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Accounting for Income Taxes
Quarterly Hot Topics

December 2012

Accounting Developments

2012 AICPA National Conference on Current SEC and PCAOB Developments

Income Taxes

The American Institute of Certified Public Accountants (AICPA) held its annual conference on current Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments from December 3-5, 2012. One of the areas that several speakers focused on was accounting for income taxes. The focus of tax-related topics was realizability of deferred tax assets (DTAs), including companies' analysis as well as financial statement disclosures.

Mr. Mark Shannon, associate chief accountant in the SEC's Division of Corporation Finance, reiterated comments made at last year's AICPA conference about assessing the realizability of DTAs. The SEC staff had noted that it would have difficulty agreeing with a registrant's assertion that losses incurred during the economic downturn are aberrations, but that it would base its conclusions on a registrant's specific facts and circumstances. Mr. Shannon also reminded registrants that in assessing the realizability of DTAs, they should consider cumulative losses in recent years to be significant negative evidence and that to avoid recognizing a valuation allowance they would need to overcome such evidence with significant objective and verifiable positive evidence. He explained that although under U.S. GAAP it is theoretically possible to do so, overcoming negative evidence presented by cumulative losses is difficult.

Mr. Shannon also noted that because many registrants have begun returning to profitability, they are considering whether they should reverse a previously recognized valuation allowance. He indicated that factors for registrants to consider in making this determination would include:

- The magnitude and duration of past losses
- The magnitude and duration of current profitability
- Changes in the above two factors that drove losses in the past and those currently driving profitability

Further, he noted that registrants should bear in mind that the goal of the assessment is to determine whether sufficient positive evidence outweighs existing negative evidence. He emphasized the importance of evidence that is objectively verifiable and noted that it carries more weight than evidence that is not. In addition, Ms. Nili Shah, deputy chief accountant in the SEC's Division of Corporation Finance, explained that in performing their analysis, registrants should (1) assess the sustainability of profits in the current economic environment and (2) consider their track record of accurately forecasting future financial results. She noted that any doubt about sustainability of profitability in a period of economic uncertainty may give rise to evidence that is less objectively verifiable. Likewise, an entity's poor track record of accurately forecasting future results would also result in future profit projections that are less objectively verifiable. Thus, such evidence would carry less weight in a valuation allowance assessment.

Ms. Shah also pointed out that registrants' disclosures should include a discussion of the factors or reasons that led to a reversal of a valuation allowance that effectively answers the question "why now?". Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the entity weighed each piece of evidence in its assessment. She also reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

Foreign Private Issuers

Ms. Jill Davis, associate chief accountant in the SEC's Division of Corporation Finance, presented the comments most frequently noted in the staff's reviews of Foreign Private Issuers' (FPIs') financial statements. Like last year, the topics on which the staff commented most frequently were similar to those for domestic registrants, continuing to underscore that the economics of transactions, rather than the underlying U.S. GAAP, is the primary factor prompting the staff's comments. As it relates specifically to income taxes, the SEC comments have focused mainly on the rate reconciliations for tax assets and the nature of the items disclosed as well as on the completeness and adequacy of disclosures required by IAS 12, particularly regarding the amount of DTAs that were not recognized.

For additional details, please see **Heads UP – Volume 19, Issue 32**.

Income tax accounting implications of Hurricane Sandy

Affects: All entities.

Summary: Hurricane Sandy made landfall as a "superstorm" in the northeastern United States in late October. In addition to tragic loss of life, Sandy caused widespread damage and destruction of property, disruption of power supplies, and disruption of business activity to varying degrees in regions of the United States and parts of the rest of the world. Affected entities reporting under U.S. GAAP should consider some of the tax implications of the natural disaster. Such entities may include those with principal operations in the affected area of the United States or those with ancillary operations, interests, or major supplies in the region.

ASC 740 considerations: A significant event, such as a disaster, may cause a company to reassess its need for a valuation allowance against DTAs. A significant disaster could potentially lead a company to conclude that it may not generate sufficient results in the future to realize its existing DTAs and to, therefore, determine that a valuation allowance and related disclosure are required. Further, asset impairments or write-offs may result in a loss of deferred tax liabilities (DTLs), which previously would have been considered a source of future taxable income upon reversal.

For entities that use foreign tax credits, management may need to revisit its state or global apportionment as income shifts from affected operations to those that are not affected. Foreign earnings that were previously indefinitely reinvested may need to be repatriated to the United States in the future, in which case a company would be required to establish a DTL related to future taxation of such income.

Lastly, all of the items noted above may affect a company's interim accounting for income taxes. An entity should consider the potential impact on the annual effective tax rate (AETR).

Other Resources: For more information about income taxes implications of Hurricane Sandy, see **Deloitte's November 2012 – Practice Guide**.

Multistate

California voters approve tax ballot measures: Mandatory single sales factor apportionment for most multistate taxpayers

Coming on the heels of a similar failed legislative proposal, the passage of Proposition 39 by the voters underscores the increasing relevance of the initiative process to the formation of California tax policy, in part, due to the California Constitutional requirement that a tax increase must be enacted by a 2/3 majority of the legislature.[1] Proposition 39 requires most multistate taxpayers to use a sales factor-only apportionment formula, combined with market-based sales sourcing for sales of other than tangible personal property effective for tax years beginning on or after January 1, 2013.[2] California's rules regarding market-based sourcing for sales of other than tangible personal property had previously been applicable only to taxpayers electing to apportion on a sales factor-only basis. The election to use a single sales factor formula and the applicable market-based sales sourcing remains intact for the 2011 and 2012 taxable years.

The passage of Proposition 39 highlights the Court of Appeal's recent decision in The Gillette Company, et al., v. California Franchise Tax Board ("*Gillette*") because the statutory amendments adopted by Proposition 39 contain the same language that the *Gillette* court held did not override the Multistate Tax Compact's ("Compact's") provision allowing taxpayers to elect the Compact in order to apply its equally weighted three-factor apportionment formula (property, payroll, and sales). Under the reasoning in *Gillette*, a successful election to apply the Compact could thus similarly prevent the application of single sales factor apportionment by allowing taxpayers to elect three-factor apportionment under the Compact. The success of such an election would appear to depend on whether the *Gillette* opinion ultimately stands (the FTB may seek California and/or United States Supreme Court review) and whether the California legislature's recent attempt to repeal the Compact was valid without a 2/3 majority vote (required by the California Constitution if the bill is a tax increase). For additional details regarding this change to the California apportionment formula, please see **Multistate Tax: External Alert – November 12, 2012**. For additional details regarding the *Gillette* case, please see **Multistate Tax: External Alert – October 4, 2012** and **Multistate Tax: External Alert – October 8, 2012**. Information related to the California rules regarding market-based sourcing for sales of other than tangible personal property previously only applicable to taxpayers electing to apportion on a sales factor-only basis are discussed in more detail in **Multistate Tax: External Alert – March 27, 2012**.

[1] Cal. Const. art. XIII A, Section 3 requires any legislative enactment that raises the tax on any single taxpayer to be passed by a two-thirds majority vote in each house of the California Legislature.

[2] Proposition 39, Section 6, adding CR&TC Section 25128.7, available at: **http://voterguide.sos.ca.gov/propositions/39/**. An exception to that formula permits cable companies with a specified minimum investment in the State to include only 50% of sales from network services in the sales factor. Additionally, taxpayers deriving more than 50% of their "gross business receipts" from conducting one or more "qualified business activities" (e.g., agricultural business activity, extractive business activity, savings and loan activity, or banking or financial business activity) are required to continue to use the equally weighted three-factor formula.

ASC 740 implications:

Deferred taxes

Measurement – Deferred taxes should be measured using the applicable tax rate (the product of the apportionment rate and the enacted tax rate) expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. For purposes of most temporary differences, the applicable tax rate is used when measuring deferred taxes. A change in tax law must be accounted for in the period during which the law change occurs, which in this case is the annual or interim period that includes November 6, 2012.

Interim – ASC 740-270-25-5 provides that the effect of a change in tax laws or rates on deferred taxes (such as a change in the apportionment rules) shall not be apportioned among interim periods through an adjustment of the AETR.

Intraperiod allocation – Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations, in the financial reporting period that includes the enactment date of the applicable law change. This is true even if the DTA or DTL was established through an item other than continuing operations (i.e., other comprehensive income, discontinued operations).

State Amnesty Programs

Recently, Kentucky and New Jersey implemented amnesty programs applicable to income taxes:

Kentucky: Amnesty program waiving penalties & ½ interest began October 1st; non-participation fees apply

Pursuant to amnesty legislation enacted earlier this year, the Kentucky Department of Revenue announced that Kentucky's tax amnesty program will be conducted from October 1, 2012 through November 30, 2012. The program is available to all taxpayers owing most taxes, penalties, fees, or interest administered by the department, with the exception of certain ad valorem property taxes, and will apply to tax liabilities for taxable periods ending or transactions occurring after December 1, 2001, and prior to October 1, 2011. During the program, if a taxpayer pays the full amount of qualifying delinquent taxes due and one-half of any interest due, the department will waive all applicable penalties and the remaining one-half of the interest. After the amnesty program expires, the following "cost-of-collection" fees apply:

- For any taxpayer who failed to file a return for any previous tax period for which amnesty is available and failed to file the return during the amnesty period, 50% of any tax deficiency assessed after the amnesty period;
- 25% on all taxes which are or become due and owing to the department for any reporting period, regardless of when due; and
- 25% on taxes which are assessed and collected after the amnesty period for taxable periods ending or transactions occurring prior to October 1, 2011.

Also, an eligible tax liability that is not covered by an installment agreement and that remains unpaid after the program expires will accrue interest at a rate that is 2% higher than the established applicable rate. For additional information, please see **Multistate Tax: External Alert – April 17, 2012** and **Multistate Tax: State Tax Matters, Issue 2012-39**.

New Jersey – Division announces "Intangible Asset Nexus" voluntary disclosure initiative

"Recognizing that there are companies that have nexus with New Jersey as a result of having derived income from the use of intangible assets in this state that have not fulfilled their tax filing responsibilities," the New Jersey Division of Taxation has announced that it will be offering a limited voluntary disclosure initiative that began on September 15, 2012, and will run through January 15, 2013. Under this program, companies that own intangible assets and derived income from the use of those assets in New Jersey will have the opportunity to come forward and voluntarily comply with their state corporation business tax filing requirements. In addition to New Jersey's standard procedures and requirements for voluntary disclosure agreements (VDAs) for business taxes, the department states that the following principles will apply with respect to this particular program:

- The look-back period will be limited to the periods beginning after December 31, 2003, or the date business commenced, whichever is later; returns for prior periods will not be required;
- The taxpayer must file all required returns and remit payment of the full tax liability reported within 90 days of the execution of its VDA;
- The department will waive all penalties except that a 5% amnesty penalty will be assessed for all returns due prior to February 1, 2009;
- The taxpayer will remit payment of interest and the amnesty penalty within 30 days of assessment;
- The department will consider discretionary "throwout" relief by averaging a throwout receipts fraction with a non-throwout receipts fraction;
- Operating companies or those companies that have paid royalties and added the amount back to their New Jersey entire net income may submit amended returns for any period for which the statute of limitations remains open in order to claim an exception to the add-back;
- All returns will be subject to routine audit with respect to issues not specifically covered in the VDA;
- Any settlement with respect to the throwout issue will be binding on the taxpayer and the department; the taxpayer may not file a claim for refund in the event that the application of any future court decisions would suggest a different result; and
- If the disclosure candidate does not wish to settle the throwout issue, the department will hold the issue for a future determination; the department would conduct an audit on the returns filed under the disclosure agreement to make the required throwout determination.

For additional information, please see **Multistate Tax: State Tax Matters, Issue 2012-38**.

ASC 740 implications: Companies need to consider amnesty programs when determining the amount of unrecognized tax benefits (UTB) and the penalties and interest related to their UTBs recorded for income taxes accounted for pursuant to ASC 740-10.

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

Controversy

Tangible property regulation compliance delayed until 2014

On November 20th, the Internal Revenue Service (IRS) issued Notice 2012-73 (the “Notice”) announcing the following anticipated actions:

- The IRS expects to issue in 2013 final regulations on tangible property (“Final Regulations”) that will contain changes from the Temporary Regulations issued in 2012.
- The IRS expects the Final Regulations will be effective January 1, 2014; however, taxpayers may apply the Final Regulations to 2012 or 2013.
- A Treasury Decision will be published soon that will postpone the effective date of the Temporary Regulations to January 1, 2014; however, taxpayers may apply the Temporary Regulations to taxable years beginning on or after January 1, 2012, and before January 1, 2014.
- Revenue Procedures 2012-19 and 2012-20 (“Revenue Procedures”) will continue to apply to method changes necessary for a taxpayer to adopt the Temporary Regulations.
- Transitional guidance will be provided for the Final Regulations when they are issued.

Following the Notice, a company that was planning to adopt the Temporary Regulations in 2012 or 2013 may wait to adopt the Final Regulations in 2013 or 2014, and the government has informally indicated that the audit protection afforded by procedural guidance accompanying the Final Regulations will be similar to that provided under the Revenue Procedures.

ASC 740 implications: Companies that have historically been using permissible tangible property capitalization methods (i.e., companies without UTBs related to such methods) may opt to wait until the Final Regulations are issued to change their accounting method, in which case they would generally not account for any impacts related to the Temporary Regulations in 2012.

However, companies with existing UTBs with respect to tangible property should assess the impact that the Temporary Regulations and related guidance (including the Notice and the Revenue Procedures) have on their UTBs and related interest and penalty accruals.[3] For example, if a company intends to change its accounting methods to comply with the Temporary Regulations within the scope limitation waiver period by filing the required Form 3115 within such period, the company should assess the impact that such filing will have on those amounts. When a company decides and represents that it will file a Form 3115 to change its method of accounting, the company would generally also reflect both its estimate of the “new” property temporary difference and the related IRC Section 481(a) taxable temporary difference that will be created as a result of filing the Form 3115, and an updated UTB assessment for any uncertainty in the application of the Temporary Regulations.

Companies are encouraged to consult with their attest provider as there may be different interpretations of the Notice and its impact to the financial statements.

[3] Companies may have already accounted for the impact the intended filing will have on their UTBs and any related interest accruals in the interim reporting period that included March 7, 2012 (the publication date of the Revenue Procedures),

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