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March 2012

Accounting Developments

Presentation of Other Comprehensive Income

Accounting Standards Update (ASU) 2011-05, *Comprehensive Income (Topic 220), Presentation of Comprehensive Income*, (ASU or ASU 2011-05) was issued in June 2011. This ASU is effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011, as well as for nonpublic entities for annual periods ending after December 15, 2012, and interim and annual periods thereafter. This ASU revises the manner in which entities present other comprehensive income (OCI) in their financial statements. The new guidance removes the presentation options in ASC 220 and requires entities to report components of comprehensive income in either of the following ways:

- A single, continuous statement of comprehensive income — entities must include the components of net income, a total for net income, the components of OCI, a total for OCI, and a total for comprehensive income.
- Two separate but consecutive statements — entities must report components of net income and total net income in the statement of net income (i.e., the income statement), which must be immediately followed by a statement of OCI that must include the components of OCI, a total for OCI, and a total for comprehensive income. A reporting entity may begin the second statement with net income.

The original provisions in ASU 2011-05 also required entities to present reclassification adjustments out of accumulated other comprehensive income (AOCI) by component in both the statement in which net income is presented and the statement in which OCI is presented (for both interim and annual financial statements). However, after operational concerns were raised about this requirement, the FASB has indefinitely deferred the requirement to present reclassification adjustments and it will be further deliberated by the FASB at a future date.

During the deferral period, entities will still need to comply with the existing requirements in U.S. GAAP for the presentation of reclassification adjustments. Specifically, ASC 220 gives entities the option of (1) presenting reclassification adjustments out of AOCI on the face of the statement in which OCI is presented or (2) disclosing reclassification adjustments in the footnotes to the financial statements.

ASC 740 implications: The ASU does not change the items that must be reported in OCI, nor the current option for entities to present components of OCI either net of income taxes or before income tax with the total income tax related to OCI presented as a single amount. Additionally, the ASU retains the requirement to disclose on either the face of the statement in which OCI is presented or in the notes to the financial statements the amount of the income tax expense or benefit allocated to each component of OCI.

Federal

Guidance issued for taxpayers to comply with tangible property temporary regulations

On March 7, 2012, the Internal Revenue Service (IRS) issued Revenue Procedures 2012-19 and 2012-20 ("Revenue Procedures") that provide procedures for a taxpayer to follow in order to obtain automatic consent of the Commissioner to change its methods of accounting. This change was made as to comply with the tangible property temporary regulations ("Temporary Regulations") that were issued on December 23, 2011. The Revenue Procedures allow taxpayers to change their method of accounting for tax years beginning on or after January 1, 2012. Accordingly, taxpayers may not early adopt the provisions in the Temporary Regulations.

The Temporary Regulations will impact taxpayer's engaging in any of the following activities:

- Acquiring tangible personal property
- Producing tangible personal property
- Improving tangible personal property
- Disposing of tangible personal property
- Consuming materials and supplies in their operations

If a taxpayer engages in any of these activities, it is likely that the taxpayer will be required to change its method in order to comply with the Temporary Regulations for its first or second taxable year beginning on or after January 1, 2012 (i.e., its 2012 or 2013 tax year).

Taxpayers that file an accounting method change (i.e., Form 3115, *Application for Change in Accounting Method*) pursuant to the Revenue Procedures receive IRS audit protection with respect to any positions taken in prior years' tax returns related to the items for which guidance has been provided by the Temporary Regulations (i.e., similar to any change in accounting method made under Revenue Procedure 2011-14.[1])

A change in accounting method filed under the Revenue Procedures in the taxpayer's first and second tax year, beginning after December 31, 2011, is not subject to the normal scope limitations that apply to automatic method changes. Therefore, as an example, a taxpayer under examination is not precluded from filing a method change to comply with the Temporary Regulations. Similarly, a taxpayer that previously changed its method of accounting for one or more items covered by the Revenue Procedures (e.g., repairs) in the prior five taxable years is not precluded from making a change in accounting method for the same items.

[1] Audit protection does not apply with respect to the item for which the change is made if such item is an issue before Appeals.

On March 15, 2012, the Large Business and International (LB&I) Division of the IRS issued LB&I-4-0312-004, which instructs revenue agents to discontinue current exam activity with respect to the following positions taken by a taxpayer on an original return for years beginning before January 1, 2012:

1. Whether costs incurred to maintain, replace, or improve tangible property must be capitalized under Internal Revenue Code (IRC) Section 263(a); and
2. Any correlative issues involving the disposition of structural components of a building or dispositions of tangible depreciable assets (other than a building or its structural components).

The directive does not apply to current examination activity relating to (1) costs for which the IRS provides specific guidance, separate from the Temporary Regulations issued on December 23, 2011, for determining whether expenditures incurred to maintain, replace or improve tangible property must be capitalized under IRC Section 263(a), or (2) issues that do not pertain to whether costs incurred to maintain, replace, or improve tangible property must be capitalized under IRC Section 263(a).

The directive also advises that examiners should not begin any new exam activity with regard to the issues described above. If a taxpayer files a Form 3115 with regard to the issues described above, on or after December 23, 2011, for a tax year not covered by the Temporary Regulations, the examining agent is to risk assess and determine whether to examine the Form 3115. For examination of tax years beginning on or after January 1, 2012, but before January 1, 2014, the directive indicates that examiners should determine if the taxpayer filed a Form 3115, and if so, perform a risk assessment regarding the method change. If the form has not been filed and the waiver period (i.e., the 2012 and 2013 tax years) is still open, the examining agent is not to examine the issues described above. If the Form 3115 has not been filed and the waiver period (i.e., the 2012 and 2013 tax years) is not open, the examining agent is to perform a risk assessment regarding the issues described above. Examinations for tax years beginning on or after January 1, 2014 should follow normal exam procedures.

ASC 740 implications: Taxpayers that have unrecognized tax benefits (UTBs) related to their method of accounting for the activities addressed by the Temporary Regulations should assess whether they intend to make one or more method changes in accordance with the Revenue Procedures to comply with the Temporary Regulations within the time period for which the waiver of the normal scope limitations applies (i.e., with their 2012 or 2013 tax return). If taxpayers intend to make method changes within such period, they should assess the impact that the intended filing will have on their UTBs and any related interest accruals. Any adjustments to the UTBs or accrued interest should be reported in the interim and annual reporting period that includes March 7, 2012 (i.e., the publication date of the Revenue Procedures), irrespective of when the taxpayer files the Form 3115.

International

Accounting for income tax considerations for IRC Section 952(c) Subpart F income recapture

In accordance with the U.S. taxation rules codified in the IRC Sections 951 through 964 and oftentimes referred to as Subpart F, a U.S. shareholder of a controlled foreign corporation (CFC) may be taxed currently on the earnings of the CFC, if such earnings are either invested in U.S. property (as defined under IRC Section 956) or meet the definition of Subpart F income. Subpart F income is defined in IRC Section

952 and generally includes certain passive investment income, income derived from sales or services transactions with related persons, income from shipping operations, insurance income, and other similar items.

The taxation of Subpart F income is subject to certain limitations. Specifically, under IRC Section 952(c), the amount of currently taxable Subpart F income of any CFC for any taxable year may not exceed such CFC's earnings and profits (E&P) for the year. However, when the amount of Subpart F income that is currently taxable is reduced by reason of this E&P limitation, any excess of E&P over the Subpart F income of such CFC in a subsequent taxable year is re-characterized as Subpart F income under IRC Section 952(c)(2), effectively recapturing the Subpart F income that was previously deferred.

The IRC Section 952(c)(2) recapture provision is illustrated as follows:

Assume Company Y, a CFC, earns $100 of Subpart F income and generates a non-Subpart F loss of $40 in Year 1. Company Y earns $200 of Subpart F income in each of Years 2 and 3 and has non-Subpart F income of $10 in Year 2 and $100 in Year 3. Because Company Y's E&P for Year 1 is $60, per the operation of IRC Section 952(c), the amount of Subpart F income attributable to Company Y in Year 1 that Company Y's U.S. shareholder must include in its Year 1 taxable income is limited to $60. However, Company Y's U.S. shareholder must include in Year 2 $10 of Company Y's deferred Subpart F income from Year 1. Similarly, the U.S. shareholder must include in Year 3, $30 of Company Y's remaining deferred Subpart F income from Year 1 that was not taxed in Years 1 and 2. Thus, by operation of IRC Section 952(c)(2), all of the Year 1 deferred Subpart F income is recaptured.

ASC 740 implications: A common accounting for income tax question presented by situations similar to the one presented above is whether a deferred tax liability (DTL) should be recorded for deferred Subpart F income. Said differently, should a DTL be recorded for the future tax liability that will arise when the deferred Subpart F income is recaptured under IRC Section 952(c)(2)? In addressing this question, financial statement preparers may consider three separate views that determine the accounting for income tax policy as to when a DTL should be recognized related to deferred Subpart F income.

View 1 – Always record a DTL for deferred Subpart F income

Under the first view, deferred Subpart F income may be considered like other items of income that are permitted to be deferred under U.S. tax law and for which there is no readily identifiable asset or liability to which the temporary difference relates (e.g., deferred income when the completed contract method of accounting is used for income tax purposes while percentage of completion method is used for financial reporting). More specifically, any Subpart F income that is not currently taxable may be presumed recognized for financial reporting purposes (i.e., as earnings taxable in the United States) in the period in which the Subpart F earnings are generated, thereby giving rise to a taxable temporary difference for the U.S. shareholder. Under this view, a DTL would always be recognized for the deferred Subpart F earnings consistent with any other income that is deferred.

View 2 – Deferred Subpart F income requires DTL for outside basis difference

The second view is similar to the first view but for one key distinction. The first view considers the Subpart F earnings as financial reporting earnings of the U.S. entity that have been deferred from taxation and, as such, the taxable temporary difference is equal to the amount of Subpart F earnings that have been deferred from taxation. Under the second view, the deferred Subpart F earnings are not considered to be U.S. earnings, but rather earnings of the foreign subsidiary. However, under this second view, the mere presence of the deferred Subpart F earnings is considered to contradict and pre-empt any indefinite reversal assertion that the U.S. shareholder makes. Under ASC 740-30-25-3, a DTL is required to be recognized when it becomes apparent that the taxable temporary difference (i.e., the excess of the financial reporting carrying amount of the foreign subsidiary over its tax basis, also referred to as the “outside basis difference”) will reverse in the foreseeable future. Under this second view, the existence of deferred Subpart F earnings requires a conclusion that some part of the taxable temporary difference (i.e., outside basis difference) will reverse in the foreseeable future. Under this view, a DTL is recognized based on future taxable income equal to the lesser of the outside basis difference or the deferred Subpart F earnings.

View 3 – No DTL for deferred Subpart F income if recapture dependant on future earnings

The third view builds on the second view. The second view considers the mere existence of the deferred Subpart F earnings as contradicting and pre-empting an assertion that no part of the reporting date outside basis difference is anticipated to reverse in the foreseeable future. The third view does not consider the mere existence of deferred Subpart F earnings as pre-empting the indefinite reversal assertion. Rather, under the third view, further analysis is required, using one of the fundamental principles on which ASC 740 is based. That principle is that all of the subsidiary's assets and liabilities will be recovered and settled at the amounts reported in the financial statements. Under this approach, a DTL may be recognized with respect to deferred Subpart F income to the extent that the hypothetical recovery and settlement of the subsidiary’s assets and liabilities would give rise to E&P that would trigger the recognition of the deferred Subpart F income amount. Another principle of ASC 740 is that deferred taxes are intended to recognize all of the tax consequences associated with events that have already occurred and as such have been reported in the financial statements. The third view, by using the financial reporting carrying amounts of the assets and liabilities to determine whether some part of the outside basis difference should be anticipated to reverse in the foreseeable future, is consistent with that objective. In the event that the mere recovery and settlement of the subsidiary’s assets and liabilities will not result in the recognition of the deferred Subpart F earnings, then no DTL is required for any part of the outside basis difference. If the mere recovery and settlement of the subsidiary’s assets and liabilities will result in some or all of the deferred Subpart F earnings being taxed, then a DTL should be recognized for that part of the outside basis difference. Under this third view, if additional events must occur (such as future earnings in the case where the hypothetical recovery of assets and liabilities alone is insufficient) prior to the deferred Subpart F earnings becoming taxable, then no DTL should be recognized until the financial statements include those future earnings.

This third view can similarly be applied as a modification to the first view. The first view considers the Subpart F income as financial reporting income in the United States, the taxation of which has been deferred and, as such, a DTL is required. The principle in this third view could be considered in determining whether the earnings that will be considered U.S. earnings have already occurred (which would be indicated if the mere recovery and settlement of the assets and liabilities would result in recapture of the deferred Subpart F income) or the earnings that will be considered U.S. earnings have not occurred (in which case, it will be the future earnings of the foreign subsidiary that will give rise to the earnings that are considered U.S. earnings, even if those earnings do not result in an immediate recapture of the deferred Subpart F income because the E&P will not arise until the subsidiary’s assets and liabilities are recovered or settled).

Note: Given the diversity in practice and the differing views as to the acceptability of the approaches used to account for the recapture of Subpart F income, an entity is encouraged to discuss their approach with their auditor.

Accounting for changes introduced by recently issued regulations: IRC Sections 909 and 901

On February 9, 2012, the U.S. Treasury and IRS released temporary regulations under IRC Section 909 addressing foreign tax credit splitter transactions ("Foreign Tax Credit Splitter Regulations") and final regulations under IRC Section 901 providing guidance on determining who is considered the taxpayer of foreign taxes for purposes of the foreign tax credit ("Final Technical Taxpayer Regulations"). The regulations were published in the Federal Register on February 14, 2012.

IRC Section 909, enacted on August 10, 2010, suspends foreign taxes that accrue as a result of a "foreign tax credit splitting event" (FTCSE). Notice 2010-92, issued on December 6, 2010, provided initial guidance under IRC Section 909 and an exclusive list of four categories of FTCSEs for taxes accrued by foreign corporations in pre-2011 years. The Foreign Tax Credit Splitter Regulations incorporate the guidance provided in Notice 2010-92 for pre-2011 tax years, add an additional category of FTCSEs for post-2010 tax years ("Partnership Inter-Branch Payment Splitter Arrangements"), and significantly expanded the Notice's loss-sharing FTCSE category for post-2011 tax years.

On August 4, 2006, the Treasury and the IRS issued proposed regulations under IRC Section 901 providing guidance regarding who is considered the taxpayer of foreign taxes with respect to reverse hybrids, foreign consolidations, transfers of partnership interests, and transfers of disregarded entities (DRE). The final regulations adopt the approach of the 2006 proposed regulations, except with respect to reverse hybrids. The 2006 proposed rules regarding reverse hybrids (generally treating the reverse hybrid as the taxpayer) were withdrawn.

For additional details, please refer to **United States Tax Alert – 13 February 2012**.

ASC 740 implications: Companies that have recognized a DTL related to unremitted foreign earnings (i.e., the unremitted earnings are not considered to be indefinitely reinvested) should remeasure such DTLs to take into account the effect that the new regulations have on the amount of foreign tax credit that will be allowed upon the future remittance of the earnings. The DTL should be remeasured in the financial reporting period that includes February 14, 2012. Similarly, taxpayers that have UTBs for prior years related to uncertainty as to the amount of foreign tax credits that would be sustained should remeasure the UTBs considering the new regulations in the financial reporting period that includes February 14, 2012.

When considering effects of tax regulations on U.S. GAAP financial statements, it is important to understand if the tax regulations issued are legislative or interpretive in nature. Interpretive regulations are intended to interpret or clarify current law, whereas legislative regulations are intended to introduce a change to a currently enacted law. In the U.S. federal tax context, a legislative regulation is authorized by Congress to provide the substantive requirements of a specific Internal Revenue Code provision and generally has a full force of the law. By contrast, interpretive regulations are generally issued pursuant to the authority granted to Treasury under IRC Section 7805(a) and do not rise to the level of a change in a tax law. However, in certain cases the distinction is not readily identifiable and judgment may be required to determine if a regulation should be classified as legislative or interpretive.

The tax effects of legislative regulations are recorded discretely in continuing operations in the period that includes the enactment date pursuant to ASC 740-10-45-15. Interpretive regulations are considered new information for purposes of recognizing and measuring uncertain tax positions (UTPs). A change in the measurement of a tax position taken in a prior annual period is recognized as a discrete item in the period in which the change occurs pursuant to ASC 740-10-25-15. A change in the measurement of a tax position taken in a prior interim period within the same fiscal year is reflected through an adjustment to the annual effective tax rate pursuant to ASC 740-270-35-6. The change in measurement resulting from new information is allocated to the different components of comprehensive income (e.g., continuing operation, discontinued operations, and so forth) using the "with and without" approach of the intraperiod allocation rules contained in ASC 740-20-45.

Multistate

Michigan enacts changes to Corporate Income Tax

In our **June 2011 newsletter**, we addressed the enacted law change in Michigan, which replaced (except in limited instances) the Michigan Business Tax (MBT), with a 6 percent Corporate Income Tax (CIT), effective January 1, 2012.

As highlighted in the June article, one of the significant changes under the CIT, related to taxpayers holding a direct or indirect (through one or more flow-through entity or entities) ownership interest or beneficial interest in a flow-through entity. For such taxpayers, business income that is directly attributable to the business activity of the flow-through entity shall be apportioned to Michigan using an apportionment factor determined based on the business activity of the flow-through entity. This CIT provision, as originally enacted, was to be applied to ownership in any flow-through entity with no distinction drawn between unitary and non-unitary flow-through entity interests.

Under current Michigan law, which became effective on January 1, 2012, taxpayers are required to apportion their CIT tax bases pursuant to a single sales factor.

On December 27, 2011, Michigan Governor Snyder signed a series of bills amending the CIT. Senate Bills 653, 666, and 678 clarify the manner in which a DRE for federal tax purposes is treated for CIT purposes. This clarification provides that a person that is a DRE for federal income tax purposes under the IRC shall be classified as a DRE for purposes of the CIT.

Senate Bills 673 and 807 amend the CIT apportionment provisions to provide that the sales factor numerator of a corporate taxpayer shall include the taxpayer's proportionate share of the total Michigan sales of a flow-through entity that is unitary with the corporate taxpayer and the sales factor denominator shall include the corporate taxpayer's proportionate share of the total sales everywhere of a flow-through entity that is *unitary* with the corporate taxpayer. A corporate taxpayer has ownership in a unitary flow-through entity if:

- The taxpayer owns or controls, directly or indirectly, greater than 50 percent of the flow-through entity; and
- The taxpayer and the flow-through entity have business activities or operations that result in either a flow of value or that are integrated with, dependent upon, or contribute to each other.

A corporate taxpayer that has ownership in a flow-through entity with which it is not unitary, will continue to apportion the specific distributive income/loss of the non-unitary flow-through entity by application of that flow-through entity's CIT apportionment factor.

For additional details, please refer to **Multistate Tax: External Alert – January 6, 2012**.

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

Current taxes

Interim – Pursuant to ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year should be recorded after the effective dates prescribed in the statutes and reflected in the computation of the annual effective tax rate (AETR) beginning no earlier than the first interim period that includes the enactment date of the new legislation. As the Michigan CIT is effective on January 1, 2012, companies that have nexus in Michigan should consider the impact of all the CIT changes when computing their estimated AETR.

Deferred taxes

Measurement – Deferred tax assets (DTAs) and DTLs should be measured using the applicable tax rate (the product of the apportionment factor and the enacted tax rate) expected to apply in the periods in which the temporary differences are expected to reverse or be settled. Companies that hold a unitary or non-unitary interest in a flow-through entity should consider the above-referenced Senate Bills when determining the applicable tax rate for measuring Michigan DTAs and DTLs, including DTAs and DTLs for temporary differences on assets and liabilities held inside the parent investor entity ("inside basis differences") and temporary differences for the parent investor's investment in the flow-through entity ("outside basis difference").

- *Unitary (apportionment)* – Use Michigan applicable tax rate that includes apportionment factors of both the parent company and the unitary flow-through entity when measuring DTAs and DTLs for all MI temporary differences (i.e. both the inside basis differences and the outside basis difference related to the interest in the unitary flow-through entity);
- *Non-unitary (allocation)* – Use Michigan applicable tax rate that excludes the non-unitary flow-through entity's factors to measure DTAs and DTLs for inside basis differences, and Michigan applicable tax rate using only the factors of the non-unitary flow-through entity to measure DTAs and DTLs for the outside basis difference in the non-unitary flow-through entity.

Intraperiod allocations – Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations, in the period that includes the enactment date of the applicable law change, which is December 27, 2012 for Senate Bills 673 and 807. This is true even if the DTA or DTL was originally established through an item other than continuing operations – e.g., OCI, discontinued operations.

Illinois Law Change

On December 16, 2011, Illinois Governor Pat Quinn signed into law Senate Bill 0397 ("P.A. 97-0636"), as part of an Omnibus Tax package that contains various modifications to Illinois' tax regime. Some of the new provisions include the following modifications to Illinois tax law:

- **Reinstatement of the net operating loss (NOL) deduction with some limitations** – Under prior legislation adopted on January 13, 2011, Illinois suspended utilization of NOLs for tax years ending after December 31, 2010, and prior to December 31, 2014. The new law shortens the full suspension period to tax years ending after December 31, 2010 and prior to December 31, 2012. For tax years ending on or after December 31, 2012, and prior to December 31, 2014, the NOL deduction may be utilized up to $100,000 per taxable year.

- **Extension of the research and development (R&D) credit** – P.A. 97-0636 extends the Illinois Research and Development (R&D) Credit through tax years ending prior to January 1, 2016. Previously, this credit expired for tax years ending on or after January 1, 2011. The new law also eliminates language disallowing the carry forward of R&D credits for tax years ending on or after January 1, 2011. Therefore, any Illinois R&D credit that under prior law would not have been allowed to be carried forward to a taxable year ending on or after January 1, 2011, may now be carried forward for the original five-year period.

- **Creation of a special sales factor for certain federally regulated exchanges** – For tax years ending on or after December 31, 2012, federally regulated exchanges will have the option to elect an alternative apportionment methodology. Under this method, Illinois receipts are determined as follows:

  - Receipts for transactions executed on a physical trading floor within Illinois will be included in the numerator of the Illinois sales factor.

  - Receipts attributable to all other matching, execution, or clearing transactions:

    - For tax years ending on or after December 31, 2012 but before December 31, 2013, 63.77 percent of such receipts will be included in the numerator of the Illinois sale factor; and

    - For tax years ending on or after December 31, 2013, 27.54 percent of such receipts will be included in the numerator of the Illinois sale factor.

  - All other receipts will be included in the numerator of the Illinois sales factor under the normal Illinois apportionment rules.

Once a taxpayer elects to use this alternative apportionment methodology, the taxpayer's apportionment factor cannot be less than the apportionment factor computed under these rules for the first full tax year ending on or after December 31, 2013.

- **Creation of an Illinois independent tax tribunal** – Effective July 1, 2013, P.A. 97-0636 creates an Independent Tax Tribunal Board that will exercise all rights, powers, and responsibilities pertaining to notices of tax liability or deficiencies for all taxes administered by the Illinois Department of Revenue (IDOR). This tribunal will replace the current protest process whereby taxpayers could contest notices of tax liability or deficiencies before administrative law judges employed by the IDOR. P.A. 97-0636 does not contain specific information regarding the implementation or operation of the new tribunal.

In addition, P.A. 97-0636 included an extension, and in some cases an expansion of various other income tax and non-income tax based credits, incentives, and deductions that should be considered when determining the financial reporting implications of the law change.

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

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

Current taxes

Interim – Pursuant to ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year should be recorded after the effective dates prescribed in the statutes. Both calendar and fiscal year companies should consider the retroactive extension of the R&D credit and the extension and expansion of other credits, incentives, and deductions when computing their estimated AETR. In accordance with ASC 740-270-25, when retroactive legislation is enacted in an interim period before the fourth quarter of the annual accounting period, the effect on the current annual accounting period is generally recognized by updating the AETR for the effect of the retrospective legislation. That updated AETR is then applied to the year-to-date ordinary income through the end of the interim period that includes the enactment date. The cumulative amount of tax expense or benefit for the current year is then adjusted to this amount, which effectively "catches up" the prior interim periods for the change in law.

Deferred taxes

Measurement – DTAs and DTLs should be measured using the applicable enacted 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. Qualifying federally regulated exchanges electing the alternative apportionment method should schedule the reversals of temporary differences in order to determine the applicable Illinois tax rate for measuring DTAs and DTLs considering the changes to the apportionment rate. Companies that previously derecognized R&D credits as a result of the expiration under prior law should consider PA 97-0636 to determine whether they should record a DTA for such credits, and evaluate whether a valuation allowance is needed.

NOL suspension – Companies that previously determined that it was not more likely than not that the DTA related to Illinois NOLs would be realized due to the utilization suspension should reevaluate that conclusion based on the current law change that reinstates the NOL utilization (in a limited capacity) for tax years ending after December 31, 2012, and before December 31, 2014. Pursuant to ASC 740-270-25-4, any decrease to the beginning-of-the-year valuation allowance related to the expected utilization of the NOL in future years should be recognized as a discrete item in the interim period in which the change in judgment occurs and should be allocated to income from continuing operations pursuant to ASC 740-10-45-20.

Intraperiod allocations – Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations, in the period that includes the enactment date of the applicable law change, which is December 16, 2011. This is true even if the DTA or DTL was originally established through an item other than continuing operations – e.g., OCI, discontinued operations.

Interim – For fiscal year companies, ASC 740-270-25-5 provides that the effect of a change in tax law or rate on a DTA or DTL shall not be apportioned among interim periods through an adjustment of the AETR. Rather, the tax effect is recorded as a discrete item in the period in which the enactment occurs.

Controversy

Domestic production activity guidance issued

The LB&I of the IRS issued guidance on February 1, 2012, to examiners to use in determining whether a taxpayer has the benefits and burdens of ownership under a contract manufacturing agreement for purposes of Treasury Regulation Section 1.199-3(f)(1). The LB&I directive provides a three-part analysis related to contract terms, production activities, and economic risks that the examiner should follow in determining whether the taxpayer has the benefits and burdens of ownership. This LB&I directive is administrative guidance to examiners so it does not constitute an official pronouncement of law.

Overview of IRC Section 199

IRC Section 199 allows certain taxpayers to claim a deduction for a percentage of the lesser of: (1) qualified production activities income resulting from domestic production activities; or (2) taxable income (determined without regard to IRC Section199 deduction). Taxpayers frequently enter into contractual arrangements with unrelated parties to perform some or all of the activities required to manufacture, produce, grow, or extract (the “qualifying activity”) tangible personal property, computer software, sound recordings, electricity, natural gas, potable water, or qualified films (the “property”). Treasury Regulation Section 1.199-3(f)(1) provides that if one taxpayer performs a qualifying activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the property during the period the qualifying activity occurs (“Benefits and Burdens”) is treated as engaged in the qualifying activity and may claim a deduction under IRC Section 199 with regard to the property.

Three-part analysis

The LB&I directive provides a three-step process that an examiner should use in determining whether a taxpayer has the Benefits and Burdens. Each step asks three questions. If the answer is “yes” to at least two of the questions, the step is completed. If any two of the three steps are completed, the taxpayer has the Benefits and Burdens. If at least two of the three steps are not completed, the examiner should determine whether the taxpayer has the Benefits and Burdens based on all facts and circumstances as in any examination risk assessment. In doing so, the examiner should not rely solely on the nine questions but should consider all relevant factors. The process includes the following steps and questions:

Step 1 – Contract terms

1. Did the taxpayer have title to the work in process (WIP)?
2. Did the taxpayer have risk of loss over the WIP?
3. Was the taxpayer primarily responsible for insuring the WIP?

Step 2 – Production activities

1. Did the taxpayer develop the qualifying activity process (determined without regard to who designed the property, provided the specifications for the property, or holds intellectual rights to the property)?
2. Did the taxpayer exercise oversight and direction over the employees engaged in the qualifying activity (determined without regard to who designed the property, provided the specifications for the property, or holds intellectual rights to the property)?
3. Did the taxpayer conduct more than 50 percent of the quality control tests over the WIP while the qualifying activity was occurring?

If the examiner answers yes to at least two questions in both Step 1 and Step 2, the taxpayer has the Benefits and Burdens and it is not necessary to go to Step 3. If the examiner answered no to at least two questions in both Step 1 and Step 2, the examiner is advised to consider all facts and circumstances in determining whether the taxpayer has the Benefits and Burdens of ownership. If the examiner answered yes to at least two questions in either Step 1 or Step 2 but not both, the examiner should proceed to Step 3.

Step 3 – Economic risks

1. Was the taxpayer primarily liable under the "make-good" provisions of the contract – for example, the warranty, quality of work, spoilage, overconsumption, or indemnification provisions?
2. Did the taxpayer provide more than 50 percent, based on cost, of the raw materials and components used to produce the property?
3. Did the taxpayer have the greater opportunity for profit increase or decrease from production efficiencies and fluctuations in the cost of labor and factory overhead?

If the examiner answered yes to at least two questions in either Step 1 or Step 2 and the examiner answered yes to at least two questions in Step 3, then the taxpayer has the Benefits and Burdens. If the examiner answered no to at least two questions in Step 3, then the examiner must consider the facts and circumstances to determine whether the taxpayer has the Benefits and Burdens.

For additional details, please refer to **IRS Insights – March 2012**.

ASC 740 implications: ASC 740-10-35-2 provides "subsequent measurement of a tax position meeting the recognition requirements of paragraph 740-10-25-6 shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date. Paragraph 740-10-30-7 explains that the reporting date is the date of the entity's most recent statement of financial position. A tax position need not be legally extinguished and its resolution need not be certain to subsequently measure the position. Subsequent changes in judgment that lead to changes in measurement shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period."

ASC 740-10-25-15 provides "a change in judgment that results in subsequent recognition, de-recognition, 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."

Companies that have contract manufacturing arrangements in the United States should review the LB&I directive and determine if the new information causes a change in judgment for which a re-measurement of an UTB related to a prior year UTP will be appropriate. The LB&I directive only directs agents under LB&I supervision, but does not direct the Appeals Division; therefore, companies should distinguish UTPs for Section 199 deductions that are currently under exam or that will be subject to exam from those before Appeals.

Companies should also consider the impact of the LB&I directive on their current year Section 199 deduction and related UTBs when computing their estimated AETR. ASC 740-270-35-6 states that a change in judgment that results in subsequent recognition, de-recognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year is an integral part of an annual period. Therefore, the effect of such change is generally recognized by updating the AETR for the effect of the change in judgment.

Finally, as a reminder, ASC 740-10-55-29 provides "the qualified production activities deduction's characteristics are similar to special deductions discussed in paragraph 740-10-25-37 because the qualified production activities deduction is contingent upon the future performance of specific activities, including the level of wages. Accordingly, the deduction should be accounted for as a special deduction in accordance with that paragraph." ASC 740-10-25-37 provides "the tax benefit of statutory depletion and other types of special deductions… shall not be anticipated for purposes of offsetting a DTL for taxable temporary differences at the end of the current year. The tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return. However, some portion of the future tax effects of special deductions are implicitly recognized in determining the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor and the need for a valuation allowance for deferred tax assets. In those circumstances, implicit recognition is unavoidable because those special deductions are one of the determinants of future taxable income and future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance."

Did You Know?

Elections to change tax status cannot be considered until actually filed

Did you know that an election to make a voluntary change in the tax status of an entity cannot be considered earlier than the period in which the election is actually filed (if no approval is necessary) or the period in which it is approved (when approval is necessary)? ASC 740-10-25-33 and 740-10-25-34 provide that the effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary.

To illustrate, consider two calendar-year companies that have each completed all of the necessary requirements to qualify for S Corporation status as of December 31, 20X1. The first company has filed its election with the IRS in November 20X1, while the second company plans to file its election with the IRS in January of 20X2. Both elections will be effective as of January 1, 20X2. Even though the filing of the election is considered perfunctory, pursuant to ASC 740-10-25-33 and 740-10-25-34, only the first company should reflect the tax effects of the change in status in its December 31, 20X1 financial statements since its election was filed before year-end. Since the second company filed its election with the IRS after year-end, the tax effects should not be reflected in the December 31, 20X1 financial statements, but rather in the first quarter of 20X2. Adequate disclosure of the change is still recommended for each company.

This rule is equally applicable to check-the-box elections. While you can file a check-the-box election to change a regarded entity into a DRE (or vice versa) subsequent to the end of the year, with the change being effective prior to year-end (i.e. retroactive), the financial accounting for the change in status generally[2] cannot occur until the period in which the form is actually filed.

In general, the change in status from taxable to nontaxable will result in the de-recognition of previously recorded DTAs and liabilities on temporary differences to the extent that the expected recovery or settlement of the related assets and liabilities will not result in a taxable or deductible amount in the future.

Tax effects from a change in tax status will generally be recorded as an income tax expense or benefit from continuing operations as noted in ASC 740-10-45-19. This is true even for DTAs and DTLs that were originally established through an item other than continuing operations – e.g., OCI, discontinued operations.

[2] There are exceptions to the general rule. For example, under ASC 740-10-25-3, a company is required to recognize a DTL with respect to the excess of financial reporting over the tax basis of a foreign subsidiary when it becomes apparent that such difference will reverse in the foreseeable future. If the effect of making a voluntary change in tax status will be to cause such a basis difference to close (i.e., the recognition of taxable income and a higher tax basis in the foreign entity or its assets) then a DTL will be required even though the voluntary change in status cannot otherwise be accounted for.

Converting a taxable C Corporation into a real estate investment trust (REIT) might not technically be considered a change in tax status because the REIT remains a taxable C Corporation after the REIT conversion (although, if it distributes all of its income, it is in substance a flow through entity, as its owners are taxed on its income rather than the REIT itself). There is no REIT election. Rather, the change occurs when the corporation is compliant with the REIT provisions set forth in IRC Sections 856-860 and is communicated to the IRS by filing a specific type of corporate tax return (1120-REIT).

As ASC 740 does not specifically address when to account for the consequences of a change where no election or approval is required, diversity has developed in practice. One view is that the tax effects of a conversion to REIT status would be recognized when the company has committed to a plan to file as a REIT prospectively and has met all the legal requirements to be a REIT under the Code, including the distribution of accumulated E&P of the corporation to the shareholders. Alternatively, some companies have analogized a conversion to REIT status as a change in tax status (i.e., taxable to nontaxable) in accordance with the guidance in ASC 740-10-25-32. Under this view, the recording of the tax effects would most likely be delayed until the company files its first tax return as a REIT.

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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