Deloitte.

Accounting for Income Taxes
Quarterly Hot Topics

March 2013

Accounting Developments

Emerging Issues Task Force (EITF) reaches consensus-for-exposure on Issue 13-B, "Accounting for Investments in Tax Credits"

Background

The Low-Income Housing Tax Credit (LIHTC) program is a federal government program designed to stimulate investment in the construction and rehabilitation of low-income housing. The program provides tax credit benefits to the owners of an entity that owns qualifying property. Generally, these investments are accounted for under the equity method or cost method in accordance with Accounting Standards Codification (ASC) 970-323. Under the equity method, the pretax investment performance and tax benefits are presented separately in the statement of financial performance (and the tax benefits are included in the tax provision). The cost method may result in a similar presentation. Some entities use an alternative method in ASC 323-740, known as the "effective yield" method, to account for these investments. Under the effective yield method, an investment's performance is presented in the statement of financial performance on a net basis, along with the tax benefits within an entity's tax provision. However, this method can only be used when an entity meets the following criteria[1] in ASC 323-740 (which many entities are not able to meet):

- The availability of the investor's allocable tax credits is guaranteed by a creditworthy entity.
- The investor's projected yield on the LIHTC investment based solely on cash flows from guaranteed tax credits is positive.
- The investor is a limited partner, and its liability is limited to its capital investment.

Some believe that (1) the financial statement presentation under the equity method and cost method makes an investment's total performance difficult to understand since LIHTC investments generally result in pretax losses, but are profitable in light of the tax benefits from the LIHTC program, and (2) the criteria described in ASC 323-740 to qualify for the effective yield method are too restrictive.

The EITF added this Issue to its agenda to consider potential accounting and disclosure alternatives to the current U.S. Generally Accepted Accounting Principles (GAAP) requirements for LIHTC investments. Specifically, the EITF was asked

[1] See ASC 323-740-25-1.

whether the criteria to qualify for the effective yield method should be modified or retained or whether the guidance in ASC 323-740 should be eliminated.

Summary of EITF's consensus-for-exposure

The Task Force reached a consensus-for-exposure to modify the criteria that an entity must meet to account for an LIHTC investment by using the effective yield method in ASC 323-740 — thus, more LIHTC investments would be likely to qualify for this method. The proposed criteria are as follows (from the Financial Accounting Standards Board (FASB) staff's Issue Summary for this meeting and adapted for the decisions reached by the Task Force):

- It is probable that the tax credits allocable to the investor will be available.
- The investor retains no operational influence (other than certain protective rights) over the investment, and substantially all of the projected benefits are from tax credits and other tax benefits.
- The investor's projected yield, based solely on the cash flows from the tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment), is positive.
- The investor is a limited partner in the affordable housing project (or an investor in a limited liability company) for both legal and tax purposes, and the investor's liability is limited to its capital investment.

The Task Force also reached a consensus-for-exposure to require an entity to disclose the impact of LIHTC investments on its financial statements. For example, an entity might disclose additional information for the components recognized on a net basis in an entity's tax provision during a given period, including pretax investment performance, tax credits, and other tax benefits.

Finally, the Task Force requested that the FASB staff include questions for respondents on the following two topics in the upcoming proposed Accounting Standards Update (ASU):

- Some Task Force members were concerned that, under the proposed qualifying criteria for the effective yield method, some LIHTC investments might no longer have attributes that are similar enough to those of a debt instrument to justify using that method to measure the investment. Therefore, these Task Force members requested feedback on a method that would derecognize the investment on a straight-line basis over the investment's life and recognize the tax credits and other tax benefits on a similar basis within an entity's tax provision.
- The Task Force members requested feedback on other types of tax credit investments that would meet the proposed qualifying criteria for the effective yield method. The Task Force needs feedback on this topic so that it can decide whether to allow or prohibit certain analogies to this guidance.

Effective date and transition

The Task Force reached a consensus-for-exposure that entities would apply this Issue retrospectively; early adoption would be permitted. The Task Force will discuss the Issue's effective date at a future meeting.

Next steps

FASB ratification is expected at the Board's March 29, 2013, meeting, after which the proposed ASU will be exposed for public comment.

EITF releases exposure draft regarding the Presentation of an Unrecognized Tax Benefit When a Net Operating Loss or Tax Credit Carryforward Exists

On February 21, 2013, the FASB issued its exposure draft of a proposed ASU related to EITF Issue 13-C, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward or Tax Credit Carryforward Exists." The comment period for this exposure draft ends April 22, 2013.

The exposure draft proposes that an unrecognized tax benefit (UTB), or a portion of a UTB, should be presented as a reduction of a deferred tax asset (DTA) for an net operating loss (NOL) or tax credit carryforward (rather than as a liability) when the NOL or tax credit carryforward is available under the provisions of the tax law to settle any additional income taxes that would result from a disallowed tax position. For example, if a company took a tax position that had the effect of under-reporting taxable income in a given year, and if there are tax attributes (i.e., NOL or unused tax credits) that exist on a particular balance sheet date, the consequence of not sustaining the tax position would be to reduce the attribute remaining for carryover to subsequent periods (resulting in reduced DTA to be reported for the related attribute). Once tax attribute carryforwards that net against UTBs are considered "used," by virtue of the tax position taken on a tax return, the UTBs are recorded as a liability.

The exposure draft proposes that entities would apply this guidance retrospectively and that early adoption would be permitted. The effective date of this guidance will be discussed at a future EITF meeting. In the EITF's deliberations on this Issue, it also considered and rejected an alternative approach that the FASB has proposed in its responses to technical inquiries about this topic — thus, some entities currently follow this approach. Under the alternative approach, the UTB would be presented as a separate liability in the balance sheet unless the UTB "is directly associated with a tax position taken in a tax year … that resulted in the recognition of an NOL carryforward for that year," in which case the liability would be presented on a net basis.

ASC 740 implications: The FASB is currently requesting comments (through April 22, 2013) on the exposure draft, and this Issue will likely be discussed by the EITF at its June 11, 2013, meeting; therefore, no action is required at this time. If guidance in the exposure draft is finalized and net presentation (as described in the preceding section) is required, companies currently using the alternative approach (generally resulting in gross UTB presentation) would be required to switch to net presentation (including for prior periods presented if the EITF affirms its proposal for retrospective application).

Private Company Council did not formally add accounting for uncertain tax positions to its agenda

The Private Company Council (PCC) was established in May 2012 by the Board of Trustees of the Financial Accounting Foundation (FAF) to work with the FASB to determine whether and when to modify U.S. GAAP for private companies. The PCC is dedicated to advocating for appropriate differences in GAAP for private companies and replaced The Private Company Financial Reporting Committee, which operated from January 2007 to December 2012.

Accounting for uncertain tax positions (UTPs) was identified by the FASB as a potential agenda item for the PCC following the January 2012 FAF post-implementation review (PIR) where, in considering whether the standard provides decision-useful information, the FAF noted that financial statement preparers "are concerned that the judgments required to recognize and measure income tax uncertainties result in reporting information that is not comparable, and may not represent amounts expected to be settled." Overall, the FAF post-implementation review concluded that "on balance, the benefits of FIN 48's improved consistency and reporting of income tax uncertainty information outweighs its costs." In response to the specific comments on accounting for UTPs in the FAF PIR, the FASB noted that it planned to consider whether differences or simplifications are appropriate for private companies (and, potentially, for all entities).

The PCC's inaugural meeting was held on December 6, 2012; the PCC directed the FASB staff to develop agenda research memorandums in four areas:

1. ASC Topic 810, *Consolidation*
2. Accounting for "plain vanilla" interest rate swaps
3. Recognizing and measuring various intangible assets (other than goodwill) acquired in business combinations
4. Accounting for UTPs (ASC Topic 740, Income Tax, formerly FASB Interpretation 48 (FIN 48))

At the PCC's second meeting on February 12, 2013, the PCC voted to add the first three areas to its agenda. The PCC did not add accounting for UTPs to its agenda. Members of the PCC did not identify specific practice issues in accounting for UTPs, which required immediate attention, but acknowledged the desire to continue to solicit feedback from stakeholders on this issue.

FAF to conduct Post-Implementation Review of FASB standard on Accounting for Income Taxes

The FAF, organized in 1972, is an independent, private-sector organization. Although it does not set accounting standards, one of FAF's responsibilities is improving financial accounting and reporting standards. The FAF is the oversight body of the FASB and the Governmental Accounting Standards Board (GASB). The FAF, on February 4, 2013, announced that it will conduct a post-implementation review (PIR) of Financial Accounting Standard (FAS) 109, *Accounting for Income Taxes*, issued in 1992 and codified in ASC 740, *Income Taxes*. This standard establishes financial accounting and reporting standards for the effects of income taxes that result from an organization's activities during the current and preceding years.

FAF President and Chief Executive Office, Teresa S. Polley, stated that "FAS 109 was chosen for review because it meets several of our post-implementation review criteria. When it was issued, it represented a significant change in the accounting for income taxes and affected a wide range of organizations…Additionally, stakeholders frequently note that income tax accounting is a complex topic, and over the years, the FASB's advisory groups have mentioned that it is an area that could be improved — both the accounting guidance and the information disclosed to investors."[2]

The PIR process, implemented in 2010, is intended to determine whether a standard is accomplishing its stated purpose, to evaluate the standard's implementation and continuing compliance costs and related benefits, and to provide feedback to improve the standard-setting process. In achieving its objectives and in determining whether a standard is accomplishing its stated purpose, the PIR team will assess whether:

- The standard resolved the issues underlying its need.
- Decision-useful information is being reported to, and being used by, investors, creditors, and other users of financial statements.

[2] FAF February 4, 2014 News Release.

- The standard is operational: that is, stakeholders are able to apply the standard as intended, the standard is understandable, and preparers are able to report the information reliably.
- Any significant unexpected changes to financial reporting and operating practices resulted from applying the standard.
- Any significant economic consequences that the Board did not consider resulted from applying the standard.[3]

The PIR process is independent of the standard-setting process of the FASB and GASB. The PIR staff reports to the FAF Board of Trustees and the FAF President/CEO, but members are drawn from experienced FASB and GASB staff.

Since the inception of the PIR process, the FAF has completed the review of two FASB standards, ASC 280, Segment Reporting (formerly FAS 131) and FIN 48, "Accounting for Uncertainty in Income Taxes" (now codified in ASC 740). The *Post-Implementation Review Report on FASB Interpretation No. 48* was published on December 30, 2011 and can be accessed using the following link. The report discusses overall conclusions the PIR team reached about FIN 48 and the **recommendations to the FASB from the PIR team** for improving the standard-setting process.

The PIR team expects a review of a selected standard to require approximately six months, but the length will be determined partly by the complexity of the standard.

You can **register on the FAF website** if you are a stakeholder and would like to participate in the PIR process with respect to its review of accounting standards, including FAS 109.

Federal

United States Court of Federal Claims' summary judgment on depreciation allocable to exempt income

On May 11, 2012, the U.S. Court of Federal Claims granted summary judgment allowing tax refunds related to the gain on the sale of two jets (*CBS Corporation v. United States*, *105 Fed. Cl. 74 (May 2012)* or the "CBS case"). The Federal Claims Court allowed the basis used to compute the gain to be increased by depreciation deductions that had previously been disallowed under the Foreign Sales Corporation (FSC) regime, former Internal Revenue Code (IRC) Sections 921–927.

CBS Corporation had purchased aircraft and entered into leasing agreements in 1990 where income from the leasing agreement qualified for a partial exclusion from income under the FSC regime. In 2005, CBS sold these aircraft and reported a gain on the sale equal to the sales price minus the adjusted basis, which included all depreciation deductions allocable to the aircraft claimed on page one of its tax returns from 1990 to 2005. In 2009, after realizing it had incorrectly reduced the adjusted basis of the aircraft by disallowed depreciation allocated to exempt foreign trade income, CBS filed refund claims for the reduction in tax attributable to the reduced gains. The court held that CBS was entitled to the adjusted basis for its previously disallowed depreciation deductions and, as a result, agreed CBS had a lower taxable gain on the disposition of its aircraft.

Under the FSC regime, the foreign trade income that was exempt from U.S. taxation was exempt on the basis that such income was not effectively connected with the conduct of a trade or business within the United States. The FSC regime did not allow deductions that were attributable to the generation of exempt foreign trade

[3] December 2012 PIR: Evergreen Process Description.

income, and as such, depreciation that was allocable to such income was not allowed as a deduction (i.e., the foreign trade income exempted from tax under the FSC regime was the income net of all allocable deductions, including depreciation). The FSC provisions were replaced by the extraterritorial income (ETI) regime in 2000.

The court stated the adjusted basis as provided in IRC Section 1016 should be reduced by allowable deductions such as depreciation. The court concluded that the term “allowable” refers to a deduction that is permitted, and not otherwise forbidden by the Tax Code. As the language of Sections 161, 261, and 265(a)(1) forbids deductions for depreciation allocable to tax-exempt income, adjusted basis is not reduced by this amount. The court concluded that while adjustments to basis must be made to the extent of the amount of depreciation either allowed or allowable as a deduction, no adjustment is permitted or required to the extent of disallowed depreciation deductions.

In the CBS case, the Internal Revenue Service (IRS) argued that a single aircraft should be treated as two separate assets — one 30 percent exempt asset and one 70 percent non-exempt asset — attempting to find a parallel in situations involving the allocation of basis within a single asset used for both income-generating and non-income-generating purposes. The court found there was nothing in the Code or Treasury Regulations to require a taxpayer to treat an aircraft as two distinct assets for the purpose of calculating the amount of gain/(loss) upon sale in the case of an asset used in the FSC regime and that it is inappropriate to draw a parallel with prior case law.

The CBS case may have application outside of the FSC regime, such as depreciation or amortization deductions allocated to net income excluded under the ETI tax regime. Entities may also consider the principles of the CBS case in determining whether there would be an upward adjustment to the basis of subsidiary stock in a disposition. The holding in this case may also apply to IRC Section 59(e) elections and assets amortized under IRC Section 174(b). It may impact foreign tax credit-related computations and could also have an unfavorable impact on certain Section 382 computations. Taxpayers may consider both assets still on hand and assets disposed of in prior years open under the statute of limitations. If the potential tax benefit is significant, taxpayers may want to consider the need for a tax opinion.

ASC 740 implications: For prior dispositions, taxpayers should analyze tax positions taken in open tax years and consider whether a refund claim or adjustment to tax attribute carryforwards will be asserted as a result of the filing or the intent to file an amended return. For assets still on hand, taxpayers should consider whether these tax positions will result in adjustments to temporary differences.

Taxpayers should consider the CBS case as new information to be considered when evaluating UTBs for recognition and measurement as well as for the calculation of related interest and penalties. A client that reaches a decision to apply the principles of the CBS case in a subsequent accounting period will have to evaluate the related financial reporting considerations.

The American Taxpayer Relief Act of 2012 signed into law on January 2, 2013

The American Taxpayer Relief Act of 2012 (the “Act”) cleared the House of Representatives and the Senate on January 1, 2013, and was signed into law by President Obama on January 2, 2013. Among other things, the Act permanently extends the reduced Bush-era income tax rates for lower- and middle-income taxpayers, allows the top rates on earned income and investment income to rise for wealthier households, permanently “patches” the individual alternative minimum tax (AMT), and increases the estate and gift tax rate for high-value estates. The Act also extends through 2013 an array of temporary business and individual tax provisions.

The Act extends through 2013 several expired or expiring temporary business tax provisions, commonly referred to as “extenders.” Provisions that expired at the end of 2011 are retroactively extended to the beginning of 2012. Some of the more significant extenders include:

- *Active financing income exception and controlled foreign corporation (CFC) look-through* — the exception in Subpart F allowing deferral of the active financing income of a CFC engaged predominantly in banking, financing, or similar business activity expired at the end of 2011. The Act retroactively extends the exception through the end of 2013. Similarly, the IRS rules for look-through treatment for payments between related CFCs expired in 2011. The Act retroactively extends the treatment through 2013.
- *Research and experimentation credit* — the credit for certain research and experimentation expenses expired at the end of 2011. The Act retroactively extends the credit through the end of 2013 and modifies the rules for (1) calculating the credit when there is a change of ownership for a portion of the trade or business and (2) aggregation of research expenses within a controlled group.
- *Bonus depreciation* — The Act extends for one year the 50 percent bonus depreciation for qualified property. The provision applies to qualified property placed in service before January 1, 2014 (before January 1, 2015, for certain longer-lived and transportation assets).
- *AMT credit in lieu of bonus* — In addition, the Act provides for another temporary election to accelerate some AMT credits in lieu of bonus depreciation for property placed in service in 2013. This election allows corporations to effectively “monetize” a portion of their AMT credits in lieu of claiming bonus depreciation.
- *Leasehold improvements* — The Act retroactively extends the 15-year straight-line cost recovery for certain leasehold, restaurant, and retail improvements, as well as for new restaurant buildings that are placed in service before January 1, 2014. The provision had originally expired at the end of 2011.

ASC 740 implications: Under ASC 740, *Income Taxes*, the effects of new legislation are recognized upon enactment, which in the U.S. federal jurisdiction is the date the President signs a tax bill into law. Although many of the extenders are effective retroactively for 2012, entities should only consider currently enacted tax law as of the balance sheet date in determining current and deferred taxes. For calendar-year-end reporting entities, this means that both the retroactive tax effects for 2012 and the tax effects for 2013 will be recognized in the 2013 financial statements.

Interim period reporting considerations

During the first quarter of 2013 (i.e., the period that includes the enactment date) for calendar-year-end reporting entities, any amounts pertaining to the retroactive effects for 2012 would be recognized as a discrete item and would not be reflected in the 2013 estimated annual effective tax rate (AETR). Similarly, the tax effects on deferred tax liabilities (DTLs) and DTAs as of the enactment date would not be apportioned among 2013 interim periods through an adjustment of the AETR. Rather, only the tax effects of the new law on taxes currently payable or refundable for 2013 and on changes in deferred taxes after the enactment date would be reflected in the 2013 AETR.

For non-calendar-year-end reporting entities, the retroactive legislation can also affect current year-to-date tax expense or benefit. During the interim period that includes the enactment date, the effect on the current annual accounting period is generally recognized by updating the AETR and recognizing a catch-up adjustment.

See paragraphs 3.265 through 3.276 of Deloitte's **A Roadmap to Accounting for Income Taxes** for additional discussion and examples of accounting for changes in tax laws and rates and paragraphs 9.30 through 9.36 for additional discussion about accounting for such changes during interim periods.

Intraperiod allocation

For both calendar and non-calendar-year-end reporting entities, the effect of the tax law change on prior-year taxes and on DTAs and DTLs existing as of the enactment date would be presented as a component of income tax expense or benefit from continuing operations. The effects of changes in tax law on items not included in income from continuing operations (e.g., discontinued operations, other comprehensive income) arising in the current year and before the enactment date should be included in the current interim period as part of income from continuing operations. The effect of the change on total tax expense or benefit (current and deferred) related to post-enactment income would be allocated between continuing operations and other financial statement components in accordance with the intraperiod tax allocation rules in ASC 740-20.

Classification of DTAs or DTLs as current or noncurrent

An entity that presents a classified balance sheet must classify DTAs and DTLs as either current or noncurrent on the basis of the financial accounting classification of the related liability or asset for which a temporary difference exists. A DTA or DTL that is not related to an asset or liability for financial reporting purposes, such as the deferred tax consequences related to an operating loss or a tax credit carryforward, is classified in accordance with the DTA's or DTL's expected reversal or utilization date. The effect of a change in tax law on the current or noncurrent classification of a DTA or DTL that is not related to an asset or liability for financial reporting purposes should be recognized in the financial statements for the interim or annual period that includes the enactment date.

Realizability of DTAs

An entity should not consider changes in tax laws or rates when assessing the realizability of DTAs before the period in which the change is enacted. This is an exception to the general rule in ASC 740-10-30-17 under which entities should consider all currently available information about future events when determining whether a valuation allowance is needed for DTAs.

See paragraphs 4.121 through 4.124 of Deloitte's **A Roadmap to Accounting for Income Taxes** for additional discussion regarding the consideration of changes in tax laws or rates in the assessment of the realizability of DTAs.

CFC look-through rule and the active financing exception

Entities should have previously factored in the lapse of the look-through rule and active financing exception in measuring current and deferred taxes on earnings of foreign subsidiaries. Because of the lapse of the look-through rule and active financing exception, U.S. entities may have been required to recognize current and deferred taxes related to certain earnings of foreign subsidiaries even if the subsidiary did not or does not plan to remit earnings to the U.S. parent. As a result of the limited extension (i.e., through 2013) of these provisions, entities may need to adjust current and deferred taxes related to those earnings of foreign subsidiaries. This financial reporting impact would be recognized in the interim and annual period that includes the date of the Act's enactment. An entity should consider the currently enacted tax law as of the balance sheet date in calculating current and deferred taxes and should not anticipate the reenactment of a tax law that is set to expire when recognizing or measuring current or deferred taxes.

Disclosure of Subsequent Events

As stated above, the effects of a change in tax law must be recognized in the interim and annual period that includes the enactment date for financial reporting purposes. Therefore, for entities that have not yet issued their financial statements for interim or annual periods that ended before the enactment date, the extenders are treated as nonrecognized subsequent events. In accordance with ASC 855, *Subsequent Events*, to the extent that the absence of any disclosure of the extenders and their impact would cause the financial statements to be misleading, an entity should disclose both the nature of the extenders and their estimated financial effect. Entities should also consider disclosing in the Management Discussion and Analysis (MD&A) the impact of the enactment on the entity's current or future results of operations, financial position, liquidity, and capital resources.

There are a number of additional complexities to consider based upon the new legislation. For more information, see Deloitte's **Swerving From the Cliff: Tax Provisions in the American Taxpayer Relief Act of 2012** and **Multistate Tax Alert: Multistate Impact of the American Taxpayer Relief Act of 2012**.

International

France: Tax credit for competitiveness and employment

The third amended Finance Act for 2012 established a "credit for competitiveness and employment" ("Credit d'Impôt pour la Compétitivité et l'Emploi" or "CICE") when enacted on December 31, 2012. In enacting the CICE, the French government sought to enhance the competitiveness of businesses through the promotion of certain activities, including investment, research and development, training and recruitment, and the exploration of new markets.

The tax credit is based on all wages paid to salaried employees in a given calendar year for salaries that do not exceed 2.5 times the French minimum wage (salaries of employees who earn more than 2.5 times the minimum wage are excluded from the computation), calculated using statutory working hours, plus overtime or additional hours, where appropriate. The wages used to calculate the CICE base are the same as wages used to calculate an employer's social security contributions with respect to base pay, holiday pay, benefits in kind, etc. The tax credit is determined by multiplying the amount of qualifying wages paid in 2013 by four percent and the amount of qualifying wages paid in 2014 (and thereafter) by six percent.

The tax credit may be applied to offset a corporate taxpayer's income tax liability. If there is a tax credit carryforward, it is carried forward for three years and may even be refunded (as discussed below), when not fully utilized, at the end of this period. As the tax credit carryforward constitutes a receivable against the French Treasury, the tax credit may also be monetized prior to the end of the three-year period. For example, the credit carryforward may instead be assigned for cash to a bank or credit institution. Moreover, subject to certain conditions, taxpayers may, in the year that wages are paid, also be able to assign the receivable represented by the future CICE. The tax credit carryforward is immediately refundable (i.e., refundable in 2014 for those expenses incurred in 2013) for certain categories of French corporate income taxpayers: small to midsize entities (SMEs) (as defined by the European Union (EU)), innovative start-ups, distressed firms, and certain new businesses.

As a general matter and from a French GAAP perspective, filers may follow one of two options in accounting for the CICE:

1. Record the CICE as a reduction of corporate income tax (usual French GAAP treatment of tax credits); or
2. Record the CICE as a reduction of personnel expenses.

ASC 740 implications: As realization of the CICE does not depend on an entity's generation of future taxable income or an entity's ongoing tax status or tax position, the credit is not considered an element of an income tax under ASC 740.

Even though the CICE may be realized as a reduction in income taxes and refund claims (arising from the CICE) may be requested via an income tax return, the recoveries of such claims are not dependent on the existence of a tax liability and, thus, are not within the scope of ASC 740. As such, an entity should not, for U.S. GAAP purposes, record the credit as a reduction of income tax expense but rather would recognize the amount as a component of pretax income.

When determining the classification of the CICE, an entity may consider it to be a form of government grant or assistance. Because U.S. GAAP does not provide authoritative guidance for government grants, entities may consider the guidance provided in International Accounting Standard (IAS) 20. Paragraph 29 of IAS 20 states, "Grants related to income are sometimes presented as a credit in the [income statement]; alternatively, they are deducted in reporting the related expense."

Multistate

California Court of Appeal reverses trial court in Microsoft's favor and applies cost of performance sourcing to royalties

Overview

On December 18, 2012, the California Court of Appeal for the First Appellate District (the "Court of Appeal") issued its decision in *Microsoft Corp. v. Franchise Tax Board*[4] ("Microsoft"), reversing a lower court decision in favor of the Franchise Tax Board (FTB). In this case, Microsoft challenged the FTB's tangible property-based sales factor treatment of royalties paid by original equipment manufacturers (OEMs) for licensing the right to replicate and install Microsoft's software programs ("OEM royalties"). The Court of Appeal concluded that, for Microsoft's tax years ended June 30, 1995 and June 30, 1996, OEM royalties should be treated as sales other than sales of tangible personal property (TPP) and sourced to the State of Washington under the cost of performance (COP) rules in Cal. Rev. & Tax. Code (CRTC) Section 25136.[5] This decision provides guidance for taxpayers concerned with the proper sales factor treatment of receipts from licensing the right to replicate and install software.[6]

Factual background

During the years in question, in exchange for a royalty, Microsoft's licensing agreements permitted OEMs to replicate and install Microsoft software on computer

[4] *Microsoft Corp. v. Franchise Tax Board*, 212 Cal. App. 4th 78 (Dec. 18, 2012).

[5] All references to "Section" herein are to the CRTC, unless otherwise provided. All references to "Regulations section" herein are to Cal. Code Regs., tit. 18, unless otherwise provided.

[6] In tax years beginning on or after January 1, 2011 and before January 1, 2013, where an election has been made under Section 25128.5, and for all tax years beginning on or after January 1, 2013, Section 25136 has been amended to incorporate market sourcing rules for taxpayers apportioning income using a single sales factor apportionment formula.

systems that were to be sold by the OEM. Microsoft granted no ownership interest to the OEMs.

Microsoft contended that OEM royalties were from the license of intangible property; therefore, they should be sourced under Section 25136 (i.e., sourced to the state where the greater proportion of the income-producing activity occurred, based on COP). Approximately 99.5 percent of the direct costs to generate OEM royalties occurred outside California, with the majority occurring in the State of Washington.[7] The only income-producing activity that occurred within California during the years at issue was related to the development of plaintiff's PowerPoint product. Therefore, Microsoft sourced OEM royalties to Washington under the COP method and excluded them from its California sales factor numerator. The FTB argued that OEM royalties were from the license of TPP because Microsoft's software products (often delivered to the OEM on a gold master disk to facilitate replication) constituted TPP as software, as has generally been viewed by the FTB. Under the rules for sourcing sales and licenses of TPP contained in Section 25135, the FTB argued that OEM royalties from property delivered to the OEM purchasers in California must be included in the sales factor numerator.

The Court of Appeal framed the issue in Microsoft as "not whether software itself is tangible or intangible property, but whether the *right* to *replicate and install* software is a tangible or intangible property right."

For additional details regarding the Microsoft case, please see **Multistate Tax: External Alert – December 27, 2012**.

ASC 740 implications:

Deferred taxes – 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. Companies should assess whether the Court's decision impacts the measurement of DTLs, DTAs, and any related valuation allowance. New information must be accounted for in the period the new information becomes available, which in this case is the annual or interim period that includes December 18, 2012.

UTBs — Companies should determine whether the Court's decision provides new information that may impact the evaluation of prior years' UTBs. Any change in the UTBs resulting from these changes should be accounted for in the period that includes the date the new information became available.

Current taxes — Companies should consider the Court's decision when calculating their current tax expense and current payable for the period.

Did You Know?

Exceptions to DTA and DTL recognition for corporate joint ventures

In ASC 740, *Income Taxes*, there are certain exceptions to the comprehensive model of recognizing deferred income taxes that are applicable to an entity's investment in a domestic or foreign corporate joint venture that is essentially permanent in duration. One of these exceptions states:

- A DTL shall not be recognized for the excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration

[7] *Microsoft Corp*., No. A131964, at p. 8.

unless it becomes apparent that the temporary difference will reverse in the foreseeable future.[8]

While this exception most commonly applies to subsidiaries consolidated for financial reporting purposes, it may also apply to unconsolidated corporate joint ventures. In order to apply this exception to an unconsolidated investment, the investment must be both a corporate joint venture[9] and essentially permanent in duration. There are two types of corporate joint ventures, those that are essentially permanent in duration and those that have a life limited by the nature of the venture or other business activity.[10] For both types of corporate joint ventures, similar to foreign subsidiaries, the presumption is all undistributed earnings will be remitted to the investors. However, this presumption may be overcome in the case of a corporate joint venture that is essentially permanent in duration if sufficient evidence shows that the corporate joint venture has invested or will invest the undistributed earnings indefinitely. An investor's accounting for a limited life corporate joint venture does not qualify for this exception since the reversal of the outside basis difference is foreseeable.

The duration of a corporate joint venture generally depends on the terms of the contract between the parties. However, when a defined term of duration is not stipulated in the contract, factors such as the intention of the parties regarding duration of the joint venture and objective of the joint venture should be considered. The determination regarding the duration of a corporate joint venture should be consistent among all the parties.

Another exception to the comprehensive model of recognizing deferred income taxes states:

- A DTA shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future.[11]

This exception also applies to a corporate joint venture, either domestic or foreign, that is essentially permanent in duration. Again, limited life joint ventures are not subject to this exception since it is foreseeable that the outside basis difference will reverse in the future.

ASC 740 implications: Entities that have investments in unconsolidated entities should evaluate whether its investments are corporate joint ventures and, if so, whether they have a limited life or are essentially permanent in duration, as different deferred tax consequences may result. If the exception provided in ASC 740-30-25-18(a) is applied, the same documentation and disclosure required for an investment in a foreign subsidiary applies to an investment in a foreign corporate joint venture that is essentially permanent in duration.

---

[8] ASC 740-30-25-18(a) (FAS 109, paragraph 31(a)).

[9] As defined in the Accounting Standards Codification Master Glossary: A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

[10] ASC 740-30-05-6 (APB23, paragraph 15).

[11] ASC 740-30-25-9 (FAS 109, paragraph 34).

Financial Reporting for Taxes 2013 Training

Professionals continue to face significant challenges in financial accounting and reporting for income taxes. Deloitte's Financial Reporting for Taxes training can help you stay informed. Our next program with multiple course offerings is scheduled for May 13–17, 2013 in Jersey City, New Jersey. Course offerings are designed for corporate tax and accounting professionals. Please note the early registration discount for this program ends April 4. New multiple course discounts continue beyond April 4. 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**.