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September 2012

Accounting Developments

FASB proposes new disclosures for reclassification adjustments out of AOCI

In our **March 2012 newsletter**, we addressed Accounting Standards Update (ASU) 2011-05,[1] *Comprehensive Income (Topic 220), Presentation of Comprehensive Income*, which revised the manner in which entities present other comprehensive income (OCI) and total comprehensive income in their financial statements. The ASU removes the presentation options in ASC 220, *Comprehensive Income*, and requires entities to report components of comprehensive income in either (1) a single continuous statement or (2) two separate but consecutive statements.

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 issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, which indefinitely deferred the presentation requirements under ASU 2011-05 for reclassification adjustments and allowed the FASB to redeliberate the matter.

On August 16, 2012, the FASB issued a proposed ASU, *Presentation of Items Reclassified Out of Accumulated Other Comprehensive Income,* that would expand the disclosure requirements for items reclassified out of AOCI for both interim and annual periods. The proposal focuses solely on new disclosures and would not amend the current requirements for the reporting of net income or OCI in the financial statements.

OCI includes gains and losses that are initially excluded from net income for an accounting period. Those gains and losses are later reclassified out of AOCI into net income. For example, an available-for-sale security is adjusted to its fair value at each financial reporting date with the associated unrealized gain or loss being reflected in OCI. When the security is sold, the related unrealized gain or loss that was in AOCI is effectively reversed from AOCI and reported in the statement of

[1] The 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.

operations. The proposed ASU would require a tabular disclosure for reclassifications out of AOCI in two separate tables: one reflecting changes in AOCI, and the other reflecting items reclassified out of AOCI.

Tabular disclosures of changes in AOCI

Under the proposed ASU, entities would disaggregate the total change of each component of AOCI (e.g., foreign currency items and gains and losses on cash flow hedges) and separately present (1) current period reclassification adjustments and (2) the remainder of OCI for the period. The disclosure would also include a subtotal for the changes in the accumulated balances (i.e., total OCI of each component for the period). Either before-tax (with the total income tax related to OCI presented as a single amount) or net-of-tax presentation would be permitted.

Tabular disclosure of items reclassified out of AOCI

Under the proposal, entities would disclose "significant items" reclassified out of each component of AOCI, along with a subtotal for those significant items, in a separate table. Totals for each component displayed in the table would need to be consistent with the amounts presented in the "changes in AOCI" disclosure discussed above. Amounts would be presented on a before-tax (with the total income tax related to OCI presented as a single amount) or net-of-tax basis, consistent with the entity's presentation of the related line item in net income. In addition, for significant reclassification adjustments, the proposal would require entities to disclose the affected financial statement line item in the statement in which net income is presented (i.e., the comprehensive income statement under a single-statement approach, or the income statement under a two-statement approach). This requirement would be limited to amounts that are reclassified into net income in their entirety.

The examples below and on the next page, adapted from the proposed ASU, illustrate the additional disclosures that would be required for (1) changes in AOCI and (2) reclassifications out of AOCI.

Entity XYZ
Notes to financial statements changes in AOCI[(a)]
for the period ended December 31, 201X

	Gains and losses on cash flow hedges	Unrealized gains and losses on available-for-sale securities	Defined benefit pension items	Foreign currency items	Total
Beginning balance	$(1,200)	$1,000	$(8,800)	$1,300	$(7,700)
OCI before reclassifications	3,000	2,500	(3,000)	1,000	3,500
Amounts reclassified from AOCI[(b)]	(750)	(1,500)	4,500	–	2,250
Net current-period OCI	2,250	1,000	1,500	1,000	5,750
Ending balance	$1,050	$2,000	$(7,300)	$2,300	$(1,950)

(a) All amounts are net of tax. Amounts in parentheses indicate debits.
(b) See separate table found in paragraph **FASB Exposure Draft - Topic 220, Paragraph 220-10-55-17E**, for details about these reclassifications.

Entity XYZ
Notes to financial statements reclassification out of AOCI[(a)]
for the period ended December 31, 201X

Details about AOCI components	Amounts reclassified from AOCI	Affected line item in the statement where net income Is presented
Gains and losses on cash flow hedges		
Interest rate contracts	$1,000	Interest income/(expense)
Credit derivatives	(500)	Other income/(expense)
Foreign exchange contracts	2,500	Sales/revenue
Commodity contracts	(2,000)	Cost of sales
	1,000	Total before tax
	(250)	Tax (expense) or benefit
	$ 750	Net of tax
Unrealized gains and losses on available-for-sale securities		
	$2,300	Realized gain/(loss) on sale of securities
	(285)	Impairment expense
Insignificant items	(15)	
	2,000	Total before tax
	(500)	Tax (expense) or benefit
	$1,500	Net of tax
Amortization of defined benefit pension items		
Prior-service costs	$ (2,000) [(b)]	
Transition obligation	(2,500) [(b)]	
Actuarial gains/(losses)	(1,500) [(b)]	
	(6,000)	Total before tax
	1,500	Tax (expense) or benefit
	$(4,500)	Net of tax
Total reclassifications for the period	$(2,250)	Net of tax

[(a)] Amounts in parentheses indicate debits.
[(b)] These AOCI components are included in the computation of net periodic pension cost (see pension footnote for additional details in the **FASB Exposure Draft - Topic 220, Paragraph 220-10-55-17E**).

For additional details, please refer to **Deloitte Heads Up: (Re)class is in Session – FASB Proposes New Disclosures for Reclassification Adjustments Out of AOCI – August 21, 2012**.

ASC 740 implications:

The proposed ASU's new disclosure requirements would require companies to separately present each significant item reclassified out of a given component of AOCI. Companies should consider the following income-tax related matters as they relate to reclassification adjustments out of AOCI.

Reclassification

Tax effects related to reclassification adjustments are computed under ASC 740-20 – *Income Taxes – Intraperiod Tax Allocation.* Under the general intraperiod tax allocation rules, a company is required to calculate the tax expense or benefit from items reported in continuing operations without considering the tax effects of items other than continuing operations. The difference between this amount, and the total tax expense or benefit – the sum of the current payable and the change in the deferred tax assets (DTAs) and deferred tax liabilities (DTLs) – is allocated to the other items (such as OCI) in the period. When an amount is reclassified (e.g., moved from AOCI to continuing operations) there is often no identifiable tax effect related to the amount in continuing operations (i.e., there is no associated current tax effect or change in deferred taxes). Examples of this phenomenon are provided by the accounting for post-retirement benefit-related actuarial gains or losses (recorded in AOCI and then allocated over time to continuing operations) and other than temporary impairments (OTTI) that get reclassified from AOCI to continuing operations when the impairment is determined to be other than temporary. One approach to address the reclassification issue is to associate pretax reclassified amounts with hypothetical movements in the related balance sheet account in order to "create" related tax effects under the intraperiod tax allocation rules (this approach would comply with the requirement to determine the tax consequences of items in continuing operations without considering the tax effects of items other than continuing operations).

Additionally, reclassification adjustments related to pretax items may create residual tax effects or rate anomalies in AOCI. Any residual tax effects or rate anomalies should be released based on the company's accounting policy for releasing any residual tax effects in each component of AOCI.

Application of ASC 740-20-45-7

Another issue to consider is the application of the ASC 740-20-45-7[2] exception with regard to reclassification. ASC 740-20-45-7 states that all items (e.g., extraordinary items, discontinued operations, and so forth) should be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations and that should be allocated to continuing operations.

Companies should consider whether or not a reclassification of a loss from AOCI into continuing operations is a source of income for purposes of applying the ASC 740-20-45-7 exception. Due to the diversity in practice, companies should consult with their attest firm regarding their view on the application of ASC 740-20-45-7 to losses reclassified from AOCI into continuing operations.

International

UK corporate tax rate reduction

On July 17, 2012, the UK Finance Act 2012 received Royal Assent, passing into law a number of tax measures announced in the UK Budget 2012 on March 21, 2012. The key measure is a phased-in 2% reduction to the corporate income tax rate. Pursuant to the newly enacted legislation, a 24% corporate income tax rate is effective April 1, 2012, in place of the recently enacted 25% tax rate, and is followed

[2] ASC 740-20-45-7 – The tax effect of pretax income or loss from continuing operations generally should be determined by a computation that does not consider the tax effects of items that are not included in continuing operations. *The exception to that incremental approach is that all items (for example, extraordinary items, discontinued operations, and so forth) be considered in determining the amount of tax benefit that results from a loss from continuing operations and that shall be allocated to continuing operations.* That modification of the incremental approach is to be consistent with the approach in Subtopic 740-10 to consider the tax consequences of taxable income expected in future years in assessing the reliability of DTAs. Application of this modification makes it appropriate to consider an extraordinary gain in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations.

by a further tax rate reduction to 23% effective April 1, 2013. An additional tax rate decrease to 22% was proposed in the Budget 2012 but since it was not included in the Finance Act 2012 it cannot be considered to have been enacted. Because thereduced tax rates are effective from April 1, companies that do not have a March 31 year-end may be subject to a blended tax rate on income earned in the reporting period that includes the effective date of the tax rate change. For example:

- Company X is organized and operating under UK law and has an accounting period ending December 31, 2012.
- With the enactment of the 24% tax rate effective as from April 1, 2012, Company X's 2012 blended tax rate will decrease to 24.5% – 26% applicable from January 2012 through March 2012 and 24% is applicable from April 2012 through December 2012.
- Similarly, the 23% tax rate becomes effective on April 1, 2013 and Company X's 2013 blended tax rate will be 23.25%.

In addition to the corporate income tax rate reduction, the measures passed by the Finance Act 2012 include controlled foreign corporation (CFC) reform, introduction of a "patent box" regime, and other investment-promoting measures. The CFC reform is prospective and may have a significant impact on current and deferred tax balances for enterprises with operations in the UK.

ASC 740 implications:

Pursuant to ASC 740-10-25-47, current and DTAs and DTLs are required to be measured using the tax laws and rates that are fully enacted (rather than substantially enacted) as of the balance sheet date. The effect of changes in tax laws, including those with a retroactive application, should be recorded in the financial reporting period that includes the enactment date with the entire tax effect of a change allocated to continuing operations. According to the UK legislative process, tax laws are considered enacted at the time they receive Royal Assent. Thus, the reductions in the main rate of corporation income tax to 24% and 23% were fully enacted on July 17, 2012, and the impact of these tax rate changes, including the effect on enactment date deferred tax balances, should be reflected in the interim or annual financial reporting period that includes the enactment date. In computing the effect of the tax rate change, a detailed scheduling of the timing of the reversals of the underlying temporary differences may be necessary in order to determine the applicable tax rate at which to measure deferred tax balances.

In accordance with 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 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 (but no earlier than) with the first interim period that includes the enactment date of the legislation. As such, the effect of the reduced UK tax rates should be accounted for in the AETR computation in the interim period that includes the enactment date of July 17, 2012.

Companies that have UK subsidiaries that have investments in foreign subsidiaries should also consider the effect of the CFC provisions on future current and deferred taxes to be recognized by the UK parent.

Lastly, in accordance with ASC 740, significant adjustments of a DTL or asset for enacted changes in tax laws or rates should be separately disclosed. When effects of changes in tax laws or rates are material – or could be material for the prospective disclosures in Management's Discussion & Analysis (MD&A) – financial statement preparers also should consider disclosing in MD&A the anticipated current and future impact on their results of operations, liquidity, and capital resources. In addition, financial statement preparers should consider disclosures in the critical accounting estimates section of MD&A, the footnotes to the financial statements, or both, to the extent that the changes could materially impact existing assumptions used in making estimates of tax-related balances.

France – Accounting for the newly enacted 3% distribution surtax

Effective with its publication in the Official Journal on August 17, 2012, France introduced several significant measures in the revised budget law for 2012. One of the key changes enacted is a 3% surtax that is levied on dividends and certain other distributions paid on or after August 17, 2012 by French and foreign entities subject to corporate income tax in France (including permanent establishments of foreign entities).

In practice, the scope of the surtax is broader than originally anticipated as it ultimately applies to all dividends, even those paid to a parent company that holds more than 10% of the distributing entity. The revised budget, however, does provide for specific exemptions from the surtax for dividends/distributions paid between members of a French tax consolidated group, dividends paid by small and medium-sized enterprises, and dividends paid by their qualifying subsidiaries to SIICs and SPPICAVs (i.e., real estate funds).

The surtax is expected to be a new source of French tax revenue following the May 10, 2012, decision of the European Court of Justice in the Santander case, in which the court held that the 30% French withholding tax levied on dividends paid to a nonresident collective investment fund was incompatible with EU law (the tax did not apply to dividends paid to French collective investment funds).

The new surtax is not deductible or creditable for French corporate income tax purposes.

ASC 740 implications:

Dual rate tax regime

In analyzing the ASC 740 implications of the surtax, the applicable question is whether the surtax is imposed on the recipient of the distribution (in which case the surtax pertains to that company's outside basis difference in the French company) or whether it is imposed on the French distributing company (in which case the surtax would be considered part of a "dual rate" tax regime). The determination of which entity is intended to be taxed is generally undertaken through an analysis of the law, and here, it is clear that the tax, as enacted, is intended to be imposed on the French entity making the distribution (e.g., the distribution proceeds are not reduced by the amount of the surtax). The law identifies the taxpayer as the French distributing company and the reportable tax base as the distribution made by the French company.

In certain instances, a tax imposed on the distributor can be "in substance" a withholding tax for the benefit of the recipient of the dividend (interestingly, the criteria relied upon to make such an analysis was developed with another French tax regime in mind). Pursuant to ASC 740-10-15-4, "A tax that is assessed on an entity based on dividends distributed is, in effect, a withholding for the benefit of recipients of the dividend and is not an income tax if both of the following conditions are met:

(1) The tax is payable by the corporation if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the corporation would otherwise pay, and

(2) Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders."

As enacted, the distribution recipients are not entitled to a refundable tax credit at least equal to the 3% surtax paid; hence, the new French surtax would not be treated as "in substance" a withholding tax. As a result, this means that the new surtax effectively creates a dual tax rate regime in France.

Accounting for the surtax by the entity subject to the dual rate

ASC 740 provides limited guidance with respect to dual tax rate regime jurisdictions and the tax rate that should be used when measuring DTAs or DTLs. The guidance in ASC 740 is specific to a tax regime that refunds prior taxes when a distribution is made (i.e., the tax rate on distributed earnings is lower than the tax rate on undistributed earnings). There is no authoritative guidance that expressly addresses a dual rate regime in which incremental tax is paid upon a distribution of prior earnings. In an earlier attempt to address the tax accounting attendant with a dual-tax regime, the AICPA International Practices Task Force (IPTF) focused on the deferred income tax accounting for entities that were subject to the now-abolished South Africa secondary corporation tax, a dual tax rate regime which, similar to France, required the payment of additional tax by South African companies when distributions of prior earnings were made. As a result of these discussions, two competing views were developed to address the income tax accounting for such a South African company. "View A," which was the preferred view, was that the higher distributed rate should be used for measuring deferred taxes on inside basis differences and that a DTL should also be maintained for the future distribution of prior earnings. "View B" was that the incremental tax payable in the future when earnings are distributed should be recognized only when the dividend has been declared and recognized as a liability. The deliberations around the South African secondary corporation tax regime ended with the acceptance of both views noted above (pending possible further review by the Emerging Issues Task Force (EITF), which has not yet occurred) and with an expectation of robust disclosure by those companies following View B. For more detailed discussion on dual tax rate jurisdictions and determination of an applicable tax rate see **Accounting for Income Taxes Quarterly Hot Topics: June 2012 Issue**.

Application of a View A approach to the new French surtax would result in inside basis temporary differences being remeasured to take into account the newly enacted additional 3% surtax. Furthermore, a DTL would be maintained for undistributed earnings that would be subject to the new 3% surtax upon distribution or liquidation.

Application of the View B approach to the new French surtax would result in no change in measurement of the DTAs and DTLs for the additional 3% tax and no additional inside basis deferred taxes would be recognized, including the amount related to prior earnings that might be distributed in the future.

Pursuant to ASC 740-10-45-15, the effect of following View A and remeasuring deferred taxes would be included in income from continuing operations in the financial reporting period that includes August 17, 2012, the enactment date of the second Amended Finance Law for 2012. 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). 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 would not be apportioned among interim periods through an adjustment of the AETR.

Companies would also be required to consider the intraperiod allocation rules with regard to changes in tax laws or rates.

Companies that follow View B would only record a liability for the 3% surtax to the extent that there is a liability for a declared but unpaid dividend that would be subject to the 3% surtax when settled and the liability recognized would be a current tax payable.

Accounting in the consolidated financial statements of a parent

ASC 740-10-25-41 addresses a dual rate regime that allows for the recovery of prior taxes paid when those earnings are distributed (i.e., the distributed tax rate is lower). This guidance ties the consolidated level accounting to whether the parent asserts indefinite reinvestment with respect to the earnings of the foreign subsidiary. If the parent has provided for deferred taxes on the earnings of a subsidiary that can recover prior taxes paid when it remits its earnings, the amount of prior taxes expected to be recovered (i.e., the future credit) that is consistent with the amount of earnings expected to be remitted is also recognized in the consolidated financial statements.

In the instance of a dual rate regime that requires the payment of additional tax on remitted earnings, the application of the guidance in ASC 740-10-25-41 is less clear. As discussed above, application of View A would require the distributing corporation to use the higher distributed rate when it measures its DTAs and DTLs. It is not clear, however, whether the amounts recognized (i.e., from applying ASC 740 using the higher distributed rate) would be adjusted under ASC 740-10-25-41 to the undistributed rate in the consolidated financial statements to be consistent with the parent's determination regarding how much of the outside basis difference is anticipated to reverse in the foreseeable future. There is no similar confusion if the distributing corporation is applying View B because the distributing corporation is always using the lower undistributed rate when it measures its DTAs and DTLs. Therefore, the additional 3% surtax would need to be accrued in the consolidated financial statements consistent with the parent's determination regarding how much of the outside basis difference is anticipated to reverse in the foreseeable future (i.e., consistent with the amount of earnings not considered to be indefinitely reinvested).

Note: Given the diversity in practice and the differing views as to the acceptability of the approaches used to account for an additional tax liability arising upon distribution in a jurisdiction with a dual tax rate regime, an entity is encouraged to discuss its approach with its external auditor.

Multistate

Texas court rules certain real property service costs are deductible COGS for Texas franchise tax

The 353rd District Civil Court in Travis County, Texas recently ruled that a taxpayer was entitled to a refund of Texas franchise tax (commonly referred to as the "Texas Margin Tax" or TMT) for costs related to real property services that were disallowed on audit.

Newpark Resources, Inc. ("Newpark") is a fully integrated oilfield services business that provides products and services to companies in the oil and gas industry. Its business lines include fluid systems and engineering; materials and integrated services; and environmental disposal and reclamation services.

The costs in dispute relate to services provided by Newpark Environmental Services, LLC (NES) for the disposal and reclamation of non-hazardous oilfield and industrial waste services related to the drilling or maintenance of oil and gas wells[3]. Upon audit, the Texas Comptroller disallowed NES' costs on the grounds they did not qualify for the Texas Costs Of Goods Sold (COGS) deduction.

For taxpayers electing the COGS deduction, the TMT is a tax based on "total revenue" less direct and certain indirect costs associated with acquiring or producing "goods" that it sells[4]. An exception to this general rule is provided for a taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property. The Texas Comptroller has acknowledged that oil and gas wells are considered real property for purposes of the TMT[5]. Additionally the Comptroller has clarified that labor and materials constituting oilfield services for the construction, repair or industrial maintenance of oil and gas wells can be included in the COGS deduction[6].

In a brief judgment, the court ruled that Newpark was entitled to a full refund of the amount paid in protest, plus interest allowed by law.

Although the ruling did not elaborate on the rationale, taxpayers providing real property services should consider whether labor and materials associated with real property construction, improvement, remodeling, repair, or industrial maintenance qualify for the Texas COGS deduction.

Taxpayers could potentially benefit from this ruling even if COGS was not elected on their originally filed return given the Comptroller's recent decision to allow taxpayers to amend reports in order to change (or make) an election using COGS or compensation.

On June 12, 2012, the Texas Comptroller announced that it has reconsidered its position with regard to the election to take the COGS or compensation deduction to compute margin for purposes of the Texas Franchise Tax. Previously, the Comptroller had strictly interpreted Texas Tax Code Section 171.101(d) as requiring that the election be made by the original due date of the franchise tax report. The Comptroller had stated its position in this regard in 34 Tex. Admin. Code Section 3.584(f)(1), which prohibits a retroactive change in computing margin. However, in its June 12th announcement, the Comptroller stated that it will allow taxpayers to amend reports to change the election, or to make an election, to use the COGS or the compensation deduction. In that announcement the Comptroller also stated that it will amend 34 Tex. Admin. Code Section 3.584 to reflect this change. Accordingly, taxpayers will be able to amend reports for any reporting period that is within the statute of limitations[7].

Taxpayers that could potentially benefit from a retroactive change in margin deduction election or an expansion of their originally computed COGS deduction should carefully consider the applicable timing requirements for filing an amended report and the other related implications of an amended filing.

For additional details regarding the District Civil Court's ruling that the taxpayer was entitled to a refund for costs related to real property services previously disallowed under audit, please refer to **Multistate Tax: External Alert – August 16, 2012**. For additional details regarding the Texas Comptroller's change in position to allow taxpayers to elect the COGS or compensation deduction on an amended return, please refer to **Multistate Tax: External Alert – June 13, 2012**.

[3] See Cause No. D-1-GN-11-002205, Paragraphs 42-51.

[4] Tex. Tax Code Section 171.1012(a)-(d)

[5] Texas Comptroller COGS Frequently Asked Questions 21 at: **http://www.window.state.tx.us/taxinfo/franchise/faq_cogs.html**

[6] Texas Comptroller COGS Frequently Asked Questions 22 at: **http://www.window.state.tx.us/taxinfo/franchise/faq_cogs.html**

[7] **http://www.window.state.tx.us/taxinfo/franchise/cog_compensation.html**

ASC 740 implications:

ASC 740 generally applies to taxes based on income. The Texas Margin Tax, based on the method in which it is calculated, is considered a tax based on income and as such, is governed by the guidance in ASC 740.

Deferred taxes

Unrecognized tax benefits – Companies should determine whether the District Civil Court's ruling that the taxpayer was entitled to deduct costs related to real property services and also whether the Texas Comptroller's change in position to allow taxpayers to elect the COGS or compensation deduction on an amended return, provides new information that may impact the evaluation of prior-years' tax benefits. Any change in the unrecognized tax benefits resulting from these changes should be accounted for in the period that includes the date the new information became available.

Interim – Pursuant to ASC 740-10-25-14, "subsequent recognition shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date." Per ASC 740-10-25-15, "a change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs." 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.

New law in Massachusetts postpones combined reporting "FAS 109" deduction for one more year

Effective July 1, 2012, a Massachusetts law postpones for one additional year the Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," (FAS 109) deduction that was scheduled to begin in 2013 (now scheduled to begin in 2014), and that was part of legislation enacted during 2008 that adopted a combined reporting regime for tax years beginning on or after January 1, 2009. Recognizing the potential accounting impact arising from this 2008 legislation, the 2008 law had provided for a deduction on behalf of a combined group if the new combined reporting requirements resulted in an increase to the group's net DTL, which was to have applied for the seven-year period beginning with the combined group's taxable year commencing in 2012. Please see **Accounting for Income Taxes Quarterly Hot Topics, September 2011 Issue**.

Legislation enacted last year (H.B. 3535) made this deduction available for the seven-year period beginning with the combined group's taxable year commencing in 2013, rather than in 2012. Now, under this new law, the deduction is available for the seven-year period beginning with the combined group's taxable year commencing in 2014, rather than in 2013.

Note that eligibility to take this deduction is generally limited to publicly traded companies, including certain affiliated corporations participating in the filing of a publicly traded company's financial statements prepared in accordance with generally accepted accounting principles.

For additional information regarding the postponement, please see **Multistate Tax: State Tax Matters – July 13, 2012, Issue 2012-28**.

ASC 740 implications:

Deferred taxes

Recognition – Companies should assess whether the one-year postponement results in a change to the amount of DTAs that are more likely than not to be realized. For example, a company may have relied on the existence of taxable temporary differences scheduled to reverse in tax years beginning in 2013 as a source of taxable income to recognize the benefit of the FAS 109 deduction. However, as a result of the postponement, the current inventory of taxable temporary differences may no longer be an available source of taxable income.

Intraperiod allocations – Pursuant to ASC 740-10-45-15, "when deferred tax accounts are adjusted for the effect of a change in tax law, including a reevaluation of a valuation allowance as a result of the change in tax law, the effect shall be included in income from continuing operations, in the period that includes the enactment date," which, in this case, is July 1, 2012.

Interim – ASC 740-270-25-5 provides that "the effect of a change in tax laws or rates on a DTA or DTL shall not be apportioned among interim periods through an adjustment of the annual effective tax rate."

Did You Know?

First in a series: Accounting for share-based compensation when the recipient is employed by a subsidiary but the shares are of the parent

To understand how ASC 718 – *Compensation – Stock Compensation* applies when the recipient of the share-based compensation is not employed by the parent but rather by a subsidiary, it is helpful to understand the accounting and tax models that apply. While they are similar, there are differences that will have interesting consequences when we examine more complicated fact patterns in later articles. This article is first in a series and outlines the U.S. GAAP accounting and income tax models for share-based compensation for a U.S. corporate subsidiary's stand-alone financial statements.

Let's first examine the accounting model. ASC 718-10-15-4 provides the following guidance:

> Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

The above accounting model can be referred to as a "contribution model." When separate company financial statements are prepared for a subsidiary, it is important that those statements reflect all applicable expenses of that business, whether incurred by the subsidiary or on behalf of the subsidiary by the parent.[8] In this case, even though the equity award is granted by the parent directly to the employee of the subsidiary, it is accounted for as if the share-based compensation (whether an option or a restricted stock award) was contributed by the parent to the subsidiary for

[8] SEC SAB Topic 5.T; ASC 225-10-S99-4

the subsidiary's use in compensating its employees. Compensation expense related to the share-based compensation would be accounted for as an expense balanced by an increase in the subsidiary's contributed capital on the subsidiary's stand-alone financial statements.

For income tax purposes, the basic model also has a contribution element.[9] However, unlike the accounting model that accounts for a contribution equal to the fair value of the award over the vesting period, in the case of compensation transactions, the deemed contribution is assumed to occur at the time that the employee recognizes income and the employer is allowed a tax deduction rather than over the vesting period.

As a general principle, the employer transferring property to the employee is allowed a deduction pursuant to Internal Revenue Code (IRC) Section 83(h)[10] when the employee has taxable income, and that deduction is equal to the amount of income taxable to the employee. In the case of the exercise of a nonqualified option, the amount of taxable income to the employee and deduction to the employer is commonly referred to as the intrinsic amount, the difference between the fair value of the shares on the date the option is exercised and the amount paid by the employee when exercising the option. In the case of a restricted stock award, the deductible amount is generally equal to the fair value of the shares when the employee vests.

In the case of a corporation, IRC Section1032 generally provides that no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Under Reg. 1.1032-1(a), for purposes of Section1032(a), a transfer by a corporation of its own stock as compensation for services is considered a disposition for money or other property and as such, the corporation does not recognize gain or loss under Section1032. Because a corporation is not treated as having gain when receiving money or other property for its shares, the deduction related to the transfer by a U.S. corporation of its own stock as compensation for services is not offset by an equal amount of gain. A different problem arises in the case of the compensation of an employee of a subsidiary with shares of its parent's stock. The shares being used are not its own; therefore the protection provided by Section1032 is not applicable (Reg. 1.1032-1(a) discussed above pertains to the "disposition by a corporation of its own capital stock"). In fact, absent Reg. Section 1.1032-3 (discussed below), the zero basis that the subsidiary arguably would receive in the parent shares would result in the subsidiary having to recognize gain in the parent shares equal to the amount of the deduction, resulting in no net deduction. However, Reg. Section1.1032-3 solves the problem noted above by establishing a deemed cash purchase model, essentially treating the subsidiary as having received a cash contribution from its parent and then treats the subsidiary as using the cash (along with the strike price in the case of an option) to purchase parent stock from the parent. Thus, the regulations give the subsidiary full fair value basis in the parent shares (if the conditions of the regulations are satisfied), thereby eliminating the potential for the subsidiary to have gain on the parent shares. To illustrate this deemed cash purchase model, consider an option that has a strike price of $10 and a fair market value of $30 when it is exercised by the employee. Under the regulation, the parent is treated as having contributed $20 to the subsidiary. The subsidiary is then treated as using the $10 of strike price from the employee and the $20 that is deemed to have been contributed by the parent to the subsidiary to purchase the shares for their fair market value of

[9] Under Reg. 1.83-6(d), if a shareholder in a corporation transfers property to an employee of the corporation in compensation for services, the transfer of the property is considered a contribution to the capital of the corporation by the shareholder.

[10] Under Section 83(h), the service recipient is allowed a deduction under Section 162 in an amount equal to the amount included in the service provider's gross income under Section 83(a).

$30. Including the cash that is deemed to have been contributed to the subsidiary and then used by the subsidiary in acquiring the parent shares, the subsidiary ends up with a tax basis in the parent shares equal to their fair market value, eliminating the possibility of the subsidiary having gain on the parent shares that would offset the deduction equal to the intrinsic amount as provided by Section 83(h).

Financial reporting implications:

For U.S. GAAP purposes, the fair value of the award is measured on the grant date (i.e., “day 1”), provided the award qualifies for equity treatment. The expense related to share-based compensation is based on the grant date fair value of the equity instruments and that expense is recognized over the award’s requisite service period. A DTA is recorded based on the expense recognized that is expected to result in a tax deduction under existing tax law.[11]

While the compensation expense is recognized over the award’s requisite service period, the related tax deduction generally occurs when the employee either exercises the option or vests in the restricted shares and that deduction is equal to award’s intrinsic value. Intrinsic value is defined in the ASC 718-740 Glossary as “the amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5.” In the case of a restricted stock award, the intrinsic amount is equal to the vesting date fair value since there is no amount paid by the employee.

Because financial reporting compensation expense is based on the grant date fair value and the tax deduction is based on the award’s intrinsic value, there is usually a difference in the amount of compensation expense recognized for book purposes and the amount of tax deduction that an entity ultimately is allowed. If the tax deduction exceeds the cumulative book compensation cost that the entity recognized, the tax benefit associated with any excess deduction is recognized as additional paid-in capital (APIC). If the tax deduction is less than the cumulative book compensation cost, the resulting shortfall is charged first to APIC (to the extent of the entity's pool of excess tax benefits), with any remainder recognized in income tax expense.

As the subsidiary is entitled to receive a tax deduction for awards granted to its employees, for separate company financial statement purposes, DTAs can be recognized as the compensation expense is recognized (the temporary difference being equal to the compensation expense for financial statement purposes for which the tax deduction has not yet occurred). Further, the subsidiary can experience the same excess tax benefits and shortfalls that the parent could have experienced, and will account for them in a similar manner.

While the general ledger will not normally reflect all the entries (due to the parent company consolidation of the subsidiary typically making the entries unnecessary) there is a tiered accounting in place. When the award is granted by the parent to the employee of the subsidiary, the parent could debit its investment in the subsidiary and credit its own equity (the real equity of the consolidated group) while the subsidiary would recognize an equal increase in its own equity and the corresponding compensation expense. If the tax deduction exceeds the financial reporting expense recognized, the related excess tax benefit would not be recognized as a reduction in tax expense by the subsidiary. Rather, the reduction in taxes payable would be recognized as an increase in the subsidiary’s capital. The parent would similarly increase its investment in the subsidiary (to match the subsidiary’s increased equity balance) and recognize an increase in its own equity

[11] ASC 718-740-25-2

(the real equity of the consolidated group). When the tax deduction is less than the financial reporting expense, the DTA is not fully realized, and the amount not realized is generally referred to as a shortfall. If there is no pool of excess tax benefits in the consolidated group, the unrealized DTA is recognized as a tax expense by the subsidiary. If there is a pool of excess tax benefits, the unrealized DTA is passed from the subsidiary[12] to the parent (credit DTA and debit contributed capital on the books of the subsidiary while crediting investment in subsidiary and contributed capital on the books of the parent).

As noted, these entries are typically not made on the general ledgers of the parent and the subsidiary since the parent usually accounts for its interest in the subsidiary by consolidation. However, the entries described would have to be made in connection with preparing separate company financial statements of the subsidiary.

Financial Reporting for Taxes 2012 Training

Professionals continue to face significant challenges in financial accounting and reporting for income taxes. Deloitte's 2012 training program can help you stay informed. Our upcoming session will be held December 3–7 in Las Vegas, Nevada. This week-long session includes multiple course offerings allowing the registrant to choose the courses most appropriate for their needs. Course offerings are designed for corporate tax and accounting professionals. We encourage you to **register** early due to limited meeting space and number of reserved hotel rooms.

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**.

1633 Broadway
New York, NY 10019-6754
United States

[12] Whether the pool of excess tax benefits should be limited to such amounts related specifically to the subsidiary’s employees or can consider amounts related to employees of other companies (i.e., when preparing separate company financial statements prepared on a separate return basis) is outside of the scope of this article.