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June 2013

Accounting Developments

Update from the June 11, 2013 meeting of the Emerging Issues Task Force (EITF of "Task Force") on Issue 13-C

Status: Final consensus.

Affects: Entities that have a liability for an unrecognized tax benefit (UTB) and a tax carryforward asset related to the same tax jurisdiction.

Background: A liability for a UTB,[1] which may exist when an entity expects that the tax authority may disallow a benefit previously taken on a tax return, sometimes does not result in settlement of a cash payment with a tax authority because the liability is settled by reducing an available tax carryforward[2] within the tax jurisdiction. There is no explicit guidance in U.S. Generally Accepted Accounting Principles (GAAP) on the presentation of this liability. Many entities present UTBs as a separate liability (i.e., on a gross basis) in the statement of financial position unless the UTB "is directly associated with a tax position taken in a tax year . . . that resulted in the recognition of [a net operating loss (NOL)] carryforward for that year,"[3] in which case the liability would be presented on a net basis. However, some entities believe that an UTB liability should be presented net of a deferred tax asset (DTA) for a tax carryforward "when the uncertain tax position would, or is available to reduce [tax carryforwards] under the provisions of the tax law."

This Issue addresses how an entity should present a liability for a UTB when a tax carryforward exists.

Summary: At this meeting, the Task Force reached a final consensus that entities would be required to present "[a]n unrecognized tax benefit, or a portion [thereof] . . . as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward except as follows. [When the] net operating loss carryforward, a similar tax loss, or tax credit carryforward that exists at the reporting date is either not available under [applicable tax law] or would not be used to settle any additional income taxes that would result from the disallowance of a tax position, the unrecognized tax benefit [would] be presented . . . as a liability."

[1] The Codification Master Glossary defines "unrecognized tax benefit" as "[t]he difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10."

[2] The Codification Master Glossary defines "carryforward," in part, as "[d]eductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year." However, the presentation guidance included in the final consensus is related to net operating loss carryforwards, similar tax losses, or tax credit carryforwards.

[3] That is, an NOL carryforward has not been used.

The final consensus would not require entities to provide any incremental recurring disclosures.

Effective date and transition: The Task Force reached a final consensus that the Issue should be applied prospectively to any UTBs that exist as of the effective date, which is as follows:

- For public entities, for annual periods beginning after December 15, 2013, and interim periods within those annual periods.
- For nonpublic entities, for annual periods beginning after December 15, 2014, and interim periods within those annual periods.

Entities will be permitted to apply the guidance in the final Accounting Standards Update (ASU) on this Issue retrospectively; early adoption will be permitted.

Next steps: Financial Accounting Standards Board (FASB) ratification is expected at the Board's June 26, 2013 meeting, after which a final ASU will be issued.

Federal

IRS releases letter ruling regarding what constitutes a “covered transaction” within the meaning of Treas. Reg. Section 1.263(a)-5(e)(3)

On May 10, 2013, the Internal Revenue Service (IRS) released private letter ruling 201319009 (the "PLR") addressing whether the transaction described therein constitutes a "covered transaction" within the meaning of Treas. Reg. Section 1.263(a)-5(e)(3). The PLR is interesting in that the IRS concludes that a Section 351 transaction with boot qualifies as a "covered transaction" thereby allowing the acquiring corporation to recover a portion of its transaction costs.

Treas. Reg. Section 1.263(a)-5(a) provides that a taxpayer must capitalize an amount paid to facilitate, among other transactions, (i) an acquisition of assets that constitute a trade or business, whether the taxpayer is the target or acquirer; (ii) an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of Sections 267(b) or 707(b); (iii) a restructuring, recapitalization, or reorganization, including a spin-off; and (iv) a transfer described in Section 351.

However, to the extent that a transaction is a "covered transaction," certain costs are not required to be capitalized. A "covered transaction" is defined in Treas. Reg. Section 1.263(a)-5(e)(3), and includes (i) a taxable acquisition of assets that constitute a trade or business; (ii) a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of Sections 267(b) or 707(b); and (iii) certain acquisitive reorganizations described in Section 368. The definition of a "covered transaction" does not include a Section 351 transaction.

PLR 201319009

In the PLR, Parent, Company 1, and Company 2 entered into a merger agreement providing for the combination of Company 1 and Company 2 under a new holding company, Parent. The combination was effectuated as follows:

Step 1: Company 1 formed Parent and Parent formed two wholly owned subsidiaries, Sub 1 and Sub 2.

Step 2: Sub 1 merged with and into Company 1 with Company 1 surviving. Pursuant to the merger, each share of common stock of Company 1 was converted into the right to receive a share of Parent stock (the "Company 1 Acquisition").

Step 3: Sub 2 merged with and into Company 2 with Company 2 surviving. Pursuant to the merger, each share of common stock of Company 2 was converted into (i) the right to receive $a in cash, without interest, and (ii) x shares of common stock of Parent (the "Company 2 Acquisition").

The Company 1 Acquisition qualified for tax-free treatment as an exchange under Section 351, a Section 368(a)(1)(B) reorganization, or a Section 368(a)(2)(E) reorganization. Neither the shareholders of Company 1 nor Parent recognized any gain or loss in the Company 1 Acquisition.

The Company 2 Acquisition was a Section 351 transaction with boot. Parent recognized no gain or loss in the Company 2 Acquisition. However, the Company 2 shareholders recognized gain, but not loss, on cash received in exchange for their Company 2 stock pursuant to Section 351(b).

The taxpayer made the following representation (among others):

> The Company 2 Acquisition was a taxable acquisition, which qualified as an exchange to which Section 351 applies. Pursuant to Section 351(b), the Company 2 shareholders recognized gain (if any), but not loss, to the extent cash was received in exchange for their Company 2 stock.

The PLR concludes that the Company 2 Acquisition is a "covered transaction" within the meaning of Treas. Reg. Section 1.263(a)-5(e)(3).

There is no authority that would treat the receipt of "cash or other property" or "boot" in a transaction that otherwise qualifies as an exchange to which Section 351 applies as a "covered transaction" for purposes of Treas. Reg. Section 1.263(a)-5(e)(3). The taxpayer in the PLR represented that the transaction at issue was a taxable acquisition, a necessary component to determining whether a certain transaction is a "covered transaction." Thus, it is unclear to what extent taxpayers may rely on the conclusion in the PLR without receiving a ruling from the IRS.

Authoritative tax law includes statutory, administrative, and judicial guidance. Statutory guidance includes the Internal Revenue Code, tax treaties and state tax laws. Administrative tax guidance may be used as precedent in a court of law (precedential authority), or may only be binding to the individual taxpayer (non-precedential authority). Examples of administrative guidance with precedential authority include Treasury Regulations, Revenue Rulings, and Revenue Procedures. Conversely, non-precedential authoritative guidance includes PLRs and Technical Advice Memorandums. While non-precedential authority is not binding on all taxpayers, it may provide insight on how the IRS may rule in similar facts and circumstances. Judicial guidance refers to guidance arising from decisions in court cases in within the appropriate taxing jurisdiction.

ASC 740 implications:

Accounting Standards Codification (ASC) 740 applies to all tax positions in a previously filed tax return or tax positions expected to be taken in a future tax return. Applying ASC 740 to determine how to recognize tax benefits in the financial statements is a two-step process of recognition (step 1) and measurement (step 2). When recognizing a tax position, an entity often must assess the positions technical merits under the tax law for the relevant jurisdiction to determine whether the tax position is more-likely-than-not to be sustained in the court of last resort.

> In making the required assessment of the more-likely-than-not criterion:
>
> a. It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.
>
> b. Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and

case law) and their applicability to the facts and circumstances of the tax position. When past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners, and auditors, those practices and precedents shall be taken into account.

c. Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with other positions.[4]

While the PLR is non-precedential authoritative guidance regarding whether the described transaction constitutes a "covered transaction" within the meaning of Treas. Reg. Section 1.263(a)-5(e)(3), it may still be helpful to companies that would like to understand how the IRS may rule in similar facts and circumstances. Evaluating whether a tax position meets the recognition criteria is not a one-time assessment, and must be considered at each reporting date. Any changes in judgment about whether a tax position meets the recognition criteria should be based on management's assessment of new information only, not on a new evaluation or interpretation of previously available information. While the PLR represents new information, it is not precedential administrative guidance and therefore companies should discuss the issue with their attest firm to determine whether the PLR may result in subsequent recognition of a tax benefit in the financial statements.

Convertible bond hedge issuances

Convertible bond hedge transactions once again are becoming popular in the marketplace. Convertible debt instruments (hereinafter “convertible note(s)” or “note(s)”) are debt instruments with an embedded option (the conversion feature) that can be converted into common stock in the issuing company at the option of the holder of the note. In addition to physical settlement, the conversion feature may be settled in cash or partially settled in cash. Because of the value associated with the embedded conversion option, a convertible note typically has a coupon rate lower than that of a similar, non-convertible note. Hence, convertible notes have traditionally been an inexpensive source of capital. However, the dilution to shareholders’ equity when the holder of the convertible notes converts the notes into shares is an indirect economic cost of the reduced interest payments. However, the issuer of the convertible notes can hedge against the dilution effect by entering into a call spread transaction.

In a typical call spread transaction, a convertible note is issued with a low coupon rate, and simultaneously the issuer purchases a call option[5] (the “hedge”) from one or more investment banks. The hedge has the effect of offsetting the conversion feature or the dilution effect of the note and is achieved by having a strike price the same as the conversion price of the note, as well as the same number of shares and maturity date. Additionally, the cost of the hedge is typically partially offset by the issuer writing or selling warrants[6] with the same terms but a higher strike price (out-of-the-money) to the investment banks. The warrants have a dilutive effect if the stock price exceeds the strike price of the warrants.

For federal income tax purposes, the issuer can integrate the note and the hedge to treat the combined cash flow of the note and the hedge as a synthetic debt instrument via an election available under Treasury Reg. Section 1.1275-6. This synthetic debt is equivalent to a fixed rate note issued at a discount. The discount is created by the cost paid by the issuer for the hedge. As such, both the stated

[4] ASC 740-10-25-7

[5] A call option refers to a right to acquire shares from the writer of the option that is not the issuer.

[6] Warrants typically refer to a right to acquire shares from the company.

interest and the interest cost created by the hedge are considered original-issue-discount (OID) for tax purposes to be amortized and deducted over the term of the convertible note. If this tax election is used, the warrants that are sold to defray the cost of the hedge need to be European type options, exercisable on a single day that is subsequent to the maturity of the notes. In that case, the proceeds from selling the warrants cannot be integrated because they cannot be exercised until after the notes mature and, therefore, are not part of the synthetic debt instrument. Instead, they are treated as equity. There are no income tax consequences to the issuer for selling the warrants or if the warrants expire worthless. Transaction costs (other than the costs of the call spread) incurred with the issuance of the synthetic debt instrument are not part of the synthetic debt instrument and are generally amortized and deducted over the term of the convertible note.

For financial reporting purposes, pursuant to ASC 470-20, convertible notes that may be settled in cash upon conversion (including partial cash settlement) are recognized as two separate components, a liability component and an equity component. The objective is to reflect the company's non-convertible debt interest cost in periods the convertible notes are outstanding. To achieve this objective, the carrying amount of the liability component is determined by measuring the fair value of a similar liability that does not have an associated convertible feature. The difference between the proceeds of the notes and the carrying amount of the liability component is the carrying amount of the equity component, recorded as an increase in equity and an equal amount of debt discount on the issuance date. The call option purchased (to economically hedge the dilution cost) and the warrants sold (to defray the cost of the hedge) are accounted for separately as equity transactions since they are considered to be financial instruments indexed to the issuer's own stock under ASC 815-40. Transaction costs incurred with third parties other than the holders that directly relate to the issuance of the convertible notes are allocated to the liability and equity components based on the relative carrying amounts under ASC 470-20-25-26.

ASC 740 implications:

A temporary difference is defined, under ASC 740-10-20, as "a difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively". Recognizing the convertible notes as two separate components under ASC 470-20 may result in a temporary difference associated with the liability component for purposes of applying ASC 740. The initial recognition of deferred taxes for the tax effect of this temporary difference is recorded as an adjustment to equity, pursuant to ASC 470-20-25-27. That guidance is also consistent with general intraperiod tax allocation guidance that requires the tax effects of an increase or decrease in contributed capital to be recorded in equity, pursuant to ASC 740-20-45-11c.

As described above, a convertible bond hedge transaction typically includes the issuance of a convertible note, the purchase of a call option to hedge the expense of dilution and the sale of warrants to defray the cost of the hedge. The convertible note proceeds are split into liability and equity components for financial reporting purposes, while the convertible note proceeds are not split for federal income tax purposes. The hedge is treated as equity for financial reporting purposes but integrated with the convertible note as a synthetic debt instrument for federal income tax purposes. Lastly, the warrants are treated as equity for both financial reporting and federal income tax purposes. The example below illustrates the ASC 740 implications with respect to a convertible bond hedge transaction.

- Issuer issues convertible notes with a $1,000 face value convertible into 20 shares of its stock, that is, the conversion price of the note is $50 per share (the common stock of the issuer at issuance is trading at $35 per share).

- The note has a 1% stated interest per annum and is scheduled to mature in five years.
- The issuer then purchases a call option (the hedge) from an investment bank allowing it to buy 20 shares of its own common stock at $50 per share, for $105.
- The issuer also writes or sells European type option warrants to the investment bank (can be the same or different bank from the one it purchase the hedge from), allowing the bank to purchase 20 shares of the issuer's common stock for $70 per share, for $45.
- The issuer incurs $10 of transaction costs associated with the issuance of the convertible notes.
- The issuer has a statutory tax rate of 35%.

For federal income tax purposes, the election is made to integrate the convertible notes and the hedge into a synthetic debt instrument with an issue price of $895, equal to the debt proceeds less amounts paid for the hedge. Both the stated interest and interest equal to the cost of the hedge (i.e., the $105) are considered OID for federal income tax purposes, amortized and deducted over the five-year term of the notes. Transaction costs of $10 are capitalized and will be amortized for tax over the same five years. Therefore, the synthetic debt instrument and the capitalized transaction costs together essentially have a net tax basis of $885 at the date of issuance.

For financial reporting purposes, pursuant to ASC 470-20, the carrying amount of the liability component is determined to be $900 (a debt discount of $100) and equity component $100. In addition, transaction costs are allocated to the liability and equity components based on the relative carrying amounts, $9 accounted for as debt issuance costs and $1 as equity issuance costs. Therefore, the liability component of the convertible notes and the capitalized transaction costs in aggregate has a carrying amount of $891 at the date of issuance for financial reporting purposes.

Accordingly, the deductible temporary difference on this convertible bond hedge transaction is $6 because the financial reporting basis is greater than the tax basis. A DTA, of $2.10 should be recorded and is subject to valuation allowance considerations.

Alternatively, the temporary differences on the convertible notes and the hedge can be recorded separately. The temporary difference on the convertible notes would be a taxable temporary difference and the temporary difference on the hedge would be a deductible temporary difference. Both would be recorded to equity based on the aforementioned accounting guidance.

Treasury issues final deemed asset sale election regulations

On May 10, 2013, the United States Treasury issued final regulations under Section 336(e) (the "Final Regulations") of the Internal Revenue Code of 1986, as amended (the "Code") (designated as Treas. Reg. Sections 1.336-0 through 1.336-5). The Final Regulations allow for domestic taxpayers (either as sellers or shareholders, as applicable) who are a party to a disposition (either by sale, exchange, or distribution) of the stock of a domestic corporate subsidiary (or S corporation) to elect (the "Election") to have the disposition treated as a disposition of the corporate subsidiary's (or S corporation's) assets rather than a disposition of the corporate subsidiary's (or S corporation's) stock. The potential benefit of the Final Regulations is the relief from triple taxation resulting from a sale of appreciated stock in a target corporation to an unrelated party without the benefit of a step-up in the basis of the target's underlying assets. Non-corporate buyers need to be aware of this Election.

Generally, Section 336(e) of the Code permits corporations, in certain circumstances, to elect to treat certain sales, exchanges, or distributions of the stock of their corporate subsidiaries as dispositions of the assets of the corporate subsidiaries as opposed to dispositions of the stock (i.e., no gain or loss recognized on the stock disposition). The Service took the position that the Election was not available until such time as the United States Treasury issued final regulations under Section 336(e) governing the availability and application of the Election.

The Final Regulations allow for corporations and their corporate subsidiaries (or S corporation shareholders and their S corporations, as applicable) to make such an Election in certain sales, exchanges, or distributions of 80% or more of the stock of their corporate subsidiaries (or S corporations) that occurs over a 12-month period. By making an Election, corporate taxpayers can legally dispose of the stock of a corporate subsidiary to non-corporate acquirers or non-corporate shareholders while the corporate subsidiary is deemed to have sold its assets for U.S. federal income tax purposes. The U.S. federal income tax consequences of such a sale are generally intended to be similar to those achieved when an election under Section 338(h)(10) is made (i.e., a deemed sale of assets from old target to a new target). Highlights regarding the Final Regulations and making an Election include the following:

- The Election is to be made jointly by the selling corporate taxpayer (or all S corporation shareholders) and the corporate (or S corporation) subsidiary (i.e., the target) by entering into a written, binding agreement to make an Election;
- In the case of certain qualifying stock dispositions that include distributions of target stock, the net losses realized by the target subsidiary with respect to the deemed asset sale (i.e., the amount of losses in excess of gains in the target subsidiary's assets) may be disallowed. To determine the amount of the net loss that is disallowed, if any, in general, the net loss realized is multiplied by a fraction equal to the value of the target stock distribution over the total value of the target stock disposition;
- Attribution rules between partnerships and partners under Section 318 are modified, solely with respect to the Election, for purposes of determining whether dispositions of a corporate subsidiary's stock are between related persons;
- An expanded application of the asset and stock consistency rules in Section 338 generally will apply to dispositions of a corporate subsidiary's stock if an asset of the corporate subsidiary is owned, immediately after its acquisition and on the disposition date, by a person (or by a related person to a person) that acquires at least 5% by value of the stock of the corporate subsidiary; and
- The deemed sale of assets from old target to new target (and the repurchase of new target stock by seller, if applicable) will be treated as a sale to (or acquisition from) an unrelated party for purposes of the anti-churning rules of Section 197(f)(9) and the wash sale rules of Section 1091.

ASC 740 implications:

ASC 805-740 requires recognition of a deferred tax liability (DTL) or deferred tax asset (DTA) as of the acquisition date for the taxable and deductible temporary differences between (1) financial reporting values of assets acquired and liabilities assumed and (2) the tax bases of those assets and liabilities.

The financial reporting basis in a taxable and nontaxable business combination is recorded at fair value. By making the 336(e) election, new target receives a step-up in the tax basis of its assets; this step-up in tax basis is recorded in connection with the business combination as an adjustment to goodwill and should be considered when determining the taxable and deductible temporary differences between the book and tax basis of the acquired assets on the acquisition date.

International

OECD report on base erosion and profits shifting (BEPS)

The Organization for Economic Cooperation and Development (OECD) released its first report on BEPS on February 12, 2013. The OECD report, "Addressing Base Erosion and Profit Shifting," is responding to the growing perception that governments lose substantial corporate tax revenue because profits are shifted to favorable tax locations and that traditional international tax principles may no longer be adequate for countries to develop appropriate responses to BEPS. The 91-page report was presented at the February 15-16 meeting of G20 finance ministers and central bank governors in Moscow.

The stated goal of this report is to present issues related to BEPS shifting in an objective and comprehensive manner. The G20 agreed that a problem exists and that action is needed. In a communique issued at the end of the Meeting of G20 Finance Ministers and Central Bank Governors in Moscow on February 16, 2013, the G20 Finance Ministers and Central Bank Governors stated:

> In the tax area, we welcome the OECD report on addressing base erosion and profit shifting and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July.

The report has garnered a great deal of attention. It was released contemporaneous with inquiries by the governments of Australia, France, Germany, the UK, and BRICS countries about the tax planning activities of the world's largest companies. In addition, the U.S. Senate Committee on Homeland Security and Governmental Affairs' Permanent Subcommittee on Investigations held a marathon session on May 21 to examine "structures and methods employed by multinational corporations to shift profits offshore and how such activities are affected by the Internal Revenue Code and related regulations."

The OECD is concerned that some multinationals have been able to reduce total taxes payable by structuring their operations such that a portion of global profits is earned by entities in low-tax or no-tax jurisdictions, while many expenses are deductible by entities domiciled in higher tax rate jurisdictions. In its report, the OECD observed:

> While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy. This reflects the fact that BEPS takes advantage of a combination of features of tax systems which have been put in place by home and host countries. This implies that it may be very difficult for any single country, acting alone, to effectively combat BEPS behaviors.

The OECD is calling for cooperation and coordination among all stakeholders to develop comprehensive solutions to what they see as an urgent need to address key pressure areas. The OECD has committed to issue a draft action plan as early as June 2013 to be presented to the G20 at their next meeting in July 2013. The draft action plan will include components to address key pressure areas, with proposals to develop:

- Instruments to put an end to or neutralize the effects of hybrid mismatch arrangements and arrangements that result in a tax arbitrage;
- Improvements or clarifications to transfer pricing rules, particular with respect to rules related to intangibles;
- Updated solutions to determine which jurisdiction has the right to tax, especially as it relates to digital goods and services;
- More effective anti-avoidance measures;
- Rules on the treatment of intra-group financial transactions; and
- Solutions to counter harmful preferential tax regimes.

The action plan will also propose solutions for quick implementation of changes to treaties and timely implementation of measures governments can agree upon.

ASC 740 implications:

It is important to recognize that the OECD proposals are not self-executing. Until any changes proposed by the OECD are actually implemented, e.g., in the form of enactment (by member countries) of new laws, the promulgation of new regulations, or the entering into force of new treaties or protocols to existing treaties, there may be very little impact on the accounting for income tax of any organization. ASC 740-10-30-2 states that "[t]he measurement of current and deferred tax liabilities and assets is based on provisions of enacted tax law; the effects of future changes in tax laws or rates are not anticipated."

Nonetheless, it may be necessary to consider the potential transfer pricing implications and the impact on the measurement of UTBs. The report comes at a time when governments are looking for additional revenues without increasing tax rates or broadening the tax base. The OECD report may have emboldened governments to more aggressively scrutinize the transfer pricing principles applied to arrangements that result in the shifting of profits away from their countries. Transfer pricing guidelines typically give broad authority to tax administrations to interpret the law.

ASC 740-10-05-6 states, "a tax position is first evaluated for recognition based on its technical merits. Tax positions that meet a recognition criterion are then measured to determine an amount to recognize in the financial statements. That measurement incorporates information about potential settlements with taxing authorities." An entity is permitted to recognize the financial statement effects of a tax position when it is more likely than not to be sustained upon examination based on its technical merits [ASC 740-10-25-6], which includes consideration of technical merits of a tax position derived from sources of authorities in the tax law, such as legislation and statutes, legislative intent, regulations, rulings, and case law. "Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon settlement using the facts, circumstances, and information available at the reporting date." [ASC 740-10-30-7]

Thus, while in the short term positions may meet the more-likely-than-not recognition threshold until tax authorities promulgate new regulations or issue new rulings (the latter generally accomplished in a shorter time frame than new legislation), the measurement of a tax position may be affected by more aggressive positions taken by tax authorities and the ultimate settlement that may be reached.

Colombia: Tax reform

On December 26, 2012, tax reform was enacted in Colombia that reduced the corporate income tax rate from 33% to 25% effective January 1, 2013 and introduced a new 9% tax. The new 9% tax (reduced to 8% beginning with the 2016 tax year), "impuesto sobre la renta para la equidad," which translated means "income tax for equitableness" ("CREE tax"), replaces the existing payroll tax and is imposed in addition to the regular corporate income tax. The tax rate reduction and new tax do not apply to foreign tax payers without a branch office or permanent establishment in Colombia. Additionally, the CREE tax does not apply to certain entities that operate in a free trade zone.

The CREE tax is calculated on a modified taxable income base, which cannot be lower than 3% of the net equity as of the last day of the prior year. For CREE purposes, taxable income is modified to exclude certain costs and items of income, including, for example, the super-deduction for investments in certain tangible productive fixed assets and capital gains from the sale of fixed assets. The CREE tax modified income base cannot be offset by corporate loss carryovers. CREE taxes are not deductible for the purpose of calculating regular corporate income tax.

Because the base on which the CREE tax is calculated cannot be lower than 3% of prior year net equity, the CREE tax functions like a minimum tax.[7] Also, while this area of tax law is not well developed, it may be possible to treat taxes paid based on 3% of net equity as a tax credit carryforward (available for 5 years) to the extent that such equity based taxes exceed the CREE tax calculated on the modified taxable income base.

ASC 740 implications:

Scope

Since the CREE tax may be calculated on either a modified measure of taxable income or on net equity, questions have arisen as to whether the CREE tax is a tax within the scope of ASC 740 (i.e., whether it is an income tax).

In addressing the scope of ASC 740, Section 740-10-15-3 includes "taxes based on income" and the subsequent paragraph excludes "a franchise tax to the extent it is based on capital".

We believe that the CREE is an income tax only to the extent that the tax exceeds the equity-based component in a given year. The tax on the equity-based component is not an income tax, and should be accounted for "above the line" as a reduction of profits before tax.

An analogous example is provided in ASC 740-10-55-139 through 55-144, addressing questions raised when in 1991 the state of Texas amended its franchise tax statute to include a tax on income apportioned to Texas based on the federal return. The franchise tax was payable on the greater of 0.25% of the corporation's net taxable capital or 4.5% of the corporation's net taxable income. The FASB concluded in the example that the total computed tax is an income tax "only to the extent that the tax exceeds the capital-based tax in a given year". The FASB further concluded that "…the accounting described above would be appropriate if the tax structure of another state was essentially the same as this Example."

Deferred tax

Corporate income tax – Deferred taxes for corporate income tax related temporary differences should be measured at the new 25% tax rate.

[7] The CREE tax is an additional tax and not an alternative minimum tax (AMT) and therefore ASC 740 guidance related to AMT systems is not applicable.

CREE Tax – Pursuant to ASC 740-10-55-144, entities should recognize deferred taxes for temporary differences that will reverse in years for which the total CREE tax will exceed the equity-based component of the CREE tax. This guidance also refers to ASC 740-10-55-138 to determine whether a detailed analysis of net reversals of temporary differences in each future year is warranted. When measuring deferred taxes for CREE tax purposes, entities should consider the reduced tax rate beginning with the 2016 tax year.

As discussed above, the CREE tax is based on a "modified income base" and thus temporary differences and carryovers related to the CREE tax may be different than temporary differences related to corporate income taxes. As such, entities may need to maintain separate inventories of temporary differences and carryovers for corporate income tax purposes and CREE tax purposes (e.g., an entity may conclude that it is appropriate to recognize a DTA for NOLs at the corporate tax rate of 25%, but would not recognize a DTA for the corporate NOLs for CREE tax purposes and similarly tax credit carryforwards for CREE tax purposes may not be available to offset corporate income tax).

Multistate

Virginia provides final guidelines on single-sales-factor apportionment election for manufacturers and phase-in of single-sales-factor apportionment for retailers

Overview

The Virginia Department of Taxation (the "Department") issued final guidelines on January 7, 2013 with respect to the manufacturer's election to use single-sales-factor apportionment for corporate income tax purposes.[8] The election, codified at Va. Code Ann. Section 58.1-422, allows qualifying manufacturers to use a modified apportionment factor for tax years beginning after July 1, 2011.[9] The Department had issued amended draft guidelines on August 30, 2012 regarding the election. The final guidelines incorporate the changes resulting from the 2012 General Assembly (House Bill (H.B.) 460 Chapter 427 of the 2012 Acts of the Assembly) and certain public comments received regarding the draft guidelines.

Also, in 2012 Virginia adopted mandatory single-sales-factor corporate income tax apportionment for retailers.[10] This mandatory apportionment formula is being phased in beginning July 1, 2012.

Manufacturer election to use single-sales-factor apportionment

Taxpayers in Virginia generally use a three-factor apportionment formula (with double-weighted sales). Va. Code Ann. Section 58.1-422 allows qualified Virginia manufacturers to elect to use a modified apportionment factor that, when fully

[8] The Department's guidelines, issued on January 7, 2013, may be accessed at: **http://www.tax.virginia.gov/Documents/2012_Single_Sales_Factor_Guidelines.pdf**.

[9] H.B. 2437, Chapter 821 of the 2009 Acts of the Assembly.

[10] Va. Code Ann. Section 58.1-422.1 as added by H.B. 154, Chapter 86 of the 2012 Acts of the Assembly, and S.B. 49, Chapter 666 of the 2012 Acts of the Assembly.

phased in, will provide for single-sales-factor apportionment. The election is binding for three years, and the single sales factor will be gradually phased in over a three year period.

Va. Code Ann. Section 58.1-422 defines a “manufacturing company" as a domestic or foreign corporation primarily engaged in activities that in accordance with the North American Industry Classification System (NAICS) would be included in Sectors 11, 31, 32, or 33.[11] Under the guidelines, “primarily engaged” means that either 50% or more of the gross receipts are derived from the sale of goods that are manufactured by the taxpayer, or 50% or more of the employees are engaged in manufacturing activities.[12]

Retailer mandatory single-sales-factor apportionment

For retailers, a mandatory single-sales-factor apportionment formula is being phased in beginning July 1, 2012.[13] Currently, the only requirement for this mandatory apportionment provision is that the “retail company” must be a domestic or foreign corporation primarily engaged in activities that, in accordance with NAICS, would be included in Sectors 44-45. For retailers, the sales factor will be gradually phased in over a three year period.

For additional details regarding the manufacturer’s election to use single-sales-factor apportionment, please see **Multistate Tax Alert: Virginia Update – January 18, 2013**.

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. Manufacturers that have elected or plan to elect to utilize the single-sales-factor apportionment formula and retailers that are required to adopt the single-sales-factor apportionment formula, should be measuring deferred taxes accordingly.

Companies should assess whether the Department’s final guidelines impact the measurement of DTAs and DTLs. 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 January 7, 2013.

UTBs – Taxpayers that do not intend to follow the guidance provided by the Regulations should take the Regulations into account when measuring UTBs, interest, and penalties related to uncertain tax positions.

[11] NAICS is used to classify businesses according to the type of activity. Activities are grouped by Sectors. Sector 11 includes Agriculture, Forestry, Fishing, and Hunting. Sectors 31-33 cover a variety of Manufacturing Activities. The full list of Sector Codes can be viewed at: **http://www.naics.com/info.htm**.

[12] The amended draft guidelines defined “primarily engaged” to mean that either 50% or more of the gross receipts are derived from the sale of goods that are manufactured in Virginia, or 50% or more of the employees are engaged in manufacturing activities within Virginia. These controversial requirements limiting the election to companies with certain levels of manufacturing activity within Virginia were not embodied in the final guidelines.

[13] Va. Code Ann. Section 58.1-422.1 as added by H.B. 154, Chapter 86 of the 2012 Acts of the Assembly, and S.B. 49, Chapter 666 of the 2012 Acts of the Assembly

New Mexico reduces the corporate tax rate, imposes mandatory combined reporting on certain retailers, phases-in elective single-sales-factor apportionment and a gross receipts tax deduction for manufacturers, and modifies certain credits

Overview

New Mexico Governor Susana Martinez signed H.B. 641[14] on April 4, 2013, which includes the following modifications to New Mexico tax law:

1. Phases in, over five years, corporate income tax rate reductions.
2. Requires combined reporting for certain unitary corporations engaged in retail sales.
3. Phases in, over five years, elective single-sales-factor apportionment for eligible manufacturing corporations and eliminates throwback for electing corporations.
4. Amends the gross receipts tax deduction for tangible property consumed in the manufacturing process.
5. Extends the high-wage jobs tax credit and tightens the criteria for qualification.
6. Allows municipalities and counties to impose a local option gross receipts tax.
7. Expands the scope of the film production tax credit and requirements for eligibility.

Corporate income tax rate

Effective January 1, 2014, H.B. 641 amends the Corporate Income and Franchise Tax Act to phase in a corporate income tax (CIT) rate reduction between taxable years 2014 and 2018, however, the corporate income tax rate of 4.8% that currently applies to net income of $500,000 or less remains unchanged.[15]

Mandatory combined reporting for certain unitary retail corporations

For taxable years beginning from and after January 1, 2014, all unitary corporations making retail sales of goods in a facility of more than 30,000 square feet in New Mexico must file a combined CIT return with other affiliated unitary corporations as though the entire combined net income were that of one corporation.[16] A unitary retail corporation will not be subject to mandatory combined filing under this provision if: (1) it has operations in New Mexico at facilities that do not provide retail sales of goods, and (2) it employs at least 750 employees at such facilities. The unitary entities must continue to file on a combined basis unless an election is made to file a consolidated return or permission is granted to file otherwise.[17]

Elective single-sales-factor apportionment for manufacturing corporations

Effective for taxable years beginning from and after January 1, 2014, H.B. 641 amends the Corporate Income and Franchise Tax Act to phase in over five years an elective single sales factor for businesses engaged in manufacturing. "Manufacturing" means combining or processing components or materials to

[14] Laws 2013, Chapter 160, 1st Regular Session; adopted Apr. 4, 2013, effective Jun. 14, 2013.

[15] Laws 2013, Chapter 160, Sec. 3, amending Section 7-2A-5 NMSA 1978.

[16] Laws 2013, Chapter 160, Sec. 4, amending Section 7-2A-8.3(A) NMSA 1978.

[17] Laws 2013, Chapter 160, Sec. 4, amending Section 7-2A-8.3(B) NMSA 1978.

increase their value for sale in the ordinary course of business, but does not include construction, farming, power generation, or the processing of natural resources. In tax year 2014, the elective sales factor is double weighted, and will transition to an elective triple-weighted sales factor in tax year 2015. For tax year 2016, a 70% weighted sales factor may be elected, while for tax year 2017, an 80% weighted sales factor election may be made. Beginning tax year 2018, a 100% weighted sales factor may be elected.[18]

The election must be made in writing and will remain in effect until the taxpayer notifies the Taxation and Revenue Department that the election is terminated. The election must remain in effect at least three taxable years containing 36 calendar months.[19]

Impact of super-weighted sales factor on throwback

Effective for taxable years beginning from and after January 1, 2014, a manufacturer that elects the super-weighted sales factor is not subject to throwback to New Mexico for sales into states where the manufacturer is not subject to tax.[20]

Film production credit provisions

H.B. 641 amends Section 7-2F-1 NMSA 1978, to allow for an additional 5% film credit against CIT and personal income tax liability for certain direct production expenditures. The amended law also: (1) tightens the personal income tax provisions on performing artists by requiring withholding when the artist has an equity interest in the production, and (2) excludes expenditures from qualifying for the credit when the goods or services are supplied by nonresidents whether hired or subcontracted by an in-state vendor. Several additional changes made to these credit provisions are discussed further in the Multistate Tax Alert.

For additional information related to New Mexico House Bill 641, see **Multistate Tax Alert – April 18, 2013.**

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. Manufacturers that plan to elect to utilize the single-sales-factor apportionment formula and eliminate sales factor throwback should be measuring deferred taxes accordingly.

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 April 4, 2013.

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

Intraperiod tax 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

[18] Laws 2013, Chapter 160, Sec. 7, amending Section 7-4-10 NMSA 1978

[19] *Id.*

[20] Laws 2013, Chapter 160, Sec. 8, amending Section 7-4-17 NMSA 1978.

DTA or DTL was established through an item other than continuing operations (i.e., other comprehensive income, discontinued operations).

Minnesota enacts Omnibus Tax Bill with changes to corporate income tax provisions, personal income tax rate, and sales and use tax

Overview

On May 23, 2013, Minnesota Governor Mark Dayton signed House Bill 677 ("H.F. 677").[21] The bill amends Minnesota tax law in the following manner:

- Eliminates certain corporate income tax subtraction modifications, adopts a Finnigan sales factor sourcing rule and modifies the utilization of the Research and Development Credit.
- Creates a new 4th tier individual income tax bracket for high income earners and increases the AMT rate.
- Repeals the provisions of Minnesota tax law incorporating the Multistate Tax Compact.
- Expands the sales tax base to include certain services, expands the definition of nexus and provides an up-front exemption for purchases of capital equipment.

Many of these tax changes were proposed in Governor Dayton's budget released on February 22, 2013[22] and revised on March 14, 2013.[23]

Corporate income tax

Effective for taxable years beginning after December 31, 2012, H.F. 677 makes the following amendments to the corporate income tax:

- The dividend received deduction for dividends paid by a Real Estate Investment Trust to a corporation is eliminated.[24]
- The foreign royalty subtraction is eliminated.[25] Under prior law, taxpayers were allowed to subtract 80% of certain royalties, fees and other income received from foreign corporations that were part of the same unitary business.[26]
- The income and apportionment provisions relating to foreign operating corporations are eliminated.[27] Under prior law, companies that qualified as a foreign operating corporation (FOC) were excluded from the Minnesota

[21] Chapter 143, H.F. No. 677, 2013 Regular Session, available at **https://www.revisor.leg.state.mn.us/bills/text.php?number=HF677&session_year=2013&session_number=0&version=latest**

[22] Budget for a Better Minnesota: Governor Mark Dayton's FY 2014-15 Budget Recommendations, available at: **http://www.mmb.state.mn.us/doc/budget/bud-op/op14/gov-presentation.pdf**

[23] Budget for a Better Minnesota: Governor Mark Dayton's FY2014-15 Supplemental Budget, available at: **http://www.mmb.state.mn.us/march14-13**

[24] Minnesota Statutes 2013, Section 290.21, subdivision 4(c), amended by H.F. 677, 129.28.

[25] Minnesota Statutes 2013, Section 290.01, subdivision 19d, amended by H.F. 677, 107.22.

[26] Minnesota Statutes 2012, Section 290.01, subdivision 19d(10).

[27] Minnesota Statutes 2013, Section 290.01, subdivisions 19c(11), (20), (21), (22), (23) and Section 290.17, subdivision 4(g) amended by H.F. 677, 103.21, 104.15, 105.1, 105.18, 105.23 and 124.11.

unitary filing group. The FOC's income was then added back to the unitary group's net income through a deemed dividend with the unitary group subsequently receiving an 80% dividend received deduction.[28] As a result of the law changes enacted by H.F. 677, the FOC characterization is no longer relevant.

- The income of a foreign entity, other than an entity treated as a C corporation for federal income tax purposes, that is included in the federal taxable income of a domestic corporation, domestic entity, or individual must be included in determining the net income of a unitary business.[29] In this situation, a proportionate share of the apportionment factors of the foreign entity will also be included in the apportionment factor of the unitary business. Under prior law, the income and apportionment factors of any foreign entity were excluded from the Minnesota unitary return.[30]
- All sales sourced to Minnesota of a unitary business are now included in the sales factor numerator regardless of whether the specific unitary member making the sale has nexus in Minnesota (i.e., Finnigan apportionment approach).[31] Under prior law, only Minnesota-sourced sales of a unitary member having nexus with Minnesota were included in the numerator of the Minnesota sales factor (i.e., Joyce apportionment approach).[32]
- The previously refundable Research and Development Credit is now nonrefundable. However, any excess credit must be applied against the tax of another unitary group member with a liability.[33] Any excess credit is carried forward to each of the 15 succeeding taxable years.[34]

Multistate Tax Compact

H.F. 677 repeals Minnesota Statutes 2012, Section 290.171, the remaining element of the Multistate Tax Compact previously contained in Minnesota tax law.[35] However, H.F. 677 adds statutory authority authorizing the Minnesota Department of Revenue to participate in audits performed by the Multistate Tax Commission.[36]

For additional information related to the Minnesota Omnibus Tax Bill, please see **Multistate Tax Alert – May 24, 2013**.

ASC 740 implications:

Deferred taxes

Measurement – Deferred taxes should be measured using the applicable tax rate expected to apply in the periods in which the DTA or DTL is expected to be realized

[28] Minnesota Statutes 2012, Section 290.01, subdivision 19c (11).

[29] Minnesota Statutes 2013, Section 290.17, subdivision 4(f), amended by H.F. 677, 123.33; Section 290.17, subdivision 4(g), amended by H.F. 677, 124.35.

[30] Minnesota Statutes 2012, Section 290.17, subdivision 4(f). Generally speaking, the income and apportionment factors of foreign flow-through entities will be impacted by this law change.

[31] Minnesota Statutes 2013, Section 290.17, subdivision 4(h), amended by H.F. 677, 125.16.

[32] Minnesota Statutes 2012, Section 290.17, subdivision 4(j)

[33] Minnesota Statutes 2013, Section 290.068, subdivision 6a, amended by H.F. 677, 113.9; Section 290.068, subdivision 3, amended by H.F. 677, 112.22.

[34] Minnesota Statutes 2012, Section 290.68, subdivision 3(b)

[35] Minnesota Statutes 2013, Section 290.171, amended by H.F. 677, 277.16. As a result of the enactment of H.F. 677, it would appear that Minnesota no longer is a full member of the Multistate Tax Compact. Since no enactment date was specified in the bill, the repeal of the Multistate Tax Compact will be effective August 1, 2013 per Minnesota Statute 645.02.

[36] Minnesota Statutes 2013, Section 270C.03, subdivision 1(9), amended by H.F. 677, 266.15.

or settled. 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 May 23, 2013.

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

Intraperiod tax 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 (e.g., other comprehensive income, discontinued operations).

Changes to D.C. Qualified High Technology Company incentive enacted; BAE decision upheld

Overview

On November 1, 2012, District of Columbia Mayor ("Mayor") Vincent Gray signed Bill 19-0747, the Technology Sector Enhancement Act of 2012 ("Act"). The Act introduced a number of changes to the treatment of Qualified High Technology Companies (QHTCs), including an expansion of the five-year franchise tax exemption to qualifying taxpayers regardless of location in the District. The Act was submitted to Congress on January 10, 2013, pursuant to the District of Columbia Home Rule Act. The Act became law on March 5, 2013 (Law #L19-0211). The provisions apply to tax years beginning on or after January 1, 2012, with certain changes potentially affecting tax periods prior to January 1, 2012.

The **Multistate Tax Alert – March 28, 2013** summarizes certain provisions of the Act and discusses the District of Columbia Court of Appeals' recent decision *in District of Columbia Office of Tax and Revenue v. BAE Systems Enterprise Systems Inc*., which addressed the QHTC "base of operations" requirement.

Overview of the QHTC Program

Incentives for QHTCs were enacted in 2000 by the District's City Council to attract certain types of technology business to the District. Under these provisions, a business had to meet the following requirements to be eligible for the incentives:

1. Be an individual or entity organized for profit;
2. Maintain an office, headquarters, or base of operations in the District;
3. Have two or more employees;
4. Be registered to do business in the District and be current in all District filing requirements and payment obligations; and
5. Derive at least 51% of its gross revenues from qualifying activities.

The various activities from which companies must generate revenue in order to qualify as a QHTC include: Internet-related services and sales, information and communication technologies, bioprocessing, engineering, and defense technologies. Qualified companies are entitled to various incentives, including but not limited to the following:

1. A reduced corporate income tax rate of 6%, instead of the District's normal tax rate of 9.975%;
2. A five-year exemption from payment of corporate franchise tax for qualified taxpayers in high technology development zones;
3. Job-related franchise tax credits;

4. Sales tax exemptions on certain purchases and sales; and
5. Property tax abatements.

Qualifying companies must self-certify to claim the benefits by submitting Form QHTC-CERT and other required forms with any tax return in which the benefits are claimed.

How the Act impacts the QHTC incentives

The Addition of the Phrase "in the District"

The Act amends the D.C. Code Section 47-1817.01(5)(A) definition of a QHTC by adding the phrase "in the District" to subsections (ii) and (iii). As a result of this change, the revised sections now read (emphasis added) as follows:

D.C. Code Section 47-1817.01(5)(A) "Qualified High Technology Company" means:

1. An individual or entity organized for profit and maintaining an office, headquarters, or base of operations in the District of Columbia;
2. Having 2 or more employees in the District; and
3. Deriving at least 51% of its gross revenues earned in the District from qualifying activities.

Prior to the Act, with respect to the gross revenues requirement under D.C. Code Section 47-1817.01(5)(A)(iii), it would appear that at least 51% of the entity's total gross revenues must come from qualifying activities. Under the Act, taxpayers claiming QHTC status will now evaluate only District sourced gross revenues for purposes of the 51% test. The change to the statute may disqualify companies that generate at least 51% of their gross revenues from qualifying activities as a whole, but generate less than 51% of their District gross revenues from qualifying activities in the District. However, other companies that generate at least 51% of their total District gross revenues from qualifying activities may now qualify as a QHTC even if their gross revenues outside of the District are primarily from non-qualifying activities.

Franchise tax exemption expansion and franchise tax cap

Under D.C. Code Section 47-1817.06 (a)(2) prior to amendment, a QHTC in a "high technology development zone" was entitled to a franchise tax exemption for a period of five years after the date that the QHTC commenced business in the high technology development zone. After the five-year period, the QHTC continued to be entitled to the 6% reduced rate. Under the Act, D.C. Code Section 47-1817.06 (a)(2)(A) was amended so that taxpayers no longer have to be located in a high technology development zone to receive the five-year franchise tax exemption. The statute states that for QHTCs certified prior to January 1, 2012, the five-year franchise tax exemption begins as of the date the QHTC commences business in the District. Taxpayers should consider whether as a result of this amendment there may be a potential opportunity for a QHTC operating outside of a high technology development zone to amend prior year returns open under the statute of limitations if the QHTC commenced business in the District within the prior five years. The amended statute also states that for QHTCs certified on or after January 1, 2012, the five-year exemption begins as of the date that the QHTC has taxable income.

In addition, amended D.C. Code Section 47-1817.06(a)(2)(B) imposes a new limitation on a QHTC that claims the five-year exemption. This limitation imposes a cap of $15 million on the total amount of District franchise taxes that each QHTC may claim under the five-year exemption. Once the cap is met, a QHTC will no longer be eligible for the full franchise tax exemption. However, the QHTC would presumably still be entitled to the reduced 6% tax rate.

Proposal to Tax Capital Gains from the Sale of Stock in a QHTC at 3%

An earlier version of the Act contained a provision that would have reduced the District's capital gain tax from the regular rate to 3% for investors who sell shares of stock in a QHTC held continuously for more than 24 months if the QHTC was headquartered in the District as of the date of the sale. The proposed provision had an effective date of January 1, 2013. However, it appears that the City Council determined that additional time was needed to understand the impact of the provision. Thus, the final Act did not include this provision and instead included a provision authorizing a study of the matter.

OTR vs. BAE Systems

In light of the Act's changes to the QHTC program, the November 2012 decision in the BAE court case is particularly relevant. On November 29, 2012, the District of Columbia Court of Appeals affirmed the 2010 Office of Administrative Hearings (OAH) decision in favor of the taxpayer, BAE Systems. BAE had claimed QHTC income tax incentives in 2001 and 2002 using customer locations in the District as the company's "base of operations," as the taxpayer had hundreds of employees who reported to these locations on a regular, 40-hours-per-week basis. The OTR denied the benefits, claiming that these locations did not qualify as a base of operations. Although both the OAH and the Court of Appeals generally defer to an agency's interpretation of its own regulations, both found that the OTR was reinterpreting the statute and regulation without concrete guidance. The Court identified examples where the OTR's interpretation of the term "base of operations" for purposes of the QHTC program contradicted other guidance and interpretations. Accordingly, the Court upheld the OAH decision. Based on this case, a taxpayer with employees working in the District on a regular basis should consider whether QHTC status may be applicable, even if the taxpayer does not own or lease real property in the District.

For additional information related to the Technology Sector Enhancement Act of 2012 or the BAE decision, please see **Multistate Tax Alert – March 28, 2013**.

ASC 740 implications:

Current taxes

Companies should consider the impact of the Act in addition to the Court's decision when calculating their current tax expense and current payable for the current and prior period.

Deferred taxes

Measurement – Deferred taxes should be measured using the applicable tax rate expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. A change in tax law must be accounted for in the period during which the law change occurs.

New information must also be accounted for in the period in which it becomes available. With respect to the Court's decision, this would include November 29, 2012. Companies should assess whether the decision impacts the measurement of DTAs or DTLs, as well as any related valuation allowance.

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.

Did You Know?

Income tax in valuations

As a tax specialist, one can expect to receive questions at times about how income taxes should be considered when determining the value of an asset or enterprise. Specifically, income taxes are an important factor when measuring the fair value of assets acquired in a business combination and when impairment testing individual assets or goodwill.

In measuring fair value under the income approach[37] on a post-tax basis (i.e., a discounting of after-tax cash flows) there are two distinct tax related cash flows that must be considered:

Tax costs – When an entity uses the income approach on a post-tax basis to calculate the fair value of a nonfinancial asset or business enterprise, the measurement should include tax costs and tax rates that a market participant would expect to incur. One such tax cost is related to the payment of income taxes on the income of the asset(s) or business being valued. As a result, the price expected to be received from the sale of assets is influenced or altered by the relevant taxation effects expected by any market participant that owns such assets; thus, an income approach should include expected income tax outflows in the determination of fair value.

Tax amortization benefits (TABs) – When an entity uses an income approach on a post-tax basis to measure the fair value of a nonfinancial asset or a business enterprise (e.g., for the purpose of goodwill impairment testing), the fair value measurement should consider tax benefits that a market participant would expect to receive for amortization expense that will be deducted on its tax return(s) in the future.

For example, when using an income approach on a post-tax basis to measure the fair value of an intangible asset, an entity should include all incremental cash flows. These would include the impact on cash flows resulting from future income tax deductions for the asset's amortization expense (commonly referred to as tax amortization benefits or TABs) that a market participant would expect to receive. A market participant would expect to receive the TABs if the jurisdiction in which the transaction is consummated allows an amortization deduction for the type of assets being valued. An entity must use judgment in determining the likely market participant and the existence and amount of TABs.

For the purpose of determining tax amortization benefits:

- In valuing a *nonfinancial asset*, an entity should generally calculate the TABs using the fair value of the asset itself consistent with the assumption that it would be bought or sold in a taxable transaction regardless of whether acquired or expected to be acquired in a taxable or nontaxable transaction. This guidance on TABs is consistent with that in paragraph 129 of Appendix A in former FAS 109, which notes that the amounts assigned to the fair value of assets should not be net of any related DTL or DTA. It is also consistent with the guidance in Chapter 5 of the AICPA practice aid on assets acquired in a business combination to be used in research and development,[38] which contains helpful examples.

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[37] ASC 820, Fair Value Measurement Subtopic ASC 820-20 Glossary: The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts.

[38] AICPA Practice Aid, Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries

- When determining the fair value of a *reporting unit* (RU) for goodwill impairment testing, an entity should consider TABs using the income tax bases of assets and liabilities consistent with the assumption as to whether the RU would be bought or sold in a taxable or nontaxable transaction. Such computations will be based on the facts and circumstances of the situation presented. When testing the goodwill of a RU for impairment in particular, significant judgment can be required in determining the tax status of the transaction (see further discussion in The Goodwill Impairment Test section).

Tax rates used in valuation techniques – An entity would generally use the statutory income tax rate unless there is substantial evidence that another tax rate should be used based on assumptions regarding the market participant. Under ASC 820, fair value is determined from a market participant's perspective to achieve a market-based measurement when pricing an asset or liability. Therefore, entity-specific data, such as an entity's own effective tax rate or the fact that the entity is not taxable (i.e., a partnership), are usually irrelevant.

Nonfinancial asset example – Assume a nonfinancial asset was estimated to produce a pretax cash flow of $2,000 each year for 3 years in a jurisdiction where the market participant tax rate is 40% (T) and the jurisdiction allows tax amortization by a buyer on a straight line basis over 15 years. Further, the present value annuity factor over the 15 year straight-line tax life at a 15% discount is 0.418. While calculated with a formula in this example, the TABs is the value of future tax deduction over the next 15 years using a 40% tax rate and discounted to present value.

Estimated cash flows	**Year 1**	**Year 2**	**Year 3**
Pretax cash flows	$2,000	$2,000	$2,000
Income taxes	***$(800)***	***$(800)***	***$(800)***
Cash flows on a post-tax basis	$1,200	$1,200	$1,200
Present-value factor at 15%	87%	76%	66%
Present value of post-tax cash flows	$1,044	$907	$789
Present value cash flows excluding tax amortization benefit (PVCF)			$2,740
Tax Amortization Benefit (PVCF x [1/(1-PVA*T)-1])			**$550**
Fair Value of Asset			**$3,290**

The goodwill impairment test – The calculation of fair value, including the effect of income taxes, is an integral part of the goodwill impairment test. As part of the goodwill impairment test, income taxes should be considered in both the step 1 RU fair value calculation and in step 2 when assigning fair value to assets and liabilities in order to determine the implied fair value of goodwill of a RU as discussed further below.

When an entity is performing a goodwill impairment test, the measurement of a RU's fair value should contain an assumption as to whether the RU would be bought or sold in a taxable or nontaxable business combination. An entity's assumption about whether a RU would be bought or sold in a taxable or nontaxable business combination is a matter of judgment and will depend on facts and circumstances. An entity should consider (1) whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value, (2) the feasibility of the assumed structure, and (3) whether the assumed structure results in the highest value to the seller for the RU, including consideration of related tax implications. For purposes of determining the highest value to the seller, the gross proceeds expected to be realized from a sale should be reduced by what the seller's tax cost would be consistent with the assumed structure. In addition, an entity must also consider the following factors (not all-inclusive) when assessing whether it is appropriate to assume a nontaxable transaction (1) whether the RU could be sold in a nontaxable transaction and (2) whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity's ability to treat a sale of the unit as a nontaxable transaction.[39]

The assumed tax status of transaction determined above can affect measurements under both steps of the goodwill impairment test:

- *Step one of goodwill impairment test* – In step one, the fair value of a RU is compared to its carrying value. If the carrying value is less than fair value, then step two of the impairment test must be performed.

  ASC 350-20-35-7 states that the deferred taxes related to the assets and liabilities of the RU should be included in the carrying value of the RU. This is true regardless of whether the entity assumes, in its determination of the fair value of the RU, that the RU would be bought or sold in a taxable or nontaxable business combination. In determining whether to assign DTAs associated with NOL and tax credit carryforwards to a RU, an entity should consider guidance from ASC 350-20-35-39 and 35-40. If an entity has recorded a valuation allowance at the consolidated level and files a consolidated return, it should allocate the valuation allowance on the basis of the DTAs and DTLs assigned to each RU. Other examples of corporate items that may be assigned to a RU, include UTBs or potential tax indemnification expected to be provided to the buyer based on the assumed disposal structure.

  As discussed previously, when determining the fair value of a RU using the income approach on a post-tax basis, entities should consider potential TABs under the assumed taxable or nontaxable transaction structures. That is, an entity may use its existing income tax bases to calculate TABs if the assumed structure used to estimate the fair value of the RU was a nontaxable transaction and it shall use new income tax bases (i.e. after step-up) to calculate TABS if the assumed structure was a taxable transaction. The expected TABs can impact how the RU is valued overall but would not impact how individual assets are valued in step two of the impairment test discussed below.

  Tax costs are the same regardless of the transaction type when an income approach on a post-tax basis is used to calculate fair value.

- *Step two of goodwill impairment test* – In step two, the implied fair value of the goodwill of the RU is determined by assigning the fair value of the RU used in step 1 to all the assets and liabilities of that RU (e.g., deferred taxes, UTBs, and indemnifications) as if the RU had been acquired in a business combination. The fair value of individual assets and liabilities is not impacted by the taxable or nontaxable transaction assumptions.

  For the purpose of determining the implied fair value of goodwill of a RU, the value assigned to DTAs and DTLs for temporary differences should be

[39] Many RUs include a mix of divisions and subsidiaries. The authoritative literature appears to only contemplate the RU as a whole being sold in either a taxable or nontaxable transaction. It may be that market participants would be likely to purchase the RU in a mixed transaction both taxable and nontaxable in order to optimize the value of a potential transaction. Where the accounting literature does not contemplate this situation, an entity should consult with its advisors as to whether a mixed transaction assumption may be used in the valuation of a RU.

consistent with the assumed tax status of the transaction (i.e., use existing income tax bases if the assumed structure is a nontaxable transaction or use new income tax bases if the assumed structure is a taxable transaction).

For additional information on income taxes in asset impairments also see the **Issue 2 of the May 2013 Media and Entertainment Spotlight Impairment of Unamortized Film Costs**.

U.S. GAAP – IFRS difference background

Both U.S. GAAP and International Financial Reporting Standards (IFRSs) require comprehensive recognition of deferred taxes resulting from differences between the carrying amount of an asset or liability and its tax base. ASC 740, however, does not define "tax basis." U.S. GAAP does provide guidance that an asset's tax basis is not determined simply by the amount that is depreciable for tax purposes but also considers tax basis deductible upon sale or liquidation of the asset.

Under IFRSs, International Accounting Standard (IAS) 12.7 defines the tax base of an asset as "the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount."

Under IFRS, when an asset's tax basis for depreciation could differ from that for a sale, the appropriate tax basis is determined according to whether the asset will be held and used or sold.

Under IFRS, if an asset is not eligible for tax depreciation or amortization, and management has no intention of selling it to realize the tax basis that would be available should the asset be sold, the tax basis of the asset would be zero. Note that upon the initial acquisition of such an asset, no DTL may have been recognized on this temporary difference (book carrying amount over zero tax basis) because of the application of the initial recognition exemption under IAS 12.15. However, if the same asset were acquired in a business combination, a DTL would have been required to be recognized.

European Union (EU) endorsement received for 2010 amendments to IAS 12 for deferred tax on investment properties

In December 2010, the IASB published *Deferred Tax: Recovery of Underlying Assets – Amendments to IAS 12* ("the Amendments"). The Amendments introduce a rebuttable presumption for investment properties measured at fair value, that the carrying amount of the investment property will be recovered entirely through sale.

For foreign private issuers who file IFRS reports with the SEC and other entities that issue financial statements in conformity with IFRSs as issued by the International Accounting Standards Board (IASB), the Amendments were effective for annual periods beginning on or after January 1, 2012, however, European entities could not adopt them until endorsed by the EU. The Amendments received EU endorsement on December 29, 2012, with mandatory EU adoption deferred until January 1, 2013.

IAS 40 defines an investment property as "property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both rather than for:

- Use in the production or supply of goods or services or for administrative purposes; or
- Sale in the ordinary course of business"

The Amendments introduced IAS 12 paragraph 51C, which provides a 'rebuttable presumption' that the carrying amount of the investment property measured using the fair value model in IAS 40 will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of deferred tax shall reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale.

The presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits over time, rather than through sale, in which case deferred tax shall be measured under the general principles of IAS 12 – consistent with the expected manner of recovery.

Effect on the recognition of existing deferred taxes

The Amendments will have the greatest effect on companies operating in jurisdictions where tax law provides for differing tax bases for an investment property depending on whether the carrying value is recovered through use or sale.

Entities holding investment properties in such jurisdictions which had no definite plans to sell the investment property may have previously assumed some or all recovery through "use" which would have resulted in zero tax basis if the property was not depreciable for tax purposes.

The rebuttable sale presumption in the Amendments may result in a change in the tax basis from a zero "use" basis to a sales basis which could have the effect of reducing DTLs recognized in the statement of financial position. If the initial recognition exception had previously been applied, the impact on recognized DTLs may be less significant. A reduction in DTLs also may affect the support for DTAs recognized prior to the Amendments. In some jurisdictions, the Amendments would impact the character of the taxable income from the reversal of DTLs (i.e., capital vs. ordinary).

The IAS 12 amendment should be applied retrospectively, requiring a retrospective restatement of all DTAs or DTLs within the scope of the amendment, including those that were initially recognized in a business combination.

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 December 9-13, 2013 at Mandalay Bay Resort and Casino on the strip in Las Vegas, Nevada. Course offerings are designed for corporate tax and accounting professionals. Please note the early registration discount for this program ends October 1. New multiple course discounts continue beyond October 1. 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**.