of the underlying temporary differences may be necessary in order to determine the applicable tax rate to measure the DTAs and DTLs. Because the new rate is effective for income earned from April 1, 2011, companies that do not have a March 31st year-end, may need to apply two different tax rates to income earned in the reporting period that includes the effective date of the tax rate change.

For example, Company X is organized and operating under the UK law and has an accounting period ended December 31, 2011. For the three-month period ending March 31, 2011 Company X's taxable income is subject to a 28 percent tax rate, which is applicable to the UK 2010/11 financial year (from April 1, 2010 to March 31, 2011). For the nine months period ending December 31, 2011 Company X's taxable income is subject to the reduced 26 percent tax rate applicable to the 2011/12 financial year. The apportionment of profits across the financial years is undertaken on a time basis and accordingly, the 2011 blended tax rate for Company X is 26.5 percent. Similarly, the 25 percent tax rate becomes effective on April 1, 2012 and Company X's 2012 blended tax rate will be 25.25 percent.

For additional details, please refer to **Accounting for Income Taxes: International Tax Developments, August 5, 2011, *UK Corporate Tax Rate Changes – Update*.**

Multistate

District of Columbia's 2012 Budget Support Act

On June 14, 2011, the D.C. Council adopted the Fiscal Year 2012 Budget Support Act of 2011 (D.C. Bill 19-203, referred to herein as "Act 19-0098" or the "Act"), containing the city's fiscal 2012 budget. On July 8, 2011, the bill was transmitted to D.C. Mayor Gray for his review, and on August 2, 2011, the Act was transmitted to Congress for the 30-day review and approval period. As of the date this publication went to press, the official Web site of the Council of the District of Columbia indicates that the Act is projected to become permanent law on September 14, 2011.

The Act provides for, among other things, the following:

- *Combined reporting* – Require a taxpayer engaged in a unitary business with one or more corporations to file a unitary combined D.C. Franchise Tax report ("combined report"), which includes the income and the allocation and apportionment factors of all corporations that are part of a water's-edge combined group. The "combined report" appears to be generally limited to corporations. This change will apply to tax years beginning after December 31, 2010.
- *Worldwide unitary combined reporting election* – An election is available for taxpayers to file as a worldwide unitary combined group that includes all corporations that are members of the unitary business. A worldwide unitary combined reporting election is binding for the tax year made and all tax years thereafter for a period of 10 years. It may only be withdrawn or reinstituted within the 10-year period upon written approval of the Mayor.
- *Net operating losses (NOLs)* – If the taxable income computed under the Act results in a loss for a member of the combined group, that member has a D.C. NOL, subject to the D.C. NOL limitations and carryover provisions. The D.C. NOL is applied as a deduction in a subsequent year only against that taxpayer's D.C. source positive net income, whether or not the taxpayer is or was a member of a unitary combined reporting group in the prior or subsequent year.

- *Tax credits and post-apportionment deductions* – Except where otherwise provided, no tax credit or postapportionment deduction earned by one member of the group may be used by another member of the group or applied against the total income of the combined group.
- *Deduction for increase in net DTL* – If the enactment of unitary combined reporting results in an increase to a combined group's net DTL, the group may be entitled to a deduction to the extent of the net increase in the taxable temporary differences that caused the increase in the net DTL. Only publicly traded companies, including affiliates participating in the filing of a publicly traded company's financial statements as of the effective date of the Act, will be eligible for the deduction. In determining the deduction allowed, "net deferred tax liability" means the net increase, if any, in DTLs minus the net increase, if any, in DTAs of the combined group. Computations must be made in accordance with either U.S. GAAP or IFRS. The deduction is allowed over seven years, beginning in the fifth year of combined filing. The annual deduction is equal to one-seventh of the net increase in the taxable temporary differences resulting from the imposition of unitary combined reporting computed at the time of enactment that caused the increase in the net DTL. To the extent the deduction would produce a NOL in any tax year, the unused deduction is carried forward to each succeeding tax year indefinitely by the combined group and deducted without regard to any limitation. The cumulative deduction is limited to the amount necessary to offset any increase in the net DTL that results from the imposition of unitary combined reporting but for this deduction.
- *Apportionment factor changes* – The current corporation franchise tax apportionment formula of equally-weighted property, payroll, and sales factors is changed to a formula utilizing a double-weighted sales factor for tax years beginning after December 31, 2010.
- *Minimum tax* – The minimum corporation franchise and unincorporated business taxes have been increased. The change is effective December 31, 2010.
- *Estimated tax penalty safe harbor* – The "prior year's tax" safe harbor amount for corporate estimated tax penalties increases from 100 percent to 110 percent of the prior year's tax, for tax years beginning after December 31, 2011.

For additional details, please refer to **Multistate Tax: External Alert – September 14, 2011, *District of Columbia 2012 Budget Support Act of 2011 – Unitary Combined Reporting and Various Other Income and Transaction Tax Changes***.

ASC 740 implications: The D.C. 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 certain provisions of the Act may be retrospectively effective to tax years beginning after December 31, 2010, companies should consider the impact on their quarterly estimated AETR in the period it is enacted.

Deferred taxes

- *Temporary differences* – Deferred taxes shall be determined separately for each tax-paying component in each tax jurisdiction pursuant to ASC 740-10-30-5. Companies should consider the combined reporting requirements, the worldwide unitary combined reporting election, and the availability of the deduction for the net increase in DTLs provided for publicly traded companies under the Act, when determining the inventory of temporary difference in D.C.
- *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 D.C. tax rate for measuring DTAs and DTLs considering the apportionment factor changes under the Act.
- *Interim* – ASC 740-270-25-5 provides that the effect of a change in tax laws or rates on a DTL or DTA (such as a change in the apportionment rules) shall not be apportioned among interim periods through an adjustment of the AETR.
- *Intraperiod allocation* – 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 financial reporting period that includes the enactment date of the applicable law change. 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.
- *Valuation allowance* – While the DTA for the deduction for the increase in net DTL should be equal to the increase in the net DTLs caused by the imposition of the combined reporting requirements, companies should consider the timing of the reversals of the DTLs and DTAs when determining whether the DTLs are an available source of taxable income for recognition of the DTAs and whether a valuation allowance is necessary. For example, to the extent DTLs reverse in the first through fourth years of combined filing, they would not be a source of taxable income to recognize the benefit of the DTA for the deduction for increase in net DTLs because the deduction is available beginning in the fifth year. Furthermore, companies should consider the limitations on the utilization of NOLs, credits, and post-apportionment deductions by other members of the combined group when analyzing DTAs for realization and the need for a valuation allowance.

Massachusetts law change

On July 11, 2011, Governor Patrick signed House Bill (H.B.) 3535. Section 136 of the new law postpones for one year the Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," (FAS 109) deduction that was scheduled to begin in 2012 (now scheduled to begin in 2013) and that was part of legislation enacted during 2008 that i) adopted a combined reporting regime for tax years beginning on or after January 1, 2009, and ii) phased in corporate tax rate reductions. Recognizing the potential accounting impact arising from this 2008 legislation, the 2008 law had provided for a deduction on behalf of a combined group if the new combined reporting requirements resulted in an increase to the group's net DTL. Now, under this new law, the deduction is available for the seven-year period beginning with the combined group's taxable year commencing in 2013, rather than in 2012.

Note that eligibility to take this FAS 109 deduction is generally limited to publicly traded companies, including certain affiliated corporations participating in the filing of a publicly traded company's financial statements prepared in accordance with U.S. GAAP. Note that corporations seeking to claim this deduction are required to have filed notice with the Commissioner of Revenue on or before July 1, 2009. This notice was required to have been filed through the Department’s Web site.

For additional details, please refer to **Multistate Tax: State Tax Matters – July 15, 2011, Issue 2011-28**.

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

Deferred taxes

- *Recognition* – Companies should assess whether the one-year postponement results in a change to the amount of DTAs 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 740-10-45-20. For example, a company may have relied on the existence of taxable temporary differences scheduled to reverse in tax years beginning in 2012 as a source of taxable income to recognize the benefit of the FAS 109 deduction. However, as a result of the postponement, 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, including a reevaluation of a valuation allowance as a result of the change in tax law, the effect shall be included in income from continuing operations, in the period that includes the enactment date, which is July 11, 2011.
- *Interim* – ASC 740-270-25-5 provides that the effect of a change in tax laws or rates on a DTL or DTA shall not be apportioned among interim periods through an adjustment of the AETR.

State Programs – Recently, both New Jersey and Ohio have implemented programs applicable to income taxes and nonincome taxes

New Jersey – The New Jersey Division of Taxation (“Division”) recently announced a Voluntary Disclosure Initiative (VDI) that began on August 15, 2011 and ends on November 15, 2011, for Media and Media Content Companies that fall within the state’s jurisdiction. Media and Media Content taxpayers eligible for the VDI that come forward and comply with their Corporate Business Tax filing requirements for the disclosure period and remit the taxes due within 90 days of execution of its VDI agreement will receive a waiver of all late filing penalties except for the 5 percent amnesty penalty for periods covered under the last amnesty (applicable to returns due on or after January 1, 2002 and prior to February 1, 2009). The VDI also provides for a limited look-back period of four years (current period and previous three years). The announcement does not provide relief from interest. Interest must be paid within 30 days of assessment.

Media and Content Companies choosing not to participate in this initiative will also be ineligible for New Jersey’s general Voluntary Disclosure Agreement program and will be subject to a longer look-back period and applicable late filing penalties.

For additional details, please refer to **Multistate Tax: External Alert – August 12, 2011, *New Jersey Announces Voluntary Disclosure Initiative for Media Companies***.

Ohio – On June 30, 2011, Ohio governor John Kasich signed into law the 2011–2013 Budget Bill, H.B. 153, which, among other things, requires the Tax Commissioner to administer a tax amnesty program. The amnesty program includes the Corporate Franchise Tax, which prior to being fully phased out in tax year 2010, was an income tax and accounted for within the scope of ASC 740, and other “above-the-line” taxes not considered within the scope of ASC 740. The amnesty program begins on May 1, 2012 and ends on June 15, 2012 for all taxes except the use tax. The Commissioner is required to administer a tax amnesty program for the use tax for the period from October 1, 2011 to May 1, 2013. The requirements for relief available to the Corporate Franchise Taxpayer had not been released by the state by the date this publication went to press.

For additional details, please refer to **Multistate Tax: External Alert – July 1, 2011, *Ohio Adopts 2011-2013 Budget***.

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 nonincome 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

Recent guidance: Schedule UTP updated FAQs

In the **December 2010 issue of *Accounting for Income Taxes Quarterly Hot Topics***, we discussed the release of Schedule UTP and related instructions. On March 23, 2011, the IRS released seven FAQs on Schedule UTP, including three pertaining to their policy of restraint. On July 19, 2011, the IRS revised one FAQ and issued eight additional FAQs on Schedule UTP. The answer to FAQ No. 4 regarding inclusion of interest and penalties in determining the size and ranking of a tax position has been augmented and questions 5 through 12 were added. The 12 FAQs on Schedule UTP include a discussion of:

1. The term "sufficiently certain so that no reserve was required" contained in the Schedule UTP instructions and the term "highly certain" in ASC 740 (FIN 48).
2. Treatment of the elimination of a reserve in an interim financial statement.
3. Treatment of carryforwards.
4. Whether interest and penalties should be included for the purpose of determining the size and ranking of a tax position and the computation of a major tax position.
5. Whether a taxpayer should file a blank Schedule UTP with its 2010 tax return if it has no 2010 tax positions for which reserves have been recorded.
6. When a reserve is considered recorded in an audited financial statement since the term "reserve" is not a defined accounting term.

7. Whether the requirement to report a tax position exists even if the IRS identifies the tax position for examination prior to the recording of the reserve.
8. Whether a position that was originally determined to be correct must be reported if circumstances change in a later year and a reserve is recorded or is not recorded because the company expects to litigate.
9. Treatment of tax positions taken on the final return of a merged corporation.
10. Reporting of deductions, losses, and credits on tax returns that contain NOLs or credits.
11. Whether reporting accruals of interest on a tax reserve recorded with respect to a tax position taken on a pre-2010 tax return is required.
12. Reporting of tax positions that result in an adjustment to a line item on a schedule or form attached to a corporation's Form 1120.

The FAQs regarding the policy of restraint (previously FAQ Nos. 5-7) are now FAQs Nos. 1-3 in a separate Policy of Restraint section of the FAQs. No changes have been made to these FAQs, which include the following:

1. Applicability of the policy of restraint to documents requested by Appeals.
2. Applicability of the policy of restraint to documents requested by Counsel after the filing of a Tax Court petition.
3. The effective date of changes to policy of restraint.

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

ASC 740 implications: This IRS reporting requirement does not change the company's obligation around financial reporting. However, the FAQs provide additional guidance regarding certain areas for which consistency between the Schedule UTP reporting and the audited financial statements is required, including:

- If an amount of interest or penalties relating to a tax position is not separately identified in the books and records as associated with that position, then that amount of interest and penalties is not included in the size of a tax position used to rank that position or compute whether the position is a major tax position.
- For a corporation subject to FIN 48 (ASC 740), a tax position is considered "sufficiently certain so that no reserve was required," and therefore need not be reported on Schedule UTP, if the position is "highly certain" within the meaning of FIN 48 (ASC 740).
- A reserve is recorded when an uncertain position is stated anywhere in a corporation's or related party's financial statements, including footnotes and other disclosures.
- If a corporation records a reserve in an audited financial statement but later eliminates the reserve in a subsequent interim unaudited financial statement, the tax position must still be reported on Schedule UTP. However, if the corporation eliminates the reserve in an interim audited financial statement before the tax position is taken in the return, the corporation need not report the position on Schedule UTP.
- When determining whether a tax position must be reported on Schedule UTP filed with the final return of a corporation that is merged into another corporation, the merged corporation must consider the reserve decisions of a surviving corporation and when the surviving corporation records the reserve.

Did You Know?

Income tax accounting for partnerships – Measuring deferred taxes (3rd in a series)

As we have discussed in prior newsletters, pass-through (or flow-through) entities such as partnerships are not subject to tax in most jurisdictions. 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.[1] This creates an interesting dilemma when applying deferred tax accounting principles to any book/tax basis difference in the underlying assets and liabilities of the pass-through entity. The taxable entity, the owner of the pass-through entity, does not directly own the underlying assets and liabilities that have an associated book/tax basis difference while the pass-through entity that does own the underlying assets and liabilities is itself not a taxable entity.

One might expect that there would be no difference between the amount of deferred taxes that would be recognized when using the outside basis difference[2] and the amount of deferred taxes that would be recognized based upon the temporary differences in the partner's proportionate share of book and tax basis in underlying assets and liabilities. However, there is a potential for the determination of a different deferred tax amount when (a) the partnership is consolidated (such that the pass-through entity's assets and liabilities retain their character when consolidated); and (b) certain of the consolidated assets and liabilities would be subject to an exception to the application of deferred tax accounting if held directly rather than through a pass-through entity.

With no guidance directly on point, two approaches have developed in practice for determining the deferred tax related to an investment in a pass-through entity. These two approaches are often referred to as the "entity approach" and the "aggregate approach." Both of these approaches assume that the net investment in the pass-through entity will be recovered for its financial reporting carrying amount.

Entity approach – The entity approach measures deferred taxes by multiplying the owner's outside basis difference in the pass-through entity by the applicable tax rate. This approach views the investment in the pass-through as a single asset and a single temporary difference requiring the recognition of the associated DTA, subject to realizability, or DTL.

Aggregate approach – The aggregate approach measures deferred taxes by applying the applicable tax rates and exceptions[3] to each identifiable component of the owner's outside basis difference. In effect, the single outside basis difference is divided into as many temporary differences as necessary to apply any potentially applicable exceptions to deferred tax recognition. The components of the outside basis difference are identified by comparing the consolidated investor's proportionate investment in the pass-through entity's assets and liabilities to its related tax basis.

While some believe the "aggregate approach" would not appear to be appropriate for cost and equity method investments (since the underlying assets and liabilities do not retain their character in the equity investor's financial statements) others suggest that the "aggregate approach" can be applied when accounting for equity method investees.

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[1] 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.

[2] Outside basis difference refers to the difference between the book and tax basis in the pass-through interest held (i.e., that specific asset).

[3] The normal exceptions to recording deferred taxes are found in ASC 740-10-25-3 and ASC 740-30-25-7 through 25-9.

The following example illustrates and compares the basic entity-level and aggregate approaches to recording deferred taxes on pass-through investments. Parent (P), a U.S. corporation consolidates S, a domestic partnership with a 40 percent noncontrolling interest. S is not subject to income taxes in any jurisdiction in which it operates. P has a book basis of $8,100,000 and a tax basis of $2,544,000 in its investment in S as follows:

Compare the deferred tax liabilities recorded under the entity ($1,944,600) and aggregate ($894,600) approaches.

View #1 — Entity approach	Book	Tax	Difference	Rate	Deferred tax
	8,100,000	2,544,000	5,556,000	35%	1,944,600

View #2 — Aggregate approach	Book	Parent's 60% interest	Tax	Difference	Rate	Deferred tax
Cash	100,000	60,000	60,000	-	35%	0
Inventory	250,000	150,000	180,000	(30,000)	35%	(10,500)
PP&E	1,400,000	840,000	504,000	336,000	35%	117,600
Intangibles	5,000,000	3,000,000	-	3,000,000	35%	1,050,000
Goodwill	2,000,000	1,200,000	-	1,200,000	ASC 740-10-25-3(d) exception	
Foreign subsidiary outside basis	6,000,000	3,600,000	1,800,000	1,800,000	ASC 740-30-25-18 exception	
Deferred revenue	(1,250,000)	(750,000)	-	(750,000)	35%	(262,500)
Total	**13,500,000**	**8,100,000**	**2,544,000**	**5,556,000**		**894,600**
Noncontrolling Interest	(5,400,000)					
Equity attributable to P	8,100,000					

Application of ASC 740-30-25-9: Whether the company is using the aggregate method or the entity method, it should consider ASC 740-30-25-9's prohibition on recognizing a DTA for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary[4] unless that temporary difference will reverse (i.e., as a tax deduction) in the foreseeable future. This exception would generally not apply to outside basis differences that are expected to reverse as the partnership recovers its assets and settles its liabilities in the normal course of its operations (i.e., the foreseeable future).

[4] Because the definition of subsidiary has changed over time and it is unclear whether those changes were intended to modify the meaning of subsidiary for purposes of FAS 109 and now ASC 740, it is unclear whether the exception under ASC 740-30-25-9 is applicable because partnerships are now subsidiaries for that purpose or by analogy.

One instance where the ASC 740-30-25-9 exception to recognizing DTAs could apply is where a deductible temporary difference is created when a controlling partner increases its ownership interest in its consolidated partnership investment through a contribution of cash and the additional interests are acquired at a premium over the financial reporting carrying amount. In this instance, absent the use of the Section 704(c) remedial method for allocating deductions, the additional tax basis from the premium paid would not provide any additional amortization or depreciation deductions in the normal operation of the partnership (i.e., to the controlling partner). The temporary difference resulting from the premium paid for the noncontrolling interest will only reverse upon a future sale or liquidation of the pass-through entity, making the exception under ASC 740-30-25-9 applicable.

Given the diversity in practice and the differing views as to the acceptability of the approaches used to account for the outside basis differences attributable to assets and liabilities that are subject to exemptions from ASC 740's comprehensive recognition model, an entity is encouraged to discuss their approach with their auditor.

Update on safe harbor election for success-based fees incurred in connection with covered transactions

In the **June 2011 issue of *Accounting for Income Taxes Quarterly Hot Topics***, we discussed the release of Rev. Proc. 2011-29, which provides for a safe harbor election for allocating success-based fees paid in a business acquisition or reorganization described in Treas. Reg. Section 1.263(a)-5(e)(3), and is effective for success-based fees paid or incurred in taxable years ending on or after April 8, 2011.

A taxpayer must capitalize amounts paid to facilitate certain capital transactions, including a business acquisition or reorganization as described in Treas. Reg. Section 1.263(a)-5(a). An amount is paid to facilitate a transaction if the amount is paid for services received in the process of investigating or otherwise pursuing the transaction.

Treas. Reg. Section 1.263(a)-5(f) provides that an amount that is contingent on the successful closing of a transaction described in Treas. Reg. Section 1.263(a)-5(a) ("success-based fee") is presumed to facilitate the transaction and thus must be capitalized. However, taxpayers may rebut this presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. A taxpayer's method for determining the portion of the fee that facilitates a transaction and the portion that does not facilitate the transaction is a method of accounting under IRC Section 446.

In an attempt to reduce controversy related to whether the taxpayer has adequate documentation to support its allocation of success-based fees to nonfacilitative activities, the IRS has provided (in Rev. Proc. 2011-29) an elective safe harbor for allocating success-based fees paid in a covered transaction between facilitative and nonfacilitative activities. Under the safe harbor, electing taxpayers may treat 70 percent of success-based fees paid or incurred in taxable years ending on or after April 8, 2011, as an amount that does not facilitate the transaction and therefore is not required to be capitalized under Section 263. It is then necessary to determine whether such amount is recoverable under Section 162 or Section 195. The remaining 30 percent of the fee must be capitalized as an amount that facilitates the transaction (the 70 percent deduction is the "safe harbor" amount). Recovery of the capitalized amount depends upon the type of transaction engaged in, and these rules are set forth in Treas. Reg. Section 1.263(a)-5(g).

Acquiring companies that anticipate paying or incurring success-based fees in tax years ending on or after April 8, 2011, should consider making the election provided by Rev. Proc. 2011-29. Assuming the election is made, the amount of success-based fees that can be benefited will be determined based on such election. If the election is not made, the company must evaluate whether the facts and documentation overcome the presumption that success-based fees are facilitative, as required by the regulations.

On July 28, 2011, the IRS issued guidance to LB&I examiners (LB&I 04-0511-012) directing them not to challenge a taxpayer's treatment of success-based fees where the taxpayer's original return position is to capitalize at least 30 percent of the total success-based fees incurred by the taxpayer with respect to the transaction. This directive applies only to taxpayers that capitalized the 30 percent (or greater) amount on an original timely-filed return for taxable years ending prior to April 8, 2011, and it does not apply to formal and informal claims

ASC 740 implications: When a company that acquires a target company in a business combination, pays a success-based fee, and makes the safe harbor election under Rev. Proc. 2011-29, a tax benefit (i.e., current benefit or DTA) should be recognized for 70 percent of the success-based fee.[5] If the transaction is a taxable 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 taxable stock purchase, a tax benefit (i.e., DTA) generally will 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. Pursuant to ASC 740-30-25-9, no DTA can be recognized for the excess of the tax basis over financial reporting basis in the stock of a subsidiary unless that temporary difference is expected to reverse in the foreseeable future. If the transaction is an acquisitive tax-free reorganization, a tax benefit (i.e., DTA) generally will not be recognized for the remaining 30 percent of the success-based fee because there is currently no guidance as to the deductibility of such amounts.

Rev. Proc. 2011-29 will also apply to target companies who pay success-based fees. In the case of costs incurred by a target in a taxable asset acquisition, the 30 percent that must be capitalized reduces the amount realized, and as such, will provide an immediate tax benefit. In the case of costs incurred by a target in a taxable stock acquisition or an acquisitive tax-free reorganization, there is currently no guidance as to the deductibility of such amounts. Accordingly, no DTA should be recognized.

Acquiring companies that paid or incurred success-based fees in tax years ending before April 8, 2011, should consider the LB&I directive and, if applicable (i.e., at least 30 percent of the success-based fees were capitalized on the company's originally filed tax return), should reverse any related unrecognized tax benefits in the financial reporting period that includes the date the IRS issued the LB&I directive. The LB&I directive does not apply if the treatment of the success-based fees is an issue before Appeals (the LB&I directive applies to agents under LB&I supervision, but is not applicable to the Appeals Division).

If a company is not within the scope of the LB&I directive (e.g., it did not capitalize at least 30 percent of success based fees in its originally filed tax return), it should evaluate whether the LB&I directive (as well as the revenue procedure) should be considered to be new information that would result in remeasurement. Companies that have well documented rebuttals of the facilitative presumption, and whose

[5] 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.

unrecognized tax benefit amount was determined based on the expected cost to settle the issue while avoiding litigation, might conclude that these developments are new information that can support remeasurement of the unrecognized tax benefit. Alternatively, a company that did not have as strong a rebuttal or documentation of nonfacilitative activities will likely conclude that these developments do not constitute new information that would result in remeasurement under its circumstances.

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**.