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# Accounting for Income Taxes
# Quarterly Hot Topics

**September 2013**

## Accounting Developments

**Emerging Issues Task Force (EITF) makes tentative decisions Issue 13-B, "Accounting for Investments in Tax Credits"**

***Background***

Under U.S. Generally Accepted Accounting Principles (U.S. GAAP), entities account for investments in limited partnerships that operate affordable housing projects by using the cost method, the equity method of accounting, or the effective yield method. Accounting Standards Codification (ASC) 323-740-35-2 states that under the effective yield method, "the investor recognizes [related Low Income Housing Tax Credits (LIHTC)] and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor." In addition, entities present the amortization of their investments net within their provision for income taxes along with tax credits and other tax benefits. To apply the effective yield method, an entity must first assess whether the investment meets certain conditions outlined in EITF Issue 94-1,[1] codified in ASC 323-740, and make an accounting policy election to use the effective yield method to account for qualifying LIHTC investments.

An entity often cannot apply the accounting policy election in ASC 323-740 to use the effective yield method to account for its LIHTC investments, because many such investments do not meet the required conditions. Specifically, many such investments do not include a guarantee that the tax credits allocable to the investor will be available. In addition, many LIHTC investments do not provide a positive yield on the basis of the tax credits alone.

In March 2013, the EITF reached a consensus-for-exposure that would make it easier for investments to qualify for the effective yield method by eliminating the requirement that the availability of related tax credits be guaranteed and by permitting entities to consider both tax credits and other tax benefits when determining whether an LIHTC investment provides a positive yield. During its September 13 meeting, the EITF made a number of tentative decisions in response to feedback that the Financial Accounting Standards Board (FASB) received on the EITF's consensus-for-exposure.

[1] EITF Issue No. 94-1, "Accounting for Tax Benefits Resulting From Investments in Affordable Housing Projects."

***Summary***

The Task Force tentatively decided that entities would be permitted to elect to apply a proportionate amortization method[2] to LIHTC investments and other tax credit investments by analogy to the guidance in this Issue, if certain conditions are met. Conditions that must be met for both LIHTC and other tax credit investments for an investor to apply the proportionate amortization method include the following (as stated in the Issue Summary):

a. It is probable[[3]] that the tax credits allocable to the investor will be available.

b. The investor retains no [significant ability to influence the operating and financial policies of the limited liability entity] and substantially all of the projected benefits are from tax credits and other tax benefits.

c. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.

d. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor’s liability is limited to its capital investment.

The Task Force also tentatively decided that an entity that enters into other transactions with the limited liability entity (e.g., makes a loan in addition to its investment) may not apply the proportionate amortization method to equity investments in that entity – even if they are made to receive tax credits and other tax benefits – unless it is an LIHTC investment and meets the following conditions (as stated in the Issue Summary):

- “The reporting entity is in the business of entering into such other transactions.”
- “Such other transactions are entered into at market rates commensurate with rates offered to other counterparties with similar credit quality.”
- “The reporting entity does not acquire [a significant ability to influence the operating and financial policies of the limited liability entity] as a result of such other transactions.”

The Task Force also tentatively decided that an entity should:

- Combine qualifying tax credit investments accounted for under the proportionate amortization method with other deferred tax assets (DTAs) in the statement of financial position.
- Disclose, in the footnotes to its financial statements, the amount of such investments included in the DTA line and that they relate to tax credits that have not been realized as of the balance sheet date.
- Assess whether it should record a valuation allowance for its tax credit investment along with other DTAs in accordance with ASC 740.
- Assess whether an investment qualifies for the proportionate amortization method, provided that the entity has made the accounting policy election to apply this method, at initial recognition and when an event or changes in

[2] Under the proportionate amortization method, “the cost of the investment is amortized each reporting period in proportion to the tax credits [and other tax benefits] received.” Under the tentative decision, entities would no longer be permitted to apply the effective yield method.

[3] The FASB staff clarified that the term “probable,” as used in this context, is consistent with ASC 450-20, which defines “probable” as “[t]he future event or events are likely to occur.”

circumstances arise indicating that the investment may no longer meet the qualifying conditions.

- Disclose the impact of its tax credit investment on its financial statements.[4]

Finally, the Task Force requested that the FASB staff perform additional outreach to determine whether there are unforeseen consequences that may result from permitting entities to apply the guidance in this Issue to tax credit investments other than LIHTC investments and to consider whether the qualifying criteria should be further modified to address conditions that are unique to these other tax credit investments.

***Effective date and transition***

The Task Force tentatively decided that the guidance in this Issue should be applied retrospectively to all prior periods presented. Entities that previously applied the effective yield method would be permitted to continue applying the effective yield method only to those investments previously accounted for under this method. The Task Force will discuss the effective date at a future meeting.

***Next steps***

The Task Force will discuss this Issue again at a future meeting.

## Federal

### IRS reduces payment amount of refundable AMT credits claimed under Section 168(k)(4)

An automatic budget sequestration was triggered earlier this year that forced the Internal Revenue Service (IRS) to cut its spending. The automatic budget sequestration is one of several mechanisms introduced by the Budget Control Act of 2011 that was signed into law by President Obama on August 2, 2011. On August 12, 2013, the IRS made the following announcement on its website under the heading, **Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations:**

"The Balanced Budget and Emergency Deficit Reduction Act of 1985, as amended, requires certain spending cuts during Fiscal Year 2013 due to the sequester triggered earlier this year. These required cuts reduce the refundable portion of the credit for prior year minimum tax liability made to corporations, which will be effective for original or amended tax returns beginning August 13, 2013. As a result, the refundable portion of these credits will be reduced by 38%. The sequestration reduction rate will be applied until the end of fiscal year (September 30, 2013) at which time the sequestration rate is subject to change depending on congressional action.

A corporation that can claim an additional first-year depreciation deduction under Section 168(k) can choose instead to accelerate the use of its prior year minimum tax credits, treating the accelerated credits as refundable credits. Corporations making this Section 168(k)(4) election and claiming a refund of prior year minimum tax credits should complete Form 8827. These corporations will be notified that a portion of their requested refund was subject to the sequester reduction.

Corporations making the Section 168(k)(4) election but not claiming a refund of prior year minimum tax credits are not subject to this reduction."

The Section 168(k)(4) election allows companies to claim a refund for unused

[4] The EITF's consensus-for-exposure reached in March 2013 included the suggestion that an entity provide disclosures to satisfy this objective. However, the EITF tentatively decided to remove a suggested disclosure related to regulatory reviews of the affordable housing project.

alternative minimum tax (AMT) credits from pre-2006 tax years in lieu of bonus depreciation. The American Taxpayer Relief Act of 2012 (the Act) extended this election for the third time since its original enactment in 2008, and it now applies to property placed in service through 2013. It is unknown whether the sequestration will continue after September 30, 2013 and if it does, whether it will continue with the same or different reduction percentage. In addition, it is unclear whether the 38% reduction is permanent (i.e., whether credits equivalent to the 38% refund reduction are restored to the pool of AMT credit carryforwards or simply lost).

**ASC 740 implications:** As a result of the IRS's announcement reducing the payment amount of the refundable AMT credits, the provisions under Section 168(k)(4) have been effectively amended as it relates to the amount refundable. This has the same effect as a change in tax law (not by new legislation, but rather due to the interaction of two laws enacted in prior periods). ASC 740-10-25-47 requires that the effects of a change in tax law or rates be recognized in the period that includes the enactment date. Therefore, for the interim and annual period that includes August 12, 2013, companies must evaluate the impact that this change has on its financial statements.

Even though the provisions under Section 168(k)(4) have been effectively amended as it relates to the amount of AMT credit that will be refunded for the period between August 13, 2013 and September 30, 2013, the provisions under Section 53 that allows a credit against regular tax of any taxable year in an amount equal to prior year minimum tax liability are not affected. In other words, for a calendar year taxpayer, the amount of refundable AMT credit is different but not the amount of AMT credits available to offset the company's regular tax liability for the 2012 income tax return.

If a company timely filed its 2012 income tax return, claimed a refund as result of the Section 168(k)(4) election, and has not received a refund check from the IRS by August 13, 2013, it should evaluate whether it should reduce its income tax receivable.

A company generally recognizes AMT credit carryforwards as a DTA which is reduced by a valuation allowance when management determines that it is more likely than not that the DTA will not be realized. In addition, if a company intends to apply Section 168(k)(4) in its 2013 tax return, it is possible that sequestration may impact the ability to "monetize" a portion of its unused AMT credits by foregoing bonus depreciation in 2013. However, until further notices are issued indicating whether sequestration will continue to impact recovery of prior AMT paid, it would be inappropriate to anticipate what effect sequestration may have for amounts expected to be recovered subsequent to September 30, 2013.

Companies are encouraged to consult with their attest provider due to the number of uncertainties with respect to this reduction.

### IRS issues proposed regulations to amend the definition of research and experimental expenditures under Section 174

The IRS issued proposed regulations (REG-124148-05) on September 5, 2013, to amend the definition of research and experimental (R&E) expenditures under Section 174. The regulations specifically provide definition of allowable supply expenses and costs related to construction of pilot models. The proposed amendments are generally taxpayer favorable and provide much-needed clarity for the categories of expense that the regulations address. While the regulations are under Section 174, they are expected to be useful when determining costs that can be considered when computing the research credit under Section 41.

While the proposed regulations will be effective for taxable years ending on or after the date the regulations are published in final form in the Federal Register, the preamble to the proposed regulations and the body of the proposed regulations indicate that the IRS will not challenge positions adopted by taxpayers that are consistent with the proposed regulations. Therefore, these regulations are relevant for assessing the technical merits of positions taken in prior years (or to be taken in prior years if the taxpayer files a claim based on this new guidance). Taxpayers also may rely on these proposed regulations when taking positions for the current tax year. Taxpayers wanting to change their tax-accounting method for research and development (R&D) expenditures from capitalization to expensing treatment should also consider requesting IRS consent for a method change (by filing Form 3115).

**ASC 740 implications:** Although the proposed regulations will not be effective until a future period, the proposed regulations indicate that the IRS will not challenge positions that are consistent with the proposed guidance. Additionally, the **Internal Revenue Manual Part 32** states that taxpayers may rely on proposed regulations if there are no temporary or final regulations in place, and there is an express statement in the proposed regulations stating that they may be relied upon. The **Internal Revenue Manual Part 32** also states that the Office of Chief Counsel should look to proposed regulations to determine the IRS's position on a particular matter if there are no final or temporary regulations currently in force addressing the matter. We believe that the proposed regulations represent new information as of the interim or annual period that includes September 5, 2013. Therefore, companies with existing unrecognized tax benefits (UTBs) should assess the impact that the proposed regulations have on their UTBs and related interest and penalty accruals.

### IRS releases final Tangible Property Regulations

On September 13, 2013, the U.S. Department of the Treasury and the IRS released:

- Final regulations (the "Final Regulations") that provide guidance on applying Section 263(a) of the Internal Revenue Code (IRC) to amounts paid to acquire, produce, or improve tangible property, as well as rules for materials and supplies (IRC Section 162).
- Proposed regulations (the "2013 Proposed Regulations") addressing dispositions and general asset accounts (IRC Section 168).[5]

These regulations contain certain changes from the temporary and proposed tangible property regulations (the "Temporary Regulations") that were issued on December 23, 2011. The Final Regulations are generally effective for taxable years beginning on or after January 1, 2014. In addition, taxpayers are permitted to early adopt provisions in the Final Regulations for taxable years beginning on or after January 1, 2012. Taxpayers are also permitted, but not required, to apply the 2013 Proposed Regulations to taxable years beginning on or after January 1, 2012. The government expects to issue procedural guidance pursuant to which taxpayers will be granted automatic consent to change their accounting methods to comply with the Final Regulations.

**ASC 740 Implications:** Entities will most likely be required to change tax accounting methods to comply with the Final Regulations. Further, many of the method changes will need to be applied retrospectively and will affect an entity's temporary

[5] The 2013 Proposed Regulations are expected to be finalized in early 2014 and, when the final regulations are issued, entities will need to similarly assess the impact of those final regulations.

differences and related deferred taxes under ASC 740.[6] For example, some amounts previously taken as deductions may need to be capitalized into the tax basis of property upon transition, resulting in a positive IRC Section 481(a) adjustment (a "481(a) adjustment"). In general, positive 481(a) adjustments are included in taxable income over four tax years and negative 481(a) adjustments are deducted in a single year's U.S. federal income tax return. A deferred tax liability (DTL) is required for positive 481(a) adjustments and a DTA required for negative 481(a) adjustments. Note that any positive 481(a) adjustment that must be reported in taxable income over four tax years is a temporary difference that is separate and distinct from any resulting book-tax basis difference in the related underlying asset; therefore, separate deferred taxes should be recognized.

For purposes of applying ASC 740, the Final Regulations are viewed as new tax law. Although the Final Regulations are not effective until January 1, 2014, ASC 740-10-25-47 requires that the effect of a change in tax law be recognized as of the enactment date. The recognition of the effects of a change in tax law requiring a change in tax accounting method is discussed in ASC 740-10-55-58 through 55-63, which illustrate that the effect of a change in tax law on DTAs and DTLs should be reflected as of the enactment date regardless of a later effective date.

An entity that is required to change its tax accounting methods to comply with the Final Regulations should account for the effect of the tax law changes on the tax accounts in the interim and annual period the Final Regulations were issued. At this time, the entity would generally reflect both of the following (in addition to providing appropriate disclosures):

- The estimated Section 481(a) temporary difference(s) that will be created when it files one or more Forms 3115 to request the accounting method changes along with a corresponding adjustment to its temporary differences related to the affected property.
- Updates to the liability for UTBs related to any uncertainty in the application of the Final Regulations.

In addition, an entity may need to consider changes to DTAs and DTLs (including the timing of future reversals) resulting from the Final Regulations in determining whether a valuation allowance is needed for the entity's DTAs.

In a classified balance sheet, the current/noncurrent classification of a DTL for the estimated Section 481(a) adjustment would be based on the expected reversal date of that temporary difference, which would be affected by the period in which the entity intends to adopt the Final Regulations. For example, a calendar-year taxpayer whose adoption of the Final Regulations will be effective on January 1, 2014, would include 25% of any taxable Section 481(a) adjustment (or 100% of any deductible Section 481(a) adjustment) in its current taxable income for 2014; thus, 25% of the related DTL (or 100% of a related DTA) as of December 31, 2013, would be classified as current. For an example illustrating the balance sheet classification of deferred income taxes related to a change in tax accounting method, see Paragraph 5.11 of Deloitte's **A Roadmap to Accounting for Income Taxes**.

Some entities may find it challenging to determine the impact of the Final Regulations on their interim and year-end financial reporting because of both the timing of the issuance date and uncertainty regarding the interpretation of some aspects of implementation (until the additional procedural guidance is issued). ASC 740 states that the measurement of a tax position should "be based on management's best judgment given the facts, circumstances, and information

[6] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's **Titles of Topics and Subtopics in the *FASB Accounting Standards Codification***.

available at the reporting date." Although additional analysis of *existing* information would not typically constitute *new* information for purposes of adjusting prior estimates, if subsequent administrative guidance changes the initial assessment of the impact of the Final Regulations on DTAs and DTLs, changes resulting from that additional guidance would be accounted for in the period in which the additional guidance becomes available.

## International

**Puerto Rico enacts sweeping changes to its alternative minimum tax regime**

On June 30, 2013, the governor of Puerto Rico enacted Act 40 of 2013, known as the Tax Burden Redistribution and Adjustment Act. Among other items, Act 40 makes significant changes to the AMT regime applicable to corporations engaged in a trade or business in Puerto Rico. Act 40 was enacted as part of the Puerto Rico budget for fiscal year 2013-2014.

The Puerto Rico Treasury Department has provided guidance with respect to specific taxpayer requests to apply the law differently than as enacted:

- The reduction of the additional tax on gross income,
- The reduction of the tax rate applicable to related party purchases,
- The exclusion of expenses paid to a related party from the computation of the AMT on such expenditure, and
- An exemption from the disallowance of a percentage of expenses incurred on related party payments.

In these cases, taxpayers will be required to submit a memorandum supporting the request which contains certain information for the prior four years. Taxpayers will also be required to submit a transfer pricing study for a rate reduction with respect to related party purchases.

The income tax law changes outlined below are applicable to taxable years beginning after December 31, 2012.

***Additional tax on gross income (ATGI)***

Companies in Puerto Rico are subject to income tax based on a graduated tax rate structure (normal tax plus surtax). In addition, companies are subject to an AMT and they pay tax on the greater of regular income tax or the AMT. Act 40 introduces ATGI as part of the AMT regime that applies to corporations, partnerships, special partnerships, and corporations owned by individuals engaged in a trade or business in Puerto Rico. The ATGI is applied on a graduated scale at the following rates:

| Gross income (USD) | Rate (%) |
|---|---|
| 1 million to 3 million | 0.20 |
| More than 3 million and up to 300 million | 0.50 |
| More than 300 million and up to 600 million | 0.70 |
| More than 600 million and up to 1.5 billion | 0.80 |
| More than 1.5 billion | 0.85 |

Financial institutions are subject to the ATGI at a special rate of 1%.

Taxpayers other than financial institutions may be able to request a reduction of the ATGI (but not below 0.2%) if the additional tax is found to be significant when compared to the gross margin of the taxpayer or if the tax results in an undue economic hardship. Approved rate reductions are effective for two years.

***AMT calculation***

The new law makes significant changes to the rules governing the calculation of the AMT, the most significant of which is the new ATGI, and also introduces a new tax on related party transactions. Thus, the AMT will be calculated as the greater of the following items:

- AMT net income taxed at an increased 30% rate, plus the ATGI; or
- 20% of expenses incurred or payments made to related parties that are not subject to tax in Puerto Rico (including head office expenses allocated to a branch), plus 2% of the value of personal property purchased from related parties (if certain thresholds are met) (collectively the “Related Party AMT”), plus the ATGI.

The related party purchases computation will not apply in the following cases:

- A purchaser that has gross receipts of less than USD 10 million in any of the three preceding years;
- Purchases from related persons engaged in a trade or business in Puerto Rico; and
- Purchases of property used in exempt operations under Puerto Rico Act 73 or similar tax incentives laws.

As noted above, taxpayers can request a ruling from the Secretary of Treasury that reduces the 2% tax rate applicable to related party purchases (but not to less than 0.2%, except for gas and crude oil products), if the taxpayer can demonstrate that the value of the property purchased from related parties is equal or similar to what the value would be in an arm’s length transaction. The term “gross income” is defined in the 2011 Puerto Rico IRC Section 1023.10(10)(e)(1) as “the total generated on the sales of goods or products without deducting the costs of said goods or products sold.”

Puerto Rico corporations may claim an AMT credit to offset future regular tax liabilities for any AMT liability paid (including AMT paid based upon Related Party AMT or ATGI).

**ASC 740 implications:** ASC 740-10-20 defines "income taxes" as "[d]omestic and foreign federal (national), state, and local (including franchise) taxes based on income." Taxable income is further defined in the Accounting Standards Codification Master Glossary as "[t]he excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority." The definition of taxable income identifies that for a tax to be considered an income tax there must be some component of income and expenses. Paragraph 2.05 of Deloitte’s **A Roadmap to Accounting for Income Taxes** also states “…taxes based solely on revenues (e.g., gross revenues or sales tax) would not be within the scope of ASC 740 because the taxable base amount is not reduced by any expenses.”

The ATGI is computed based upon gross income without reference to any tax deductible expenses and exemptions (i.e., the tax base is gross receipts even though it is referred to as “gross income”). As noted in the Deloitte Guidance above, taxes based solely on revenues are not within the scope of ASC 740 because the taxable base is not reduced by any expenses. Therefore, the ATGI does not fall within the scope of ASC 740.

The Related Party AMT raises similar questions. The Related Party AMT taxable base is comprised of two parts: (1) amounts paid or incurred to related parties not subject to tax in Puerto Rico for services rendered outside of Puerto Rico and (2) the value of personal property purchased from a related person. Neither of these meets the definition of “taxable income” due to a lack of both (or in the case of the tax on personal property, either) taxable revenues and tax deductible expenses. Therefore, the Related Party AMT is also not within the scope of ASC 740.

However, the fact that the AMT can reduce future regular tax liabilities raises a question regarding whether the ATGI and Related Party AMT should be considered within the scope of ASC 740 even if their taxable bases do not meet the definition of “taxable income.” The reason for allowing the AMT to be included with income taxes is its integration with the regular tax system. Under ASC 740, integrated AMT systems (like in the U.S.) are not to be accounted for separately from the regular tax system. As a consequence, the incurrence of AMT results in a greater current payable and a deferred tax benefit for the AMT credit carryforward. We would not object to treating the ATGI and Related Party AMT as a tax within the scope of ASC 740 in a manner similar to how the U.S. AMT is accounted for.

Companies are encouraged to consult with their attest provider.

### United Kingdom research and development expenditure credits

***Summary***

On July 17, 2013, the UK Finance Act 2013 received Royal Assent, passing into law R&D expenditure credits for large companies previously announced by Her Majesty’s Treasury in the U.K.’s 2011 Autumn Statement. Companies will have to elect to apply the new R&D expenditure credits regime as it will operate alongside the existing 30% super-deduction until the R&D expenditure credits become mandatory in April 2016. The super-deduction is 30% of qualifying research expenditures. The credits (including the refundable feature discussed below) are administered through corporate income tax filings.

The R&D expenditure credits are generally calculated at 10% of qualifying R&D expenditures. R&D expenditure credits are included in corporate taxable income.

In respect of the payment mechanism, the R&D expenditure credits are first applied against corporate taxes payable. Companies with no corporate tax liability, such as those with tax losses, will be able to monetize a portion of the R&D expenditure credits through a refund or discharging of other liabilities of the company to the Commissioners (referred to hereafter as “refundable”). However, the full amount of the R&D expenditure credits is not refundable. The refundable amounts are an amount equal to the full amount of the credits earned less an amount equal to the corporate tax on the full amount of credits earned. The reduction in the amounts refundable applies irrespective of the taxpayer’s income tax profile (i.e., the amounts refundable are reduced even if the company has losses and would have owed no income taxes for the year after, including the full amount of the R&D expenditure credits in its taxable income). The refundable credits are limited to payments of pay-as-you-earn tax (PAYE) and national insurance contributions tax (NIC) on directors or employees who are directly and actively engaged in relevant R&D. Refunds are subject to additional requirements such as the company being or becoming a going concern.

As an example, generally, the net economic effect of the R&D expenditure credits scheme is 7.7% of qualifying expenditures (e.g., on £10,000 in qualifying expenditures R&D expenditure credits of £1,000 are available and that £1,000 is includible in taxable income which at a tax rate of 23% results in an economic outflow of (£230) and an economic benefit net of income taxes of £770 or 7.7% of qualifying expenditures).

For a loss company not subject to the payroll limitation, the refundable credits in the above example are £770. The remaining £230 of the credits would be available as a tax credit carryforward. The full £1,000 of R&D expenditure credits are includible in taxable income and have the effect of reducing the loss carryforward which would have existed absent the taxable income from the R&D expenditure credits. The reduction in tax losses at a 23% tax rate would decrease DTAs by (£230) such that the net effect of the credits scheme on current taxes payable and net deferred income taxes is zero (i.e., the reduction in DTAs for loss carryforwards is offset by an increase in DTAs for credits carried forward and no taxes are payable).

While a loss company can realize a benefit of £770 as a refund and have zero tax expense or benefit, a profitable company will also realize £770 of benefit. However, in the case of a profitable company, that benefit is £1,000 of tax credits (a benefit) offset by £230 of tax expense (resulting from including the credits in taxable income). Therefore, the economic benefit of £770 is available to all companies incurring qualifying expenditure and is realizable even without being a taxpayer.

The wording of the PAYE/NIC limitation is designed to prevent refund claims in what the government views as potentially abusive situations where a company is loss making and qualifying R&D expenditures do not include R&D-related wages from UK employees. Where UK employee costs make up a large portion of qualifying R&D expenditures, the threshold for application of the PAYE/NIC limitation is quite high. R&D expenditure credits are 10% of qualifying expenditures and PAYE/NIC are generally 35 to 40% of staff costs. Also, where typically only a proportion of a worker's time may be included as qualifying R&D, 100% of the PAYE/NIC of R&D staff can be used in the limitation calculation.

R&D expenditure credits in an amount equal to corporate tax on the R&D expenditure credits (the reduction in the refundable amount discussed above) may only be utilized against current or future corporate taxes payable and are carried forward indefinitely if not utilized. Any further R&D expenditure credits carried forward which are in excess of the nonrefundable amount and current year PAYE and NIC limitation may be utilized against corporate taxes payable in the future or may become refundable in the future if not subject to future PAYE and NIC limitations. R&D expenditure credits may be carried forward indefinitely.

The R&D expenditure credits were designed to make R&D incentives more accessible and visible than the R&D super-deduction and to provide earlier relief to companies with no corporate tax liability, such as those with losses.

As an example, assume the corporate tax rate is 23%. Qualifying R&D expenditures are £10,000 and PAYE/NIC on R&D staff is £3,000. The R&D expenditure credits at 10% of qualifying expenditures are £1,000. The Company has other taxable income of £1,500 (excluding the R&D expenditure credits) and £1,000 of taxable income from the R&D expenditure credits. The corporate tax liability is (£575) (i.e., £1,500 other income plus £1,000 R&D credits income = £2,500 x 23% = £575).

Of the total £1,000 credits, £575 is utilized against the (£575) of corporate tax payable. The remaining £425 of R&D expenditure credits is refunded.

**ASC 740 implications:**

***Scope***

*R&D expenditure credits:*

ASC 740-10-5-1 states that the subtopic applies to "operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years." Generally, if realization of a tax credit does not depend on the entity's generation of future taxable income or the entity's ongoing tax status or tax position, the credits are not considered an element of income tax accounting under ASC 740. Thus, even if the credit claims are filed in connection with a tax return, the refunds are not considered part of income taxes and, therefore, are not within the scope of ASC 740. In such cases, an entity would not record the credits as a reduction of income tax expense; rather, the entity should classify the credits based on their nature.

The realization of the refundable portion of the R&D expenditure credits is not dependent on the existence of a tax liability and, thus, is not within the scope of ASC 740. As such, an entity should recognize the amounts that are refundable "above the line" as a component of pretax income. A similar question arose in the U.S. related to certain investment tax credits (ITC) related to alternative energy investments that could be either applied for as a grant or realized as credits in the tax return. For U.S. GAAP, the amounts that are available as refundable credits are generally accounted for as a government grant whether claimed as a grant or as an ITC. Similarly, the refundable amount of the R&D expenditure credits should be recognized in pretax income irrespective of whether the amounts are actually refunded or are applied to reduce taxes payable.

When determining the classification of the refundable portion of R&D expenditure credits, an entity may consider the refundable credits 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."

Unlike the refundable portion of the R&D expenditure credits, the realization of the difference between the total credits earned and the amounts that are refundable (an amount equal to the corporate tax on the full credits) ultimately depends on being able to reduce future taxes payable and should be recognized as a reduction of income taxes and considered to be within the scope of ASC 740.

In the above example, the net effect on pretax income and income tax expense of the R&D expenditure credits would be as follows (assuming a valuation allowance is not required):

| | | |
|---|---|---|
| **Pretax Income** | £ | |
| Net Revenues | 12,500 | |
| Other expenses | (1,000) | |
| Qualifying R&D expenditures | (10,000) | |
| Refundable R&D expenditure credits | 770 | |
| **Earnings before income taxes** | 2,270 | |
| **Income Tax Expense/(Benefit)** | | Rate Rec. |
| Pretax income taxed at 23% | 522 | 23.00% |
| Nonrefundable R&D credits and carryforward | (230) | -10.13% |
| Taxable R&D Credits in excess of refundable | 53 | 2.33%* |
| **Income Taxes**** | 345 | 15.20% |
| | | |
| **Net Income** | 1,925 | |

* (1,000 taxable R&D credits in excess of 770 above-the-line credits) x 23% / earnings before income taxes of 2,270 = 2.33%
** Absent the R&D expenditure credit scheme, earnings before tax would have been 1,500 taxable at 23% = 345 in income tax expense. Total tax is not affected by the R&D credit scheme as the (230) of credits unavailable for refund and accounted for as an income tax benefit is offset by 230 of tax expense on the taxability of the 1,000 credits at 23%.

***Deferred tax***

As noted in ASC 740-10-10-1, an entity's overall objectives in accounting for income taxes under ASC 740 include recognizing "deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns." In general, DTAs are recognized for tax credit carryforwards within the scope of ASC 740 which would include only the nonrefundable portion of the R&D expenditure credits carryforward recognized in an entity's tax returns.

A DTA is recognized when it is "more likely than not" expected to be realized. ASC 740-10-30- 5(e) requires that DTAs be reduced "by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50%) that some portion or all of the DTAs will not be realized." Accordingly, the nonrefundable R&D expenditure credit carryforward DTA would also be assessed for the need for a valuation allowance.

If, in the above example, there were nominal taxable income such that there is a tax credit carryforward of £30, and it is determined that a valuation allowance is required, the net effect on net income and income taxes would be as follows:

| | | |
|---|---|---|
| **Pretax income** | £ | |
| Net revenues | 10,870 | |
| Other expenses | (1,000) | |
| Qualifying R&D expenditures | (10,000) | |
| Refundable R&D expenditure credits | 770 | |
| **Earnings before income taxes** | 640 | |
| **Income tax expense/(benefit)** | | Rate Rec. |
| Pretax income taxed at 23% | 147 | 23.00% |
| Nonrefundable R&D credits and carryforward | (230) | -35.96% |
| Taxable R&D credits in excess of refundable | 53 | 8.27%* |
| Valuation allowance | 30 | 4.69% |
| **Income taxes** | 0 | 0.00% |
| **Net income** | 640 | |

* (1,000 taxable R&D credits in excess of 770 pretax) x 23% / earnings before income taxes of 640 = 8.27%

***Loss contingencies and uncertain tax positions***

When a loss contingency exists related to the amount of the R&D expenditure credits which are accounted for as a Grant, ASC 450 requires an estimated loss to be accrued if it is probable a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated.

The amount of the R&D expenditure credits included in taxable income and the portion of the R&D expenditure credits which are accounted for as an income tax expense or (benefit) are subject to the recognition, measurement, and disclosure requirements of ASC 740. However, since those amounts net to zero, only the ASC 450 accounting noted above will have an effect on net income.

Other views may exist in practice with respect to the approach used to account for the UK R&D expenditure credits. Companies are encouraged to consult with their attest provider.

## Multistate

**California: AB 93 eliminates current Enterprise Zone Program and creates new economic development incentives and a partial sales tax exemption for manufacturers**

***Overview***

The California Legislature has passed Assembly Bill (AB) 93, which phases out the California Enterprise Zone (EZ) tax credit and replaces it with a new economic development program comprised of a hiring tax credit, a statewide partial sales and use tax manufacturing exemption, and incentive fund.[7] AB 93 reflects many of the changes publicly advocated by Governor Brown. California's current EZ program offers income tax credits to taxpayers located within specific geographic areas called EZ's. Under AB 93, the EZ incentives will be repealed as of January 1, 2014 and replaced by three new incentives.[8]

***Summary of AB 93***

AB 93 phases out the current California EZ program and replaces it with three new incentives:

1. A hiring credit under the Personal Income Tax (PIT) and the Corporation Tax (CT) for the hiring of certain qualified employees by taxpayers located in certain current EZ's along with certain census tracts that will be designated.[9]
2. A 4.19% statewide sales and use tax exemption for manufacturing and biotechnology equipment, including R&D equipment.[10]
3. A negotiated incentive fund, administered by the Governor's Office of Business and Economic Development (GO-Biz), to provide tax credits for purposes of retaining existing and attracting new business activity throughout California.

***Current EZ credits and carryforward amounts***

AB 93 phases out the current EZ program and ends the ability to generate new EZ credits for tax years beginning on or after January 1, 2014.[11] Until December 31, 2013, the applicable EZ credits and rules will still apply. EZ credit carryforwards generated prior to January 1, 2014 shall be allowed for 10 years.[12] The 10 year carryforward provision is also applicable to hiring or sales and use tax credits generated under the local agency military base recovery area (LAMBRA), Targeted Tax Area, or Manufacturing Enhancement Area programs.[13] The EZ hiring credit will remain operative for qualified employees hired by a qualified taxpayer before January 1, 2014, and qualified wages paid to qualified employees used to generate EZ credits may continue for the 60-month period following the date of hire.[14]

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[7] AB 93 (enrolled July 3, 2013) 2013-14 Leg., (Cal. 2013). The Legislature also passed Senate Bill ("SB") 90 (enrolled July 3, 2013) 2013-14 Leg., (Cal. 2013). SB 90 modifies some provisions of AB 93. The original Tax Alert incorporates the changes made by SB 90 into the discussion of AB 93.

[8] AB 93 also phases out and ends on December 31, 2013, the current "new jobs credit" in California, as well as California credits associated with Local Area Military Base Relocation Areas (LAMBRA), Manufacturing Enhancement Areas (MEA) and Targeted Tax Areas (TTA).

[9] SB 90, Sections 2 and 4, amending Cal. Rev. & Tax. Code §§ 17053.73 (for individual taxpayers) and 23626 (for corporate taxpayers) as added by AB 93 Sections 13 and 33.

[10] SB 90, Section 1, amending Cal. Rev. & Tax. Code § 6377.1 as added by AB 93, Section 6. The 4.19% is comprised of the tax levied pursuant to Rev & Tax Code §§ 6051, 6051.3, 6201 and 6201.3 (3.94%) and the 0.25% rate pursuant to Section 36, Article XIII. The exemption does not apply to county, city or district taxes.

[11] AB 93, Sections 14 and 29, adding Cal. Rev. & Tax. Code §§ 17053.74(l)(1) (for individual taxpayers) and 23622.7(l)(1) (for corporate taxpayers).

[12] SB 90, Section 6.

[13] *Id.*

[14] AB 93, Sections 14 and 29, adding Cal. Rev. & Tax. Code §§ 17053.74(l)(2) (for individual taxpayers) and 23622.7(l)(2) (for corporate taxpayers).

***Taxpayer considerations***

Taxpayers preparing to file their 2012 California corporate franchise tax returns who currently claim EZ credits should determine the extent to which AB 93 will affect their ability to generate future credits as well as carryforward related issues. For taxpayers located in a designated census tract, planning for AB 93 should be considered as soon as possible. For taxpayers located throughout the State, careful consideration should be given to whether they qualify for the sales tax exemption. Further, taxpayers located throughout the State who are considering expansion and/or new capital investment in California in 2013 and/or 2014 should carefully consider the effect of AB 93 and whether the California Competes Tax Credit (CCTC) may prove beneficial.

For additional information, please see **Multistate Tax: EXTERNAL ALERT – July 9, 2013.**

**ASC 740 implications:**

***Deferred taxes***

Companies should consider the impact of AB 93 when assessing DTAs for recognition. Consideration should be given to the now-limited 10-year carryforward period when determining whether a valuation allowance against all or a portion of DTAs established for an EZ credit carryforward may be required.

For some companies, the change in law might result in a reduction of an existing valuation allowance. A company that continuously generated new credits might have concluded that there was no future taxes payable against which its existing credit carryforward could be applied, leading to a full valuation allowance on the amount being carried forward. Now that new credits will be limited to pre-2014 hires, there may be future taxes payable against which the existing EZ credit carryforward can be applied, allowing for a reduction in the valuation allowance.

New information must be accounted for in the period in which the new information becomes available, which in this case is the annual or interim period that includes the date that the bill was passed – July 3, 2013.

***Interim***

ASC 740-270-25-5 provides that the impact of a change in tax law on deferred taxes shall not be apportioned among interim periods through an adjustment of the annual effective tax rate.

**Tax law changes – Texas enacts franchise tax bills with changes to the tax rate, determination of taxable margin, and the addition of new credits and sales/use tax exemption**

***Overview***

On June 14, 2013, Texas Governor Rick Perry signed House Bill 500 (HB 500) and House Bill 800 (HB 800) into law. These bills contain several new provisions that impact a variety of industries and taxpayers as well as changes with potential application to a wider range of taxpayers, such as:

- Temporary tax rate reductions for Report Year 2014 and potentially 2015;
- New tax credit for certified rehabilitation of certified historic structures;
- New tax credit and sales/use tax exemption for R&D activities;
- Changes to determination of total revenue and cost of goods sold; and
- Deduction of relocation costs for entities moving to Texas after September 1, 2013.

### *Temporary Franchise Tax Rate Reduction*

- For reports originally due on or after January 1, 2014, and before January 1, 2015, a taxable entity may elect to determine its franchise tax at a tax rate of 0.975% of taxable margin.[15] A taxable entity primarily engaged in retail or wholesale trade may elect to determine its franchise tax at a tax rate of 0.4875% of taxable margin.[16]
- For reports originally due on or after January 1, 2015, and before January 1, 2016, a taxable entity may elect to determine its franchise tax at a tax rate of 0.95% of taxable margin.[17] A taxable entity primarily engaged in retail or wholesale trade may elect to determine its franchise tax imposed at a rate of 0.475% of taxable margin.[18] However, the reduced tax rates for 2015 will only be available if the Comptroller certifies, on or after September 1, 2014, that probable revenue for the state fiscal biennium ending August 31, 2015, is estimated to exceed probable revenue as stated in the Comptroller's Biennial Revenue Estimate for the 2014-2015 fiscal biennium. If the Comptroller does not make this certification, a taxable entity shall pay the tax at the rates provided by Texas Tax Code Section 171.002 (i.e., 1.0%, or 0.5% for taxable entities engaged in retail/wholesale trade).[19]
- For reports originally due on or after January 1, 2016, the franchise tax rate will revert to 1.0%, and for a taxable entity engaged in retail or wholesale trade the rate will revert to 0.5%.[20]

### *Combined Group Modifications*

Texas Tax Code Section 171.1014(d) has been amended to allow a combined group to elect to subtract either cost of goods sold or compensation that applies to all of its members, or $1 million. Regardless of the election, the taxable margin of the combined group may not exceed 70% of the combined group’s total revenue.[21]

Further, a taxable entity that provides retail or wholesale electric utilities may not be included as a member of a combined group that includes one or more taxable entities that do not provide retail or wholesale electric utilities if that combined group would not otherwise:

- Meet the requirements of Texas Tax Code Section 171.002(c) (lists what is required to be considered engaged primarily in retail or wholesale trade) solely because one or more members of the combined group provide retail or wholesale electric utilities; and
- Have less than 5% of the combined group's total revenue derived from providing retail or wholesale electric utilities.[22]

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – June 17, 2013**.

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[15] Acts of 83rd Legislature, Regular Session, HB 500, § 2, Tex. Tax Code § 171.0022(a).

[16] Acts of 83rd Legislature, Regular Session, HB 500, § 2, Tex. Tax Code § 171.0022(b).

[17] Acts of 83rd Legislature, Regular Session, HB 500, § 2, Tex. Tax Code § 171.0023(a).

[18] Acts of 83rd Legislature, Regular Session, HB 500, § 2, Tex. Tax Code § 171.0023(b).

[19] Acts of 83rd Legislature, Regular Session, HB 500, § 2, Tex. Tax Code § 171.0023(d).

[20] Acts of 83rd Legislature, Regular Session, HB 500, § 2, Tex. Tax Code § 171.0023(e).

[21] Acts of 83rd Legislature, Regular Session, HB 500, § 11; Tex. Tax Code §§ 171.1014(d), §171.101(a)(1)(A).

[22] Acts of 83rd Legislature, Regular Session, HB 500, § 11; Tex. Tax Code § 171.1014(j).

**Tax law changes – Wisconsin enacts 2013-2015 budget bill with changes to corporate and individual income tax, sales/use tax and administrative provisions**

***Overview***

On June 30, 2013, Wisconsin Governor Scott Walker signed Assembly Bill 40 (A.B. 40).[23] The bill amends Wisconsin tax law in the following manner:

- Updates references to the IRC and conforms to federal depreciation and amortization;
- Repeals several income tax credits;
- Provides that partnerships, limited liability companies, and S corporations are eligible to compute and pass through research credits;
- Modifies various individual income tax provisions, most notably a reduction of the individual income tax rates;
- Eliminates the Economic Development Surcharge for individuals, estates, trusts, and partnerships;
- Provides new exemptions for taxpayers engaged in certain commercial printing activities and for printing services that result in advertising and promotional direct mail;
- Modifies the sales/use tax exemption for R&D activities;
- Modifies the sales/use tax treatment of taxable products provided under a lump sum contract;
- Modifies various administrative provisions, including decreasing the interest rate for refunds, and establishing penalties for negligent and fraudulent income and franchise refund claims.

***Changes generally applicable to all taxpayers***

A.B. 40 makes the following changes that are generally applicable to all taxpayers:

- Updates the IRC to December 31, 2010 with various exceptions,[24] for all taxable years beginning after December 31, 2010.[25]
- Adopts federal depreciation and amortization starting with the first taxable year beginning after December 31, 2013 and that are in effect on such date.[26] In an effort to move away from decoupling from bonus depreciation, A.B. 40 provides "catch-up" adjustments to be taken over five years.

[23] 2013 Wisconsin Act 20, enacted June 30, 2013; published on July 1, 2013 and effective July 2, 2013.

[24] The IRC means the federal the IRC as amended to December 31, 2010 excluding numerous sections of Public Laws. However, A.B. 40 did not exclude any notable Public Laws; the specifics are beyond the scope of this alert.

[25] A.B. 40, Sec. 1288-1297, amending § 71.01(6), Wis. Stat.; A.B. 40, Sec. 1353-1372, amending § 71.22(4), (4m), Wis. Stat.; A.B. 40, Sec. 1374-1383, amending § 71.26(2)(b), Wis. Stat.; A.B. 40, Sec. 1399-1408, amending § 71.34(1g), Wis. Stat.; and A.B. 40, Sec. 1409-1418, amending § 71.42(2), Wis. Stat.

[26] A.B. 40, Sec. 1297d, amending § 71.01(7r)(a), Wis. Stat.; A.B. 40, Sec. 1383d, amending § 71.26.(3)(y), Wis. Stat.; A.B. 40, Sec. 1408f, amending § 71.365(1m), Wis. Stat.; and A.B. 40, Sec. 1419e, amending § 71.45(2)(a)(13), Wis. Stat.

Starting with the first taxable year beginning after December 31, 2013 and for each of the next four taxable years, taxpayers subtract 20% of the difference between the federal basis and Wisconsin basis as determined on the last day of the taxable year beginning in 2013.[27]

- Repeals several income tax credits effective for tax years beginning on or after December 31, 2013. Some of the more significant credits that are being repealed include:
  - Food Processing Plant and Food Warehouse Investment Credit;[28]
  - Research Facilities Credit;[29]
  - Electronic Medical Records Credit;[30] and
  - Relocated Business Credit.[31]

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – July 8, 2013**.

**Tax law changes – Enacted legislation in Pennsylvania includes multiple tax law changes**

***Overview***

On July 9, 2013, in conjunction with the 2013-2014 Budget process, Pennsylvania Governor Tom Corbett signed House Bill 465 into law as Act 52.[32]

***Corporate net income tax***

- Related Party Expense Addback: Effective for taxable years beginning after December 31, 2014, taxpayers generally may not deduct intangible-related expenses or interest expense paid or accrued to an affiliated entity. A tax credit is available if the affiliated entity is subject to tax on the corresponding intangible or interest item in any U.S. state or possession. Various exceptions are provided to the addback requirement if certain conditions are met, such as business purpose and arm's length criteria; transactions with affiliates located in a foreign nation that has a comprehensive tax treaty with the United States; and some instances where the affiliate incurs a similar payment to an unrelated party.
- Market Sourcing for Service Revenue: For tax years beginning after on or after January 1, 2014, the receipt from the sale of a service will to be sourced to Pennsylvania for apportionment purposes if the service is delivered to a location in the State, or based on the relative value of the services delivered to Pennsylvania. Special rules are applicable for apportioning the business income of satellite television service providers.

[27]A.B. 40, Sec. 1304gm, adding § 71.05(6)(b)50, Wis. Stat.; A.B. 40, Sec. 1383f, adding § 71.26(3)(ym), Wis. Stat.; A.B. 40, Sec. 1408c, adding § 71.34(1k)(n), Wis. Stat.; and A.B. 40, Sec. 1419f, adding § 71.45(2)(a)19, Wis. Stat.

[28] A.B. 40, Sec. 1338s-1338u, amending § 71.07(3rn), Wis. Stat.; A.B. 40, Sec. 1390s-1390u, amending § 71.28(3rn), Wis. Stat.; and A.B. 40, Sec. 1426s-1426u, amending § 71.47(3rn), Wis. Stat.

[29] A.B. 40, Sec. 1343c, adding § 71.07(4n)(e), Wis. Stat.; A.B. 40, Sec. 1395be, adding § 71.28(5)(c), Wis. Stat.; and A.B. 40, Sec. 1431be, adding § 71.47(5)(c), Wis. Stat.

[30] A.B. 40, Sec. 1345, amending § 71.05(5i)(b), Wis. Stat.; A.B. 40, Sec 1396, amending § 71.28(5i)(b), Wis. Stat.; A.B. 40, Sec. 1432, amending § 71.47(5i)(b), Wis. Stat.

[31] A.B. 40, Sec. 1304d-1304e, amending § 71.05(6)(b)47, Wis. Stat; A.B. 40, Sec. 1398k-1398L, amending §71.28(9s), Wis. Stat. and A.B. 40, Sec. 1434k-1434L, amending § 71.47(9s), Wis. Stat.

[32] Act 52 of July 9, 2013, House Bill 465, Printer's No. 2211, Session of 2013. House Bill 465 amalgamates legislative proposals from several prior bills, including House Bill 440. It should be noted that House Bill 440 also included a proposed reduction of the Corporate Net Income Tax rate; however, the reduction was not included in Act 52.

- Increased Net Operating Loss Deductions: The current net loss deduction limitation (the greater of $3,000,000 or 20% of Pennsylvania taxable income) is increased to the greater of $4,000,000 or 25% of Pennsylvania taxable income for tax years beginning after December 31, 2013, and to the greater of $5,000,000 or 30% of Pennsylvania taxable income for tax years beginning after December 31, 2014.

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – July 12, 2013.**

**Tax law changes – District of Columbia emergency legislation amends combined reporting provisions and repeals Multistate Tax Compact apportionment election provision**

***Overview***

*Previous legislation*

On September 14, 2011, the District of Columbia (the "District") enacted mandatory combined reporting for tax years beginning on and after December 31, 2010.[33] In addition, the District previously amended the combined reporting tax code provisions by enacting the Fiscal Year 2013 Budget Support Technical Clarification Temporary Act of 2012 (D.C. Law 19-0226) (the "2012 Temporary Act"), which became effective on March 19, 2013.[34]

*Fiscal Year 2014 Budget Support Act of 2013*

On July 30, 2013, D.C. Mayor Vincent Gray approved the Fiscal Year 2014 Budget Support Emergency Act of 2013 (D.C. Bill 20-337) (the "Emergency Act"), which amends the District's combined reporting provisions on a short-term basis. In addition, the Emergency Act also repeals the apportionment election provisions contained in Articles III and IV of the Multistate Tax Compact for District franchise tax purposes.

The Emergency Act became effective on July 30, 2013,[35] and will expire in 90 days on October 28, 2013.[36] While the Emergency Act and previous 2012 Temporary Act are similar, to the extent that the Emergency Act's combined reporting provisions conflict with those contained in the 2012 Temporary Act, the Emergency Act's provisions will be controlling.[37]

Additionally, the Fiscal Year 2014 Budget Support Act of 2013 was also approved by the D.C. Council on June 26, 2013, as permanent legislation (B20-199) (the "Permanent Act"). The Permanent Act, which is expected to contain the same

[33] Mandatory combined reporting was enacted by the Fiscal Year 2012 Budget Support Act of 2011 (D.C. Law 19-0021; 58 DCR 6226) (the "Original Act") and the provisions were incorporated into the Income and Franchise Tax statutes, chapter 18 of title 47 of the District of Columbia Code. See our previous Alert.

[34] As a Temporary Act, 19-0226 expires in 225 days. Equivalent language was also passed as an Emergency Bill (B19-0946) that previously expired on January 10, 2013.

[35] The Emergency Act has a general effective date of October 1, 2013. However, the combined reporting amendments in the Emergency Act are effective for tax years beginning after December 31, 2010. See D.C. Bill 20-337, Title VII, Subtitle J, §7103. Also, the Multistate Tax Compact amendments in the Emergency Act are effective tax years beginning after December 31, 2012. See D.C. Bill 20-337, Title VII, Subtitle HH, §7343. See also, D.C. Bill 20-337, Title XI, §§ 11001, 11003 and D.C. Code Ann. §1-204.12(a).

[36] D.C. Bill 20-337, Title XI, §11003. See also, D.C. Code Ann. §1-204.12(a).

[37] The 2012 Temporary Act is scheduled to expire 225 after its effective date. See D.C. Law 19-0226, Title IV, §402. However, because the Emergency Act was enacted later in time, its provisions are controlling to the extent that they conflict with those contained in the 2012 Temporary Act.

provisions as the Emergency Act, would permanently amend the District's combined reporting provisions as described in this Alert. The Permanent Act will be transmitted to Mayor Gray for his review, and upon approval be transmitted to Congress for a 30-day period of review.[38]

***Repeal of Articles III and IV of the Multistate Compact***

Effective as of July 30, 2013 and for tax years beginning after December 31, 2012, the Emergency Act repeals and reenacts D.C. Code Ann. Section 47-441, which contains the Multistate Tax Compact ("Compact").[39] Specifically, the Emergency Act repeals Article III of the Compact, which provides taxpayers an election to apportion and allocate income in accordance with Article IV of the Compact.[40] The Emergency Act also repeals Article IV of the Compact.[41]

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – August 10, 2013.**

**Tax law changes – North Carolina enacts tax bill with changes to corporate income tax rate, individual income tax provisions and sales and use tax**

***Overview***

On July 23, 2013, Governor Pat McCrory signed legislation, House Bill 998 (HB 998) in an effort to boost the state's economy.[42] The bill, known as the Tax Simplification and Reduction Act, provides changes to the corporate income tax, individual income tax, and sales and use tax.

***Corporate income tax changes***

***Tax rate[43]***

For tax years beginning on or after January 1, 2014, North Carolina General Statutes (NCGS) Section 105-130.3. was amended to reduce the corporate income tax rate to 6%. The corporate income tax rate is further reduced to 5% for tax years beginning on or after January 1, 2015 through December 31, 2016. HB 998 also provides a rate reduction trigger such that if certain net revenue targets are met the tax rate will to drop to 4% for tax years beginning on or after January 1, 2016 and to 3% for tax years beginning on or after January 1, 2017.

***Tax Credits[44]***

The expiration of the R&D tax credit, previously set for January 1, 2014, was delayed until January 1, 2016 by the amendment of NCGS Section 105-129.51(b). The absence of legislature action to extending certain other tax credit statutes, such as Article 3(J) credits for creating jobs and investing in business property, will allow these credits to expire pursuant to their respective existing sunset provisions.[45]

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – August 13, 2013.**

[38] See D.C. Bill 20-0199, Title X, § 10003. See also, D.C. Code Ann. §1-206.02(c)(1).

[39] D.C. Code Ann. §47-441, as amended by the Emergency Act, Title VII, Subtitle HH, §7342(a) and (b).

[40] See D.C. Code Ann. §47-441, prior to its amendment by the Emergency Act, Title VII, Subtitle HH, §7342(b).

[41] D.C. Code Ann. §47-441, as amended by the Emergency Act, Title VII, Subtitle HH, §7342(b).

[42] **An Act to Simplify the North Carolina Tax Structure and to Reduce Individual and Business Tax Rates,** General Assembly of North Carolina, Session 2013, House Bill 998.

[43] *Id.* at §§ 2.1.(a) – 2.2.(c).

[44] *Id.* at § 2.3.(c).

[45] These credits are repealed for business activities that occur on or after January 1, 2014.

**Tax law changes – Missouri enacts three new laws: New apportionment method, remote seller affiliate and click-through nexus, and Missouri Works Economic Incentive Program**

***Overview***

In late July and early August, Missouri Governor Jay Nixon signed three separate bills that affected Missouri tax law. House Bill (HB) 128 creates a new elective single-factor apportionment formula based on sales for the corporation income tax. Senate Bill (SB) 23 enacts new remote seller affiliate nexus and "click-through" nexus provisions to the sales/use tax law. Lastly, HB 184 eliminates and replaces certain economic incentives programs with the Missouri Works Economic Incentive Program. All three of the bills took effect in August of 2013.

***HB 128 introduces new apportionment option***

July 12, 2013, Missouri Governor Nixon signed into law HB 128, which amends Missouri law on apportionment of income for purposes of the corporation income tax with the addition of a new elective apportionment method. HB 128, which takes effect on August 28, 2013, will create a new single sales factor apportionment option.[46] Under the existing Missouri law two options currently exist for apportionment purposes: (1) single sales factor where sales are sourced using "wholly within," "partially within/without," and "wholly without" sourcing concepts; and (2) standard three factor apportionment which includes sales, payroll, and property. HB 128 adds a third apportionment option in Missouri. The new factor will be the ratio of sales from transactions within Missouri divided by sales everywhere.[47] Sales of tangible personal property will be sourced to Missouri if the purchaser's destination point is in Missouri.[48]

***HB 184 consolidates certain economic incentive programs into the Missouri Works Program***

On July 11, 2013, Missouri Governor Nixon signed into law House Bill (HB) 184, which eliminates the prior economic development programs known as "Missouri Quality Jobs", "Enhanced Enterprise Zones", "Development Credits", and "Rebuilding Communities Credits" and replaces these programs with "Missouri Works," a job creation/retention based tax credit program.[49] HB 184 will take effect on August 28, 2013. The law includes a discretionary job retention incentive and in most cases provides new lower job creation and average wage thresholds for program participation than the Missouri Quality Jobs Program. The entire program is subject to the tax credit program cap for FY 2014 of $106 million.[50]

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – August 16, 2013.**

[46] **Missouri HCS HB 128.**

[47] HB 128 amending section 143.451 RSMo.

[48] Id.

[49] **Missouri SS HB 184.**

[50] HB 184 adding section 620.2020 subsection 7 (1) RSMo. The cap increases to $111M in FY 2015 and $116M thereafter.

**Tax law changes – Illinois amends Income Tax Act**

***Overview***

On August 16, 2013, Illinois Governor Quinn signed House Bill (HB) 3157[51] an omnibus income tax bill that amended several sections of the Income Tax Act. These changes are summarized below.

***Income tax changes***

*Alternative Apportionment Methods*

HB 3157 allows the Director of the Illinois Department of Revenue (the "Department") to permit or require a taxpayer to use an alternative apportionment method if the statutory apportionment provisions do not fairly represent the market for the taxpayer's goods, services, or other sources of business income.[52] Prior to the enactment of the bill the Department was able to permit or require a taxpayer to use an alternative apportionment method if the statutory apportionment provisions did not fairly represent the extent of the taxpayer's business activity in Illinois. The Bill provides that the revised statutory language applies for tax years ending on or after December 31, 2008. The effective dates for the alternative apportionment provision changes mirror the dates that the sourcing of services changed in Illinois from cost of performance to market sourcing.[53]

For a discussion of all of the law changes or for additional detail on those listed above, please refer to **Multistate Tax: EXTERNAL ALERT – August 22, 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.

A change in tax law must be accounted for in the period in which the law change occurs. For each of the law changes discussed above, changes would be accounted for in the annual or interim period that includes each of the following dates:

- Texas – Generally June 14, 2013
    - Temporary franchise tax rate reduction requires that the Comptroller certify that probable revenue for the state fiscal biennium ending August 31, 2015 is estimated to exceed probable revenue as stated in the Comptroller's Biennial Revenue Estimate for the 2014-2015 fiscal biennium, on or after September 14, 2014. The enactment date for purposes of this aspect of the law change is the date on which the Comptroller provides for this certification.
- Wisconsin – June 30, 2013
- Pennsylvania – July 9, 2013
- District of Columbia –
    - July 30, 2013 for provisions of the Emergency Act
    - June 26, 2013 for provisions of the Permanent Act

[51] HB 3157 Enrolled, codified as Public Act 098-0478.

[52] HB 3157, amending 35 ILCS 5/304(f

[53] 35 ILCS 5/304(a)(3)(C).

- North Carolina – Generally July 23, 2013
    - Additional reductions to reduce the corporate income tax rate to 4% (effective January 1, 2016) and 3% (effective January 1, 2017) are both dependent upon a net revenue target that will trigger each respective reduction. The enactment date for purposes of each of these rate reductions is the date on which the target is reached (if applicable).
- Missouri –
    - July 5, 2013 for provisions in SB 23 related to remote seller affiliate and click-through nexus
    - July 11, 2013 for provisions in HB 184 related to economic incentive programs
- Illinois – August 16, 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 annual effective tax rate.

***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 (i.e., other comprehensive income, discontinued operations).

**Recently, Connecticut and Louisiana implemented amnesty programs applicable to income taxes:**

**State amnesty programs – Connecticut: New law creates amnesty program; non-participation penalties apply**

HB 6704 was signed by governor Dan Malloy on 6/18/13 and becomes effective on July 1, 2013. This new law requires the department to establish a tax amnesty program for persons owing any tax for any taxable period ending on or before November 30, 2012. This tax amnesty program will be conducted during the period from September 16, 2013 to November 15, 2013, inclusive. If qualifying participants pay their tax and interest due in full on or before November 15, 2013, 75% of the interest due shall be forgiven and any related civil penalties will be waived. Qualifying persons that fail to participate in this amnesty program (i.e., persons owing any tax for a qualifying taxable period for which a tax return was required by law to be filed with the department and for which no return has been previously filed by such persons, and such persons fail to file a timely amnesty application under this program with respect to such taxable period) are subject to a non-waivable penalty equal to 25% of the tax owed for qualifying taxable period(s).

Taxpayers not eligible to participate in this program include a person:

- Who is a party to any criminal investigation or to any criminal litigation that is pending on July 1, 2013, in any court of the United States or Connecticut;
- Who is a party to a closing agreement with the department,

- Who has made an offer of compromise that has been accepted by the department, or
- Who is a party to a managed audit agreement.

Note that no penalty waiver or reduction of interest granted pursuant to this program shall entitle the person to a refund or credit of any amount previously paid.

For additional information, please see **Multistate Tax: STATE TAX MATTERS – Issue 2013-26, June 28, 2013.**

**State amnesty programs – Louisiana enacts amnesty program**

***Overview***

On June 21, 2013, Louisiana Governor Bobby Jindal signed into law House Bill 456 which establishes the Louisiana Tax Delinquency Amnesty Act of 2013 (the "Act").[54]

***Louisiana Tax Delinquency Amnesty Act of 2013***

Under the Act, which is effective immediately,[55] the Louisiana Department of Revenue (LADOR) is required to establish a tax amnesty program for a period of at least two months duration occurring prior to December 31, 2013; for a period of at least one month between July 1, 2014, and December 31, 2014; for a period of at least one month between July 1, 2015, and December 31, 2015.[56]

***Participation in the amnesty program***

To participate in the amnesty program, eligible taxpayers must apply on forms prescribed by the Secretary of the LADOR and pay all of the tax, fees, and costs, if applicable, and any interest due upon filing the amnesty application. Taxpayers that are approved for amnesty during the 2013 amnesty period will receive full penalty abatement and reduced interest (one-half of the interest associated with the tax will be waived). Taxpayers that are approved for amnesty during the 2014 amnesty period will receive a waiver of 15% of all penalties associated with the tax, but no interest abatement. Taxpayers that are approved for amnesty during the 2015 amnesty period will receive a waiver of 10% of all penalties associated with the tax, but no interest abatement.[57]

***Applicable taxes***

The tax amnesty program applies to all taxes administered by the LADOR except motor fuel taxes and penalties for failure to submit information reports that are not based on an underpayment of tax.[58]

For additional information, please see **Multistate Tax: EXTERNAL ALERT – June 28, 2013.**

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

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

[54] Act No. 421, 2013 Regular Session (1st Reg. Sess.), HB 456, (hereinafter "HB456") §1.

[55] Act No. 421, HB 456, §5.

[56] Act No. 421, HB 456, §3(B).

[57] Act No. 421, HB 456, §3(G).

[58] Act No. 421, HB 456, §3(B).

## Did You Know?

**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. We encourage you to **register early** due to limited meeting space and number of reserved hotel rooms. Also, take advantage of multiple course discounts.

## Talk to Us

If you have any questions or comments about the ASC 740 implications described above or other content of *Accounting for Income Taxes Quarterly Hot Topics,* contact the Deloitte Washington National Tax Accounting for Income Taxes Group at: **USNationalWNTActIncomeTaxesGrp@deloitte.com**.



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