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December 2011

Accounting Developments

2011 AICPA National Conference on SEC and PCAOB Developments

The AICPA held their annual conference on SEC and PCAOB developments. A main topic of discussion was the U.S. conversion to IFRS. However, while many views were expressed, no final recommendations were made. SEC Chief Accountant Jim Kroeker announced that the SEC needs "a few additional months" to complete work on its recommendation to the commission about whether U.S. companies should adopt the international rules. Mr. Kroeker did indicate that the staff has completed the majority of its field work.

The chairmen of the FASB and IASB both gave their views as well. FASB Chairman Leslie Seidman stated that FASB and IASB accounting convergence efforts have run their course and a future side-by-side approach is no longer a practical option. IASB Chair Hans Hoogervorst, in separate remarks agreed with Seidman that although the IASB's convergence history with FASB has been useful in aligning IFRS and U.S. GAAP, the boards' convergence process is an "unstable way of decision making" for the long term. "The simple truth is that when you have two boards of independently thinking professionals, sometimes they will simply reach different conclusions," he said.

Mr. Kroeker noted that sometime in 2012, the SEC staff is expected to finalize its comprehensive report summarizing its progress on its work plan.

In addition to the adoption of IFRSs, the SEC staff and other presenters shared their views on a range of financial reporting, auditing, and standard-setting matters; see Deloitte's ***Heads up: Highlights of the 2011 AICPA National Conference on SEC and PCAOB Developments*** that provides in-depth summaries of recent accounting and financial reporting developments addressed at the conference. There were several tax related topics discussed, including (1) realizability of deferred tax assets (DTAs) (2) effectiveness of internal controls of foreign operations and (3) foreign income tax related disclosures.

Mark Shannon, Associate Chief Accountant, SEC's Division of Corporation Finance, discussed the impact that the current economic environment could have on the assessment of the realizability of DTAs. Entities must consider all available evidence, both positive and negative, in determining whether a valuation allowance is needed to reduce a DTA to an amount that is more likely than not to be realized. ASC 740-10-30-21 states that "[f]orming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." However, ASC 740-10-30-22 gives examples of positive evidence that could be used to overcome this negative evidence. One example is "[a] strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (e.g., an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition." Mr. Shannon said that some registrants are placing less weight on recent losses when weighing the positive and negative evidence because they view the current economic downturn as an "aberration." However, he stated that while each company's facts and circumstances could differ, in general it would be "pretty difficult to conclude the economic downturn is an aberration." He then reminded participants that overcoming such negative evidence would require significant objective positive evidence.

Kyle Moffatt, Associate Chief Accountant, SEC's Division of Corporation Finance, noted the SEC staff has continued to focus on the evaluation of registrants' assertions that the internal controls of a foreign operation are effective. While his comments were not specific to tax accounting, accounting for income taxes continues to be one of the leading causes of material weaknesses and restatements. Mr. Moffatt stated that when evaluating whether internal controls are effective, the SEC staff looks to ensure that management of the foreign operation has the appropriate knowledge and capability to prepare financial statements in accordance with U.S. GAAP. In turn, Mr. Moffatt indicated that appropriate background may be demonstrated through (1) education and ongoing training related to U.S. GAAP, (2) professional qualifications such as a U.S. CPA licensure, and (3) professional experience either as an auditor or preparer of U.S. GAAP financial statements. He also noted that the SEC staff has encountered several companies that have reported material weaknesses of internal controls as a result of not having sufficient expertise with U.S. GAAP, and that the SEC staff's ultimate goal of focusing on controls is to ensure that entities do have such sufficient expertise and capabilities.

Nili Shah, Deputy Chief Accountant, SEC's Division of Corporation Finance, discussed certain income tax matters in relation to registrants' significant foreign operations. First, when a registrant with significant amounts of cash and short-term investments overseas has asserted that such amounts are permanently reinvested in its foreign operations, Ms. Shah provided the following disclosures the SEC staff would expect to see in an Management Discussion and Analysis (MD&A) liquidity analysis:

- The amount of cash and short-term investments held by foreign subsidiaries that is not available to fund domestic operations unless the funds were repatriated.
- A statement that the company would need to accrue and pay taxes if repatriated.
- A statement that the company does not intend to repatriate those funds.

Mr. Shannon discussed situations in which profits derived from a country with very low tax rates are disproportionately large when compared to the revenue generated from that country. Noting that such occurrences could "be the result of the various tax infrastructures or a possibility in determining where revenue is allocated," he indicated the SEC staff has previously requested registrants to provide "disaggregated financial information related to pretax income and effective tax rates from particular countries."

Federal

Income tax accounting for discontinued operations

When a component of an entity has either been disposed of or is classified as held for sale, the operational results of that component, less applicable income tax expense or benefit, are required to be reflected in the financial statements as discontinued operations for all periods presented, assuming that certain criteria provided in ASC 205-20 are met. Separate company financial statements may also be required for the same reporting periods.

Differences can exist between the amounts presented as discontinued operations (net of tax) and the net income presented in the separate company financial statements despite starting with the same pretax financial position for both. These differences generally occur due to the "fictional" aspect of separate company financial statements, which will normally use a "separate return" approach[1] despite the fact that the entity has historically joined in the filing of consolidated or combined tax returns.

Discontinued operations presentation:
The discontinued operations tax expense (benefit) is equal to the incremental income tax provision associated with those activities and is determined using the "with" and "without" approach prescribed by the ASC 740-20, *Intraperiod Allocation* rules. Under the "with" and "without" approach, the total tax provision (including the discontinued operations) is compared to a tax on continuing operations only (i.e., "without" the discontinued operations). The difference is allocated to discontinued operations.

Separate company financial statement presentation:
As noted above, the separate company financial statement tax provision (benefit) is generally determined using the separate-return method.[1] Under the separate-return method of allocation, entities determine current and deferred tax expense or benefit for the period by applying the requirements of ASC 740 as if each group member were filing a separate tax return. This view is maintained even when the sum of the separate company amounts is different than the consolidated return amount.

Differences between the two approaches:
The income tax provision (benefit) allocated to a separate component, under the separate-return method, may not equal the incremental tax provision (benefit) resulting from the application of the "with" and "without" approach for a variety of reasons. The most notable of these differences include (a) a different conclusion regarding the need to record a valuation allowance (since the consolidated tax return allows the profits of one entity to be offset by the losses of another entity and that "consolidated tax return" offsetting will not be applicable when each company is viewed in isolation) and (b) a difference in the applicable state rate used to measure deferred taxes. The difference in the applicable state rate is going to pertain to the combined state jurisdictions. With respect to the discontinued operations state tax provision, the amount will be equal to the difference between the state tax expense determined for the continuing operations only (the "without" amount, which will **not** include the impact on the state footprint caused by combining with the discontinued component) and the actual state tax expense (the "with" amount, which, for the periods prior to separation, reflects the impact on the apportionment rate of filing a combined tax return (which can have current and deferred tax consequences), as well as reflect the offsetting of income and losses between continuing and discontinued operations).

Consider the following example:

- A public enterprise has two businesses that qualify as separate components for financial statement purposes: Component 1 and Component 2;
- Component 1 has a history of profits, while Component 2 has a history of losses;

[1] Although we are aware that different acceptable approaches for allocating the income tax provision for separate company financial statements may exist, we are limiting our comparison to the “separate return” approach, which is the SEC preferable method.

- The enterprise files as a consolidated group for federal and a combined group for state tax purposes, which allow for Component 2 losses to be offset by the Component 1 profits;
- No valuation allowance is necessary from a consolidated group perspective;
- The consolidated group has a state effective tax rate of 5%, while Component 2's state effective tax rate (based on its "footprint" versus the combined group's "footprint") is 8% and Component 1's state effective tax rate without Component 2 is 3.5%;
- In the current year, the enterprise distributed to its shareholders Component 2 through a spin- off transaction and is subsequently required to present the operations of Component 2 as discontinued operations for all years presented in the financial statements. In addition, the enterprise is required to file separate company financial statements (i.e., carve-out financial statements) for Component 2 for the same years. These separate company financial statements will be the historical financial statement information for Component 2 going forward, as Component 2 will be a public company for all periods subsequent to being distributed;
- From a separate company financial statement perspective, Component 2 does not have any positive evidence and determines that a valuation allowance must be recorded for both federal and state tax purposes.

Consolidated financial statements			
"With" computation	**20X1**	**20X2**	**20X3**
Component 1 – Pretax book income (loss)	5,000	3,000	4,000
Component 2 – Pretax book income (loss)	(1,000)	(800)	(2,000)
Consolidated pretax book income (loss)	4,000	2,200	2,000
Effective income tax rate	38.25%	38.25%	38.25%
Income tax expense (benefit)	1,530	842	765
Net income (loss)	**2,470**	**1,359**	**1,235**
"Without" computation			
Component 1 – Pretax book income (loss)	5,000	3,000	4,000
Effective income tax rate	37.28%	37.28%	37.28%
Income tax expense (benefit) – Continuing operations	1,864	1,118	1,491
Continuing operations - Net income (loss)	**3,136**	**1,882**	**2,509**
Discontinued operations – Pretax book income (Loss)	(1,000)	(800)	(2,000)
Income tax expense (benefit)	(334)	(277)	(726)
Discontinued operations - Net income (loss)	**(666)**	**(523)**	**(1,274)**
Separate company financial statements - Component 2 only			
	20X1	**20X2**	**20X3**
Component 2 – Pretax book income (loss)	(1,000)	(800)	(2,000)
Effective income tax rate	40.20%	40.20%	40.20%
Income tax expense (benefit)	(402)	(322)	(804)
Income tax expense (benefit) – valuation allowance	402	322	804
Total income tax expense (benefit) (net of valuation allowance)	-	-	-
Net income (loss)	**(1,000)**	**(800)**	**(2,000)**

International

Changes to net operating loss carryover rules: France, Hungary, Italy, Japan, and Spain

Recent French, Hungarian, Italian, Japanese, and Spanish tax legislation contained amendments to the rules governing the use of net operating loss (NOL) carryforwards. While the new NOL carryforward utilization rules in each of these specific jurisdictions are different (as described below), the common theme is that the annual utilization of tax losses carried forward is limited to a certain percentage of taxable income or turnover for a particular year.

Changes to the NOL carryforward rules in Italy were promulgated on July 16, 2011, as a part of the austerity measures package. Under the new rules, only 80% of a company's taxable income for a fiscal year may be offset by NOLs carried forward. For calendar-year taxpayers, the limitation was applicable beginning in 2011. In recognition of the fact that NOLs will be used more slowly, the legislation permitted the NOLs generated in or after 2006 to be carried forward indefinitely.

Similarly, on August 20, 2011, a temporary limitation with respect to NOL carryforward utilization was enacted in Spain. For the years 2011, 2012, and 2013, a company with a turnover (i.e., sales) between 20 and 60 million euro is now only permitted to offset up to 75% of its taxable income with NOLs being carried forward. A company with a turnover in excess of 60 million euro is further limited, and can only offset 50% of its taxable income. In recognition of the fact that NOLs will be used more slowly, the legislation extended the original 15 year NOL carryforward period to 18 years.

On September 20, 2011, the French government promulgated new NOL carryforward rules effective for fiscal years ending on or after September 21, 2011. The amended law limits the NOL carryback period to one year and limits annual utilization of losses carried forward to 1 million euro (i.e., up to 1 million euro without limitation). With respect to the new carryforward rules, the amount of NOL that can be used to offset taxable income is limited to 60% of that year's taxable income in excess of 1 million euro.

On November 30, 2011, Hungary enacted changes to the NOL carryforward utilization rules. Under the amended regime, effective January 1, 2012, NOLs carried forward will only be allowed to offset 50% of taxable income.

Lastly, on November 30, 2011, the Japanese government enacted new NOL carryforward rules effective for fiscal years beginning on or after April 1, 2012. Under the new rules, only 80% of a company's taxable income for a fiscal year may be offset by NOLs carried forward. In recognition of the fact that NOLs will be used more slowly, the legislation extended the original seven-year NOL carryforward period to nine years.

ASC 740 implications: In accordance with ASC 740-10-35-4, an entity with NOLs in any of the above-mentioned jurisdictions should record a valuation allowance (VA) for any DTA that was dependent on offsetting a deferred tax liability (DTL) to be realized when these new rules will prevent a full offset. In some instances, this might require a VA when none was previously recorded, and in other instances, an existing VA might need to be increased.

Prior to the change in law, taxable temporary differences that were expected to reverse in the NOL carryforward period served as positive evidence that the NOL will be realized. Accordingly, a company with significant negative evidence would generally have net deferred taxes of zero (after considering the VA). After the change in law, the company will have taxable temporary differences that will not be able to be offset by the NOL carryforward, resulting in a remaining DTL (such remaining DTL is often referred to as a "dangling credit" or "naked DTL").

To illustrate, we will consider a French subsidiary with significant negative evidence. For purposes of the example, we will only consider the 60% limitation and ignore the annual amount of one million euro that is not limited. Assume that the company had an NOL DTA of 1,000 and DTL of 600 prior to the change in law. The DTA in excess of the DTL of 400 would be offset by a valuation allowance of 400 resulting in a net deferred tax balance of zero. After the change in law, the NOL DTA will only be allowed to offset 60% of the taxable income in any particular year. Since the DTL is the only source of taxable income available to offset the NOL DTA, only 360 of the taxable income from the reversal of the taxable temporary differences can be used. The remaining unused NOL DTA of 640 will be offset by a VA, leaving the company with an exposed "naked DTL" of 240 (the 40% of the DTL that will not be offset by the NOL DTA). Accordingly, the company in this example would have an expense of 240 in the financial reporting period in which the French law was enacted due to the increase of the VA, unless the company could anticipate other sources of taxable income, such as future book income or tax planning strategies to realize the 240 of NOL DTA. The companies most impacted by these new limitations on the use of NOL will be those that have significant negative evidence that requires the recognition of a valuation and also have large DTL balances (e.g., from recent acquisition accounting).

To further illustrate, let's assume the same facts as the above example, except that the French subsidiary has an NOL DTA of 600 and a DTL of 800 prior to the change in law. Even though the entity has significant negative evidence, this has been overcome by the fact that the DTL is in excess of the DTA by 200; therefore, no valuation allowance was deemed necessary. After the change in law, the NOL DTA will only be allowed to offset 60% of the taxable income in any particular year and, as such, only 480 of the DTL will serve as a source of positive evidence for the utilization of the 600 NOL DTA, leaving the company with an exposed "naked DTL" of 120 (the 40% of the DTL that will not be offset by the NOL DTA). Accordingly, the company would be required to assess whether it is more likely than not to realize the 120 of NOL DTA that is no longer permitted to offset the DTL. That is, the company would need to anticipate other sources of taxable income, such as future book income or from tax planning strategies, in order to realize the 120 of NOL DTA. If the company cannot identify any tax planning strategies and also determines that it has cumulative losses and, as such, cannot anticipate future income other than from the reversal of taxable temporary differences, it would have to record a valuation allowance and related expense of 120 in the financial reporting period in which the French law was enacted.

Subpart F and tax accounting for foreign investments: Expiring foreign provisions

For calendar-year taxpayers, certain currently enacted U.S. tax provisions providing for the exception of certain foreign earnings from U.S. federal taxation as Subpart F income are scheduled to expire on December 31, 2011. One such expiring provision is the Internal Revenue Code (IRC) Section 954(c)(6) "look-through" rule for certain payments between related controlled foreign corporations (as defined in IRC Section 957(a), a controlled foreign corporation (CFC)). For the periods in which it is effective,[2] this look-through rule generally excludes from U.S. federal income taxation certain dividends, interest, rents, and royalties received or accrued by one CFC of a U.S. multinational enterprise from a related CFC and that would otherwise be taxable pursuant to the Subpart F regime. Another provision set to expire is the active financing exception provided for in IRC Sections 953(e) and 954(h). For the periods in which it is effective,[3] the active financing exception generally excludes

[2] The exception under IRC Section 954(c)(6) applies to CFC tax years beginning after December 31, 2005, and before January 1, 2012, and to tax years of U.S. shareholders with or within which any such CFC tax year ends.

[3] The active financing exception applies to CFC tax years beginning after December 31, 1998, and before January 1, 2012, and to tax years of U.S. shareholders with or within which any such CFC tax year ends.

from U.S. federal income taxation qualified banking or financing income of an eligible CFC that would otherwise be taxable pursuant to the Subpart F regime.

As of the date of this article, proposals to extend these provisions have not advanced in Congress. Consequently, many taxpayers are preparing for the seemingly inevitable expiration of these provisions while hoping for enactment of a retrospective extension in 2012.

ASC 740 implications: A parent company does not record a DTL for the outside basis difference in a foreign subsidiary unless it becomes apparent that such basis difference is going to reverse in the foreseeable future. In order for the outside basis difference to not be apparent to reverse in the foreseeable future, the earnings and profits of the foreign subsidiary cannot be taxable to the U.S. parent under the Subpart F regime and the U.S. parent must expect to indefinitely reinvest the income of its foreign subsidiary under ASC 740-30-25-17. When the incremental U.S. tax that will become payable in the event that the outside basis difference were to reverse is not recognized as a DTL, the overall effective tax rate of the U.S. parent company is generally reduced below 35%.

However, as noted, certain earnings of controlled foreign subsidiaries cannot be deferred from U.S. taxation, but rather must be included in U.S. income when earned and, as such, result in at least a 35% overall tax rate on such earnings (i.e., Subpart F earnings). The income that these expiring provisions relate to will become includible (as Subpart F income) when earned after the provisions expire, resulting in an increase in the affected companies overall effective tax rate.

Consider the following example with respect to the look-through rule: U.S. Company owns CFC1 that owns CFC2, incorporated and operating in another jurisdiction. The U.S. Company has historically considered the earnings of CFC1 to be indefinitely reinvested. By contrast, CFC1 has not historically considered the earnings of CFC2 to be indefinitely reinvested. With the expiration of the Section 954(c)(6) look-through rule, future distributions from CFC2 to CFC1 may be subject to immediate inclusion in the U.S. parent's taxable income pursuant to Subpart F. Accordingly, because CFC2 earnings are not indefinitely reinvested, the U.S. parent might have to conclude that it is apparent that a part of its basis difference in CFC1 will reverse in the foreseeable future[4] (i.e., the basis difference that is attributable to the income of CFC2 that has "tiered" up to the U.S. parent through CFC1).

Japan tax reform

On November 30, 2011, Japan's government enacted two tax laws that include a number of amendments. One of the most significant changes provided for in the legislation was a reduction of the effective corporate income tax rate in two phases: first by approximately 2.7% points for three fiscal years and then by another 2.3% points for all fiscal years thereafter. Consequently, the effective corporate income tax rate will ultimately be reduced from approximately 41% to approximately 36% for a company located in the Tokyo metropolitan area.[5] This phased-in reduction in the effective corporate income tax rate applies for a company's fiscal years beginning on or after April 1, 2012.

While the ultimate intent is to lower the effective corporate income tax rate by 5% points, this reduction will be phased in over two periods, to assist in financing the post-earthquake Tohoku reconstruction efforts. More specifically, under the new

[4] There might be some question regarding the prior reliance on the look-through rule given that it was scheduled to retire. Presumably, the prior reliance depended on distributing all of CFC2 earnings to CFC1 prior to the expiration of the look-through rule.

[5] Japanese corporate income taxes are comprised of the national corporation tax and multiple local taxes. Local tax rates may vary depending upon a number of factors, including location of the operations. Accordingly, a company's actual effective corporate income tax rate may differ from the rates shown above depending upon actual facts and circumstances.

legislation the national corporation tax rate will be reduced by 4.5% points (from 30% to 25.5%) with a consequential reduction in local tax rates of approximately 0.5% points. However, for a corporation's first three fiscal years beginning on or after April 1, 2012, a temporary 10% surtax will be applied to the new national corporation tax rate of 25.5%. Given the interplay and deductibility of local taxes for national corporation tax purposes, the net effect of the temporary 10% surtax, the national corporation tax rate reduction and the local tax rate reduction for the first three fiscal years beginning on or after April 1, 2012 will be a reduction of approximately 2.7% points. Subsequent to these first three fiscal years, the temporary surtax will no longer apply and taxpayers will also enjoy the remaining 2.3% point corporate effective income tax rate reduction.

Another significant change is an increase in the rate of withholding tax levied on certain payments made by Japanese companies to nonresidents. More specifically, the withholding tax rate on dividends, loan interest or royalties paid to a nonresident will be increased to 20.42% from the 20% generally applicable under current domestic tax law. However, if a reduced withholding tax rate or exemption is available under a tax treaty, that treaty rate is unchanged. This increase in withholding taxes will apply to income arising from January 1, 2013 through December 31, 2037.

Similarly, the tax legislation also includes new restrictions on the utilization of tax loss carryforwards. Please refer to *Changes to net operating loss carryover rules: France, Hungary, Italy, Japan, and Spain* for a discussion of these new restrictions and the potential ASC 740 implications.

ASC 740 implications: Pursuant to ASC 740-270-25-5, the tax effect of a change in tax law or tax 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 proposed legislation. Additionally, DTAs and DTLs should be measured using the enacted tax rate expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. Companies should schedule the reversals of temporary differences in order to determine the applicable tax rate in order to measure DTAs and DTLs. Consideration should be given to elections that are expected to apply in the future and the amounts of expected income or loss in the future years when those temporary differences are expected to reverse.

For interim purposes, 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. Companies will also be required to consider the intraperiod allocation rules with regard to changes in tax laws or rates. Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law or rate, 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 recorded other than in continuing operations (e.g., in other comprehensive income or in discontinued operations).

Accordingly, nonresident parent companies that do not assert indefinite reinvestment with respect to investments in Japanese corporations will need to consider the impact of the change in withholding taxes.

If applicable, companies should include proper disclosures for the effects of the tax law changes as prescribed in ASC 740-10-50-9.

Controversy

The use of widely understood administrative practices and precedents

In making the required assessment of whether a tax position meets the more-likely-than-not recognition threshold, ASC 740-10-25-7(b) provides that the technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood (e.g., by financial statement preparers, tax practitioners, and external auditors) those practices and precedents shall be taken into account.

ASC 740 permits consideration of past administrative practices and precedents when the tax position being taken by the entity is unsupported by the law (i.e., not more-likely-than-not), yet the tax position is widely understood to be accepted by the taxing authority. ASC 740 does not provide guidance on when to consider an administrative practice and precedent "widely understood." An entity must consider the specific facts and circumstances of the position and use professional judgment to decide what constitutes "widely understood." An entity that asserts that an administrative practice and precedent is widely understood should document the basis of that assertion including the evidence to support it. Such evidence may include reliable knowledge of the taxing authority's past dealings with the entity on the same tax matter when the facts and circumstances were similar. In other instances, a jurisdiction might establish and communicate a new administrative practice by publishing guidance (e.g., when the Internal Revenue Service (IRS) provides guidance related to securing prior year audit protection in the form of a revenue procedure or directive).

As an example, in the June 2010 and September 2011 issues of the **Accounting for Income Taxes Quarterly Hot Topics newsletter**, we discussed the amendment to IRC Section 6662 and new directive issued by the Large Business and International (LB&I) Division of the IRS in connection with the codification of the economic substance doctrine in the Health Care and Education Reconciliation Act of 2010. As described in the September 2011 issue, 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, including published guidance in the form of IRS directives.

Another such example of widely understood administrative practices and precedents may be three recent directives, LB&I-4-1111-019, LB&I-4-1111-020, and LB&I-4-1111-021: The LB&I Division of the IRS issued LB&I-4-1111-019 and LB&I-4-1111-021 on November 25, 2011 and LB&I-4-1111-020 on December 12, 2011. LB&I-4-1111-019 provides guidance to the IRS examiners with respect to audits of a taxpayer that is eligible to adopt the transmission and distribution property safe harbor method described in Revenue Procedure (Rev. Proc.) 2011-43. Rev. Proc. 2011-43 discusses a safe harbor method for determining whether expenditures to maintain, replace, or improve electric transmission and distribution property must be capitalized under IRC Section 263(a) or are a deduction under IRC Section 162. LB&I-4-1111-020 provides direction to the field in the examination of depreciation expense associated with certain tangible assets placed in service by wireless telecommunications carriers that are eligible to adopt the safe harbor method of accounting for the depreciation of certain tangible assets used by wireless telecommunications carriers under Rev. Proc. 2011-22 and Internal Revenue Bulletin 2011-18. Similarly, LB&I-04-1111-021 provides guidance to IRS examiners when converting previously capitalized assets to a deduction for repair expense when the taxpayer provides telecommunications services and is adopting one of the two safe harbor methods described in Rev. Proc. 2011-27. Under all three directives, for tax years ending before December 31, 2010, agents are to (a) withdraw Form 4564s (Information Document Request), (b) withdraw all outstanding Form 5701s (Notice of Proposed Adjustment), and (c) develop and issue a Form 886-A (Explanation of Adjustments) with specific language provided in each of the directives.[6] Further, the directives allow taxpayers a two-year period to adopt the safe harbor methods described in the Revenue Procedures, without the normal restrictions associated with when a Form 3115 can be filed, and still be entitled to the benefits of discontinuation of examination activity as described above. If the safe harbor method is not elected in the taxpayer's first or second tax year ending after December 30, 2011, then the taxpayer would be subject to risk assessment and possible examination for positions taken in tax returns for periods ending on or after December 31, 2010 (and since the issue presented pertains to an accounting method, the position would have an associated "cumulative effect" that would be subject to adjustment).

ASC 740 Implications: Collectively, these three directives, and other similar directives, provide taxpayers reliable knowledge of the taxing authority's practices and precedents. As provided by ASC 740, past administrative practices and precedents of the taxing authority can be taken into account when they are widely understood. By issuing these directives, the taxing authority has established and made widely understood its administrative practice with respect to these particular issues.

When a company is eligible and intends to avail itself of one of these safe harbors within the time periods required under the directives, it should consider the directive as new information. 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 in judgment occurs.

Did You Know?

Accounting for deferred tax assets related to tax receivable agreements

Certain businesses have historically been operated as closely held partnerships (e.g., investment banking/private equity businesses). In recent years, some of these closely held businesses have created publicly traded corporations to provide liquidity for their owners (often referred to as "the founders"). The public corporations (Pubcos) typically purchase a portion of the founders' partnership interests with the proceeds from initial public offerings (IPO). Any subsequent purchases are often funded with profits from the operating business.

The ownership structure is designed to give the Pubco a controlling interest in the operating partnership (so it will be consolidated for financial reporting purposes), but allow the founders to continue to control the operating business through a special class of Pubco voting stock. The financial accounting rules[7] prohibit changing the financial reporting basis of assets acquired from entities under common control (i.e., the founders control the operating business before and after the IPO). Therefore, the assets of the operating business must be consolidated at their historical cost (normally a small fraction of their fair value). As a consequence of the acquisition, Pubco replaces the cash from the IPO with the assets of the operating partnership (a significant reduction in total assets since the assets consolidated are at historical cost). A noncontrolling interest in the operating partnership is also recorded

[6] Under the LB&I-4-1111-019, agents are also to develop and issue a Form 5701 in addition to the Form 886-A.

[7] See ASC 805-50 – *Business combination – Related issues*

(typically, only a fraction of the operating partnership is acquired) and the equity attributable to the Pubco is reduced. It is at this point that the accounting for income taxes becomes interesting.

As noted above, the financial reporting rules prohibit the “stepping-up” of assets when acquired from an entity under common control. However, the same concept does not apply for tax. For income tax purposes, the underlying assets represented by Pubco’s interest in the operating partnership are stepped up to their fair market value by making an election pursuant IRC Section 754 of IRC. The “tax in excess of book” basis difference created by the acquisition represents a deductible temporary difference for which a DTA is recorded pursuant to ASC 740 – *Income Taxes*. The associated tax benefit is recorded to equity pursuant to ASC 740-20-45-11(g)[8] because it relates to a change in the tax basis of assets from a transaction among or with shareholders.

In connection with selling an interest in the operating partnership, the founders commonly seek to participate in Pubco’s tax savings from the tax step-up in basis described above by entering into a tax receivable agreement (TRA). Under a typical TRA, the future reduction in income taxes payable as a consequence of the tax step-up are split, with some percent being retained by the Pubco (say, 10%) and the balance being paid out to the founders (say, 90%). This TRA liability is recorded at the same time as the DTA for a net entry to equity (still a credit entry to equity).

The interesting thing about the TRA liability is that when paid, it is considered additional consideration for the original operating partnership interest acquired by Pubco, which will also be amortizable to the extent that the step-up relates to amortizable assets (commencing when the TRA liability is actually paid). Therefore, the recording of the TRA liability will result in the recording of an additional DTA, starting the whole process over again in ever diminishing amounts. This type of recursive condition requires an algebraic solution to solve for the total DTA and related total TRA liability that will exist when all the iterations are considered. It is this final amount of DTA and TRA liability that is recorded for the initial investment in the operating partnership (i.e., on Pubco’s opening balance sheet).

Consider the following example.

A and B (collectively, the “founders”) own 100% of partnership P. During 20X1, the founders form corporation X. X raises $1,000 in a public offering and purchases 40% of the founders’ partnership interests for $1,000. Assume that the founders’ tax basis in the 40% interest was $100. Also assume that P makes an IRC Section 754 election. The taxable gain upon sale of the partnership interest is computed as follows:

Step-up computation	
Fair value	$1,000
Tax basis	(100)
Taxable gain[9]	**900**

Based upon the terms of the TRA between X and the founders, X will pay the founders 90% of any cash tax savings associated with the amortization from the step-up (i.e., the taxable gain in this case). The TRA liability when paid by X represents additional consideration to founders and will result in an increase in tax-deductible goodwill. Because each payment made under the TRA results in

[8] See EITF 94-10 for the pre-codified guidance

[9] Assume that the gain realized by the founders equals the amount of step-up recognized by X (pursuant to IRC Section 754) for income tax purposes, all of which represents tax-deductible goodwill. Since the transaction is between entities under common control, the assets and liabilities transferred to X are recorded at their carrying amounts for financial reporting purposes pursuant to ASC 805-50 – *Business combinations – Related issues*.

additional tax-deductible goodwill and additional TRA liability, an algebraic equation must be used to determine the expected tax basis of the assets and the tax receivable liability. Assuming a 40% statutory tax rate, the total tax-deductible goodwill, DTA and the related TRA liability recorded by X are as follows:

DTA computation	
Initial step-up	$900
TRA liability (additional gain from step-up)[10]	$506.25
Total tax-deductible goodwill	$1,406.25
Tax Rate	40%
DTA	**$562.50**[11]

Representative Camp releases draft bill rewriting the U.S. tax rules on foreign income of U.S. multinationals

On October 26, 2011, Chairman Dave Camp (R-Mich.) of the Ways and Means Committee (the “Committee”) released a discussion draft of the Tax Reform Act of 2011, a bill that would reduce the top corporate tax rate to 25% and dramatically rewrite the rules for taxing the foreign income of U.S. multinationals (the “draft bill”). The draft bill was accompanied by a technical explanation of its provisions. The draft bill reserves space for additional tax reform proposals related to individuals and to corporate tax generally, presumably including provisions that expand the business tax base. No revenue estimate was released along with the draft bill.

The draft bill proposed would:

- Generally provide corporate U.S. shareholders a 95% dividends-received deduction (DRD) for foreign source dividends received from controlled foreign corporations (CFCs), including foreign branches and, if elected by the U.S. shareholder, any 10/50 company. The draft bill would also exempt from Subpart F taxation dividends paid by one CFC to another CFC to the extent that the dividends would qualify for the 95% DRD if paid to a U.S. shareholder (the “tiered CFC rule”).
- Eliminate the indirect foreign tax credit on all dividends, including those with respect to non-electing 10/50 companies, as well as any foreign tax credits (or deductions) for direct foreign taxes (e.g., foreign withholding taxes) on dividends for which a DRD is allowed. Note, however, that foreign withholding taxes with respect to a dividend from a non-electing 10/50 company would remain creditable.
- Deemed paid credits for Subpart F inclusions (i.e., IRC Section 960) would remain in modified form. These credits would no longer be determined on a pooled basis. Instead, the deemed paid taxes with respect to a Subpart F inclusion would be those taxes that are “properly attributable” to the Subpart F income.
- The draft bill also would exclude from gross income 95% of a domestic corporation’s gain from the sale or exchange of CFC stock if at least 70% of the CFC’s assets are “active assets.” If the exclusion applies, IRC Section 1248 (which re-characterizes certain gains as dividends) would not apply.

[10] DTA Gross-up calculation: [($900 step-up x 40% tax rate)/(1-(90% payable to members per TRA x 40% tax rate)] = $562.5; payable to members per TRA: $562.5 x 90% = $506.25.

[11] Pursuant to 740-20-45-11(g), the DTA of $562.50 is recorded to equity.

- Accumulated deferred foreign income will be treated as Subpart F income and included in its U.S. shareholder's income under IRC Section 951 (in the case of a 10/50 company as if it were a CFC) in the last taxable year of each CFC and 10/50 company ending before 2013. The U.S. shareholder will receive a deduction of 85% of such Subpart F inclusion. Any U.S. tax resulting from the Subpart F inclusion and computed under pre-effective date law may be paid in installments for up to eight years with interest.
- Largely retain the existing rules in Subpart F and also proposes three alternative options, each of which would dramatically expand the rules. Regardless of the alternative chosen, IRC Section 956, Section 959, and Section 961 would be repealed. Repatriations of Subpart F income may be largely sheltered from U.S. tax by way of the DRD mechanism discussed above, but such repatriations would be subject to a 1.25% penalty (5% times the proposed 25% tax rate). To avoid this penalty with respect to accumulated deferred foreign income treated as Subpart F income in a foreign corporation's last taxable year ending before 2013, foreign corporations must actually distribute those earnings to their U.S. shareholders before the post-2012 effective date of the repeal of IRC Section 959.
- Generally require corporate U.S. shareholders of a worldwide affiliated group to reduce the amount of otherwise allowable interest deductions by the lesser of a relative leverage test or percentage-of-adjusted-taxable-income test. The first test would disallow a percentage of net interest deductions based on the percentage which (a) the excess of the U.S. affiliated group's debt-to-equity ratio over the worldwide affiliated group's debt-to-equity ratio bears to (b) the worldwide affiliated group's debt-to-equity ratio. The second test would disallow a domestic corporation's net interest expense in excess of an as-yet-unspecified percentage of its adjusted taxable income (as defined in the present-law earnings stripping rules of IRC Section 163(j)). Interest disallowed under this proposal may be carried forward to subsequent taxable years. To the extent that this proposal would result in a disallowance of net interest expense, the amount of the disallowance reduces the amount of interest disallowed under IRC Section 163(j).

For additional details, please refer to **United States Alert (27.10.11)**.

ASC 740 Implications: If enacted in its current form, the proposed draft bill would have significant consequences to both current and deferred taxes under ASC 740.

Under the draft bill, foreign-source dividends of non-Subpart F earnings accumulated by a CFC or electing 10/50 company in a tax year beginning after 2012 may qualify for the 95% DRD, and thus, may be subject to a 1.25% U.S. tax (i.e., the product of 5% and the reduced tax rate of 25% calculated without further reduction for foreign tax credit or deduction) plus any applicable foreign withholding taxes. For companies that continue to consider the earnings of the foreign subsidiary to be indefinitely reinvested, no deferred tax liability will be recognized. However, if a company does not consider the past or current earnings (including those non-Subpart F earnings accumulated by a CFC or electing 10/50 company in a tax year beginning after 2012) to be indefinitely reinvested (perhaps partly due to the nominal U.S. tax payable if the amounts were remitted) then it will need to record a deferred tax liability for the 1.25% U.S. tax and any foreign withholding taxes for which a U.S. foreign tax credit will not be available.

As described above, in the last taxable year of each CFC and 10/50 company ending before 2013, the corporation's accumulated deferred foreign income will be treated as Subpart F income and included in its U.S. shareholder's income under Section 951 (in the case of a 10/50 company as if it were a CFC). A deduction of 85% of such Subpart F inclusion will be provided; consequently, CFC and 10/50 company earnings would be subject to an effective tax rate of 5.25% (i.e., 35% of

15%) prior to foreign tax credits. Companies that had previously considered such earnings to be indefinitely reinvested under ASC 740-10-25-3(a) (and as such, had not previously recognized a deferred tax liability) will, in the period that includes the enactment date, be required to record deferred taxes representing the future taxes payable with respect to the taxation of such unremitted earnings (i.e., accumulated earnings as of the last taxable year of a CFC or 10/50 company ending before 2013). For companies that have not previously considered such earnings to be indefinitely reinvested under ASC 740-10-25-3(e), any deferred taxes with respect to unremitted earnings that have been previously recorded should be adjusted in the period that includes the enactment date.

Companies will need to consider the effects of the limitations on the interest deductions on current and deferred taxes. Specifically, companies will need to consider whether a valuation allowance is necessary for the future deductions that are permitted to be carried forward.

Another provision of the draft bill (not discussed above) proposes to treat foreign branches of domestic corporations as separate CFCs for U.S. tax purposes. This would require companies to reconsider any U.S. deferred taxes recorded with respect to basis differences associated with the branch entity and account for the anticipated tax consequences of the incorporation of the branch. The consequences of the reversal or settlement of deferred taxes due to a change in law should be recorded in the period that includes the enactment date.

SEC registrants should consider disclosing in MD&A any material anticipated future impact of this legislation on their results of operations, liquidity, and capital resources. They should also consider disclosures in the critical accounting estimates section of MD&A to the extent that the changes could materially affect existing assumptions used in making estimates of tax related balances.

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**.

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