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December 2013

Accounting Developments

Emerging Issues Task Force (EITF) reaches a final consensus on Issue 13-B, "Accounting for Investments in Qualified Affordable Housing Projects"

Background

In April 2013, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU)[1] that would modify the criteria that an entity must meet in order to account for a low-income housing tax credit (LIHTC) investment by using the effective yield method[2] in (Accounting Standards Codification) ASC 323-740. The proposal is likely to increase the number of LIHTC investments that would qualify for this method. In September 2013, the EITF considered feedback that the FASB received on the proposal and made certain tentative decisions to further modify the qualifying criteria while also directing the FASB staff to perform additional outreach before the Task Force reaches a final consensus. The Task Force also discussed expanding the scope of this Issue to include other tax credit investments.

Summary

At its November 14, 2013, meeting, the Task Force reached a final consensus related only to LIHTC investments. To ensure that guidance related to LIHTC investments would not be further delayed, the Task Force agreed to recommend that the FASB add a separate project to the EITF's agenda to address investments in tax credits other than LIHTC. Assuming that such a project would be added to its agenda, the EITF also decided to issue a separate consensus-for-exposure that would permit entities to apply the same accounting guidance in their final consensus

[1] FASB Proposed Accounting Standards Update, Accounting for Investments in Qualified Affordable Housing Projects — a consensus of the FASB Emerging Issues Task Force.

[2] ASC 323-740-35-2 states that under the effective yield method, "the investor recognizes [related low-income housing tax credits (LIHTCs)] as they are allocated [or received] 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."

related to LIHTC investments to any other tax credit investments that meet the same qualifying conditions as those described below related to LIHTC.

Under the EITF's final consensus related to LIHTC, entities are permitted to make an accounting policy election to apply a proportionate amortization method[3] to LIHTC investments if the following conditions are met:[4]

- "It is probable that the tax credits allocable to the investor will be available."
- "The investor does not have the ability to exercise significant influence over 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."
- "The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive."
- "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."

In addition, other transactions between the investor and the limited liability entity would not preclude an investor from accounting for LIHTC investments by using the proportionate amortization method provided that all of the following conditions are met:[5]

a. [T]he reporting entity is in the business of entering into those [other] transactions.

b. [Those transactions are consistent with an arm's-length transaction at market terms].

c. [The reporting entity does not acquire] the ability to exercise significant influence over the operating and financial policies of the limited liability entity.

Finally, the EITF reached a final consensus that:

- Does not prescribe where an entity would present investments accounted for under the proportionate amortization method in its statement of financial position.[6]
- Requires an entity to evaluate its eligibility to use the guidance in this Issue "(a) based on facts and conditions that exist at the time of the initial investment or (b) upon a change in the nature of the investment or in the relationship with the limited liability entity that could result in the reporting entity no longer meeting the conditions to be able to use the guidance in the [Issue]."
- Requires an entity to test LIHTC investments accounted for under the proportionate amortization method for impairment when it is more likely than not that the investment will not be realized through the realization of tax credits and other tax benefits and to measure an impairment loss as the

[3] 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, or in proportion to the tax credits alone if the entity reasonably expects that the result of doing so would not differ significantly from amortizing the investment in proportion to the tax credits and other tax benefits.

[4] Quoted from the EITF's September 13, 2013, meeting minutes.

[5] See footnote 3.

[6] During its September 2013 meeting, the EITF tentatively decided that LIHTC investments would be combined with other deferred tax assets (DTAs); however, after FASB staff research and outreach revealed that these investments do not have all the characteristics of DTAs and that such classification could have negative consequences for entities that must meet regulatory capital requirements, the Task Force decided not to require entities to classify tax credit investments accounted for under the proportionate amortization method as DTAs.

amount by which the carrying amount of an investment exceeds its fair value.

- Requires an entity to “disclose information that enables users of its financial statements to understand. . . [(a) t]he nature of its investments in tax credit projects[and (b) t]he effect of the measurement of its investments in tax credit projects and the related tax credits on its financial position and results of operations.”

Effective date and transition

The Task Force reached a final consensus that the guidance in this Issue should be effective for public entities for fiscal years beginning after December 15, 2014, and interim periods therein. For nonpublic entities, the guidance in this Issue will be effective for annual periods beginning after December 15, 2014, and interim and annual periods thereafter. Early adoption is permitted. Entities that applied the effective yield method to account for LIHTC investments will be permitted to continue to do so, but only for investments already accounted for under the effective yield method. Otherwise, the guidance in this Issue must be applied retrospectively to all periods presented.

Next steps

FASB ratification is expected at the Board’s December 11, 2013, meeting, after which a final ASU will be issued. The scope of the FASB’s ratification of this final consensus will be limited to LIHTC investments. However, the FASB will also consider whether to ratify a consensus-for-exposure that would permit entities to make an accounting policy election to apply the guidance in this Issue to tax credit investments other than LIHTC investments that meet the qualifying criteria in this final consensus. If the FASB ratifies the consensus-for-exposure, it will issue a proposed ASU based on it.

On November 14, the FASB task force agreed to pursue a principles-based accounting framework for tax credit investments after voting to finalize similar guidance for investments in affordable housing projects that qualify for the LIHTC.

FAF concludes post-implementation review of Statement 109

The Financial Accounting Foundation (FAF) has issued its report on the post-implementation review (PIR) on FASB Statement No. 109, “Accounting for Income Taxes.” The key objectives of the PIR process included (a) determining if Statement 109 accomplished its stated purpose, (b) evaluating its implementation and ongoing compliance costs and related benefits, and (c) providing feedback to improve the standard-setting process.

The PIR team conducted a variety of outreach and research in forming its conclusions. For example, the PIR team considered survey responses received from nearly 1,000 stakeholders, including users of financial statements, preparers, accounting practitioners, and academics.

As stated in the FAF’s press release, the PIR team concluded:

- “Statement 109 adequately resolved the issues underlying its stated need but may not have reduced the complexity of accounting for income taxes. It is not clear whether the complexity is a result of Statement 109’s requirements, factors occurring after the issuance of Statement 109 (for example, significant changes in the business environment and tax laws, along with increased foreign operations by U.S. companies), or both.”

- “Information resulting from the application of Statement 109 provides investors with decision-useful information, although certain income tax information may not be sufficiently aligned with investor needs. For example, income tax information may not be detailed enough for users to (a) analyze the cash effects associated with income taxes, particularly current period taxes paid by jurisdiction (e.g., U.S. and foreign), and estimate future tax payments and (b) analyze earnings determined to be indefinitely reinvested in foreign subsidiaries."

- "Most of Statement 109's requirements are understandable, can be applied as intended, and enable income tax information to be reported reliably. The following aspects of income tax accounting are the most challenging for stakeholders: intraperiod tax allocations, accounting for intercompany transfers of assets, and [analyzing] earnings determined to be indefinitely reinvested in foreign subsidiaries (and the related disclosures)."
- "Statement 109 did not result in any significant changes in operating or financial reporting practices, nor did it have any significant unanticipated consequences."
- "Stakeholders incur significant ongoing costs to comply with Statement 109. Some of the costs relate to factors arising after the issuance of Statement 109, including the introduction of the Sarbanes-Oxley Act of 2002 and an increase in complexity of business transactions, U.S. and foreign tax laws, and business conducted in foreign jurisdictions by U.S. companies."

The FASB subsequently acknowledged the findings of the PIR and said it would conduct outreach to explore the specific concerns raised and determine whether there are any cost-effective solutions.[7] The FASB indicated that its outreach would include financial statement users, preparers, auditors, and others and would focus on concerns raised in regard to:

- Intraperiod tax allocation
- Intercompany transfer of assets
- Earnings indefinitely reinvested in foreign subsidiaries
- Cash flows from income taxes

The FASB also intends to seek input regarding the priority of addressing these concerns in relation to other projects that could potentially be added to the FASB's technical agenda.

Federal

Treasury issues final Section 382 "small shareholder" regulations (T.D. 9638)

Summary

On October 22, 2013, the United States Treasury Department issued final regulations under Section 382 of the Code, (the "final Small Shareholder Regulations") modifying, adding and providing exceptions to the segregation rules (T.D. 9638) as they relate to certain transactions involving the stock of loss corporations and 5% Entities. The final Small Shareholder Regulations, which finalized the proposed regulations (REG-149625-10) published on November 23, 2011, provide guidance regarding the application of the segregation rules to public groups of shareholders in determining owner shifts and ownership changes under Section 382. These regulations are effective on October 22, 2013 and apply to all testing dates during testing periods beginning on or after this date (i.e., non-elective). In certain circumstances, the regulations can be applied retroactively to testing dates included within a testing period that includes October 22, 2013.

[7] On December 3, 2013, the FASB published its **Response Letter to FAF PIR Statement 109**.

ASC 740 implications: ASC 740-10-25-47 requires that the effect of a change in tax law must be accounted for in the period that includes the date of enactment. Since the final Small Shareholder Regulations were issued on October 22, 2013, entities should account for the impact of the change in tax law in the interim or annual period that includes that date.

Due to the provisions contained therein, the final Small Shareholder Regulations may have an impact on entities' deferred taxes. A Section 382 limitation can limit an entity's ability to realize part or all of its deferred tax asset (DTA) related to net operating losses (NOLs) in the federal jurisdiction. To the extent that the application of provisions in the final Small Shareholder Regulations result in a higher Section 382 limitation, additional DTAs may be realizable. Entities should consider how the final Small Shareholder Regulations effect their assessment of whether prior transactions resulted in a change in ownership and should also consider the regulations when evaluating future transactions.

Gross income exclusion for biodiesel mixture credits claimed under Section 6426(c) and payments received under Section 6427(e)

Section 6426(c) provides a credit against the excise tax imposed under Section 4081 for blenders of biodiesel and diesel fuel that either sell the mixture for use as a fuel by others or use the mixture in their own trade or business. The credit amount is $1.00 per gallon of biodiesel utilized in the creation of a mixture with diesel fuel. Fuel credits determined under Section 6426 must first be applied against the taxpayer's excise tax liability owed for the quarterly reporting period (as reported by the taxpayer on **Form 720, *Quarterly Federal Excise Tax Return***). To the extent that the credit amount determined under Section 6426 exceeds the taxpayer's excise tax liability, the taxpayer may request payment of the excess amount under Section 6427(e) (on either the Form 720 or by submitting a **Form 8849, *Claim for Refund of Excise Taxes***) or may claim a refundable income tax credit under Section 34 (by attaching a **Form 4136, *Credit for Federal Tax Paid on Fuels*** to its annual income tax return). In lieu of utilizing these credit and payment options, taxpayers producing biodiesel mixtures may pursue an alternative approach of "electing out" of the Section 6426 regime and may then claim a non-refundable income tax credit under Section 40 or Section 40A. The disadvantage of this alternative approach, however, is that the credit amounts determined under Section 40 or Section 40A are specifically required by Section 87 to be included in the taxpayer's gross income for the year in which the credit is determined. The question addressed in the recently issued **IRS Chief Counsel Advice (CCA) 201342010** is whether blenders who claim the credit under Section 6426(c) or the related payment under Section 6427(e) must include those amounts in gross income.

CCA 201342010 addresses the federal income tax consequences of the biodiesel mixture credit allowed under Internal Revenue Code (IRC) Section 6426(c) and the related payment made to a taxpayer under Section 6427(e) to the extent the credit exceeds the taxpayer's excise tax liability. CCA 201342010 concludes that Section 6426(c) credits and Section 6427(e) payments are not items of gross income for federal income tax purposes. Although CCAs generally do not constitute precedential authority, the reasoning underlying CCA 201342010 should equally apply to all fuel credits determined under Section 6426 (such as the alternative fuel mixture credit determined under Section 6426(e)) and any payments received by taxpayers under Section 6427(e) with respect to fuel credits in excess of excise tax liability.

Taxpayers who, for past taxable years, claimed the biodiesel mixture credit determined under Section 6426(c) – or fuel credits determined under another subsection of Section 6426 – and who included in their gross income the credit amount or related payments received under Section 6427(e), should consider filing amended returns to reverse the income inclusion in view of the technical analysis contained in CCA 201342010. With respect to closed taxable years for which a Section 6426 credit or Section 6427(e) payment had been treated as an item of gross income accrued during the year, an opportunity may exist in some situations to effectively reverse the income inclusion and increase a NOL carryforward from such year.[8] Taxpayers should also consider CCA 201342010 when determining the appropriate income tax treatment of Section 6426 credits and Section 6427(e) payments for the current taxable year. Moreover, CCA 201342010 suggests that taxpayers are not required to make a "negative adjustment" (in the words of the CCA) to their costs of goods sold deduction to reflect a Section 6426(c) credit or Section 6427(e) payment. This raises the question – although not explicitly resolved by the CCA – whether taxpayers may disregard Section 6426 credits claimed when determining for federal income tax purposes the amount of their excise tax liability incurred. Lastly, taxpayers should consider state tax consequences arising from a change in their federal income tax treatment of Section 6426 credits or Section 6427(e) payments they receive.

ASC 740 implications: Companies that have previously recognized Section 6426(c) credits and/or Section 6427(e) payments in taxable income should evaluate whether they intend to file an amended return, claim for refund or to adjust a NOL carryforward based upon CCA 201342010.

ASC 740 applies to all tax positions included on previously filed tax returns and to positions expected to be taken on future returns. Recognition and measurement of a tax position should not be delayed to the period in which an amended tax return is filed or claim submitted to the Internal Revenue Service (IRS). Rather, a tax position should be assessed for recognition and measurement in the reporting period that management has the intent to claim the position in a tax return or other submission to the IRS (e.g., intent to claim as an affirmative issue). Companies should assess this development and determine whether they intend to file an amended return, refund claim or to adjust their NOL carryforward and recognize any resulting tax benefit from such tax position consistent with the recognition and measurement guidance of ASC 740.

Companies are encouraged to consult with their attest provider.

IRS reduces payment amount of refundable Alternative Minimum Tax (AMT) credits claimed under Section 168(k)(4) – IRS updates sequestration rate

An automatic budget sequestration was triggered earlier this year that forced the 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. The automatic budget sequestration's impact on refundable AMT credits claimed under Section 168(k)(4) was covered in the **September 2013 Accounting for Income Tax Quarterly Hot Topics.**

On September 30, 2013, the IRS revised its original announcement (made on August 12, 2013) on its website under the heading, **Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations:**

"Pursuant to the requirements of the Balanced Budget and Emergency Deficit Reduction Act of 1985, as amended, refund payments issued to corporations claiming refundable prior year AMT liability, are subject to sequestration. This means that refund payments processed on or after October 1, 2013 and on or before September 30, 2014 will be reduced by the fiscal year 2014 sequestration rate of 7.2%, irrespective of when the original or amended tax return was received by the

[8] *See, e.g.*, Rev. Rul. 82-49, 1982-1 C.B. 5; Rev. Rul. 81-88, 1981-1 C.B. 585.

Service. The sequestration reduction rate will be applied unless and until a law is enacted that cancels or otherwise impacts the sequester, at which time the sequestration reduction rate is subject to change.

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 AMT credits, treating the accelerated credits as refundable credits. Corporations making this Section 168(k)(4) election and claiming a refund of prior year AMT 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 AMT credits are not subject to this reduction."

The Section 168(k)(4) election allows companies to claim a refund for unused 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, 2014 and if it does, whether it will continue with the same reduction percentage. In addition, it is unclear whether the 7.2% reduction is permanent (i.e., whether credits equivalent to the 7.2% 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. 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 September 30, 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 October 1, 2013 and September 30, 2014, 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 on the income tax return.

If a company filed or intends to file an original or amended tax return claiming a refund as a result of the Section 168(k)(4) election, and expects to receive a refund check from the IRS between October 1, 2013 and September 30, 2014, 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 (or an amended prior period return eligible for the 168(k)(4) election), it is possible that sequestration may impact the ability to "monetize" a portion of its unused AMT credits by foregoing bonus depreciation. 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, 2014.

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

International

Mexico Tax Reform

The Mexican Senate approved a broad tax reform bill on October 30, 2013, which was signed into law by President Nieto and published in the Federal Official Gazette on December 11, 2013. On the day following the publication in the Federal Official Gazette, December 12, 2013, the tax reform law is considered "enacted" for U.S. Generally Accepted Accounting Principles (U.S. GAAP) purposes, unless a different date is stated in the law.

The tax reform bill contains a number of measures that affects companies doing business in Mexico.

General changes

- The business flat tax (IETU), which is currently imposed at a rate of 17.5%, is abolished, with certain transition provisions applying.
- A 10% withholding tax with respect to dividends is introduced, which could be reduced for nonresidents under an applicable tax treaty. The withholding tax would apply with respect to the distribution of earnings derived after December 31, 2013.
- Income from the sale of assets, which generate royalty income, is itself considered to be royalty income subject to withholding tax to the extent the sale is conditioned upon the productivity, use, or subsequent disposal of such goods or rights.
- Compensation that is exempt income to an employee (e.g., fringe benefits, employees' savings and loan funds, severance payments, annual bonuses, overtime payments, vacation and Sunday premiums, and the exempt portion of profit sharing) is deductible by employers only up to 53%. However, if an employer's contributions to such benefits are less than its contributions in the prior year, the deductibility threshold is reduced to 47%.
- The deduction for payments made to foreign related parties is limited under three different provisions:
    1. All payments made to a related or an unrelated individual, entity, trust, joint venture, investment fund or any other legal person subject to a preferential tax regime have to be made on an arm's-length basis; otherwise, the payment are nondeductible for tax purposes.
    2. Interest, royalties or technical assistance fees paid to a foreign company (whether the foreign company is a controlled or controlling company) that fall within any of the following categories are nondeductible:
        - The foreign entity is a transparent entity (except where shareholders or members are subject to an income tax and the payment is made on arm's-length terms);
        - The payment is disregarded for tax purposes in the country or territory in which the foreign entity is located; or
        - The foreign entity does not consider the payment to be taxable income.
    3. A payment to a related party, whether foreign or domestic, is nondeductible if the payment is deductible by the related recipient.

    This restriction will not apply if the related recipient includes the taxable revenue of the payor in its tax return in the same tax year the payment is made or the following tax year.

- The tax consolidation regime is repealed, transition measures will apply for groups to pay tax deferred during the consolidation period, and an optional group taxation regime is introduced to replace the consolidation regime as follows:

    - The tax consolidation regime is abolished after December 31, 2013 and consolidated groups will effectively be deconsolidated. Existing groups must pay deferred income tax in annual installments between the 2014 and 2018 fiscal years. However, taxpayers that are within the mandatory five-year deferral period as of December 31, 2013 can continue to consolidate until the deferral period ends; they will then have to pay the deferred tax using the mechanism established by applicable transition rules.

    - An optional regime replaces the consolidation regime, under which corporate groups can elect to calculate income tax on a consolidated basis. The new regime provides certain benefits for payment of tax when companies have profits or losses in the same year within a corporate group. Tax may be deferred for a maximum of three years. Groups that have been authorized to consolidate their tax results as of December 31, 2013 can apply the optional regime without having to request authorization from the Mexican tax authority, simply by filing a notice with the Mexican tax authority before February 15, 2014.

- The immediate deduction incentive for new investment in fixed assets (e.g., equipment and machinery and buildings) is abolished.

- The profit sharing rate for employees will remain at 10%. However, there will be a new formula for calculating the profit sharing base, which will be the company's taxable income, before any reduction for profit sharing paid and before offset for NOLs, with certain adjustments.

Maquiladora regime

- The special regime for maquiladoras and the permanent establishment (PE) exemption for nonresidents that operate in Mexico through a maquila structure is retained, but a stricter definition of a maquila operation is incorporated. As a result, the following requirements must be met for a maquila to qualify for benefits:

    - The maquila must derive all of its income from designated maquila operations. That is, a maquiladora's income must be associated with "productive activities" for the maquiladora to qualify for PE protection.

    - A nonresident must provide materials to be temporarily imported into Mexico for a "transformation process;" the maquiladora must physically or virtually export the manufactured products in accordance with the customs law; and

    - The nonresident principal must provide at least 30% of the machinery and equipment for the maquila operations and the machinery and equipment may not be owned (currently or previously) by the maquila or a Mexican related party. The 30% requirement will be calculated based on rules issued by the Mexican tax authorities. Notably, the approved measures, which are contrary to the IMMEX decree, would not "grandfather" maquiladoras that are below the 30% threshold. Rather, all maquiladoras must satisfy the 30% machinery and equipment requirement by the end of 2014 or risk losing PE protection.

- Mexico's Income Tax Law was amended in 2003 to provide that maquiladora operations would not create a PE in Mexico for a foreign parent company that maintained an economic and legal relationship with a Mexican maquiladora that habitually processed merchandise using machinery and equipment provided directly or indirectly by the foreign parent if the foreign parent was resident in a country that had concluded a tax treaty with Mexico and the maquiladora complied with Mexico's transfer pricing rules. Specifically, there were four ways a maquiladora could obtain protection against PE status:

    1. Have taxable income of at least the higher of: (a) 6.9% of the value of the maquiladora's assets, including fixed assets and inventory owned by the foreign parent; or (b) 6.5% of the maquiladora's costs and expenses;

    2. Prepare a transfer pricing study using the adjustments and methodologies allowed under the Income Tax Law and add an amount equal to 1% of the foreign-owned assets to the result of this analysis;

    3. Prepare a transfer pricing study using the transactional operating profit margin method in which the profitability of machinery and equipment owned by the foreign principal would be taken into account; or

    4. Negotiate an advance pricing agreement (APA) with the Mexican tax authorities confirming the methodology applied under options 2 and 3.

    - The tax reform eliminates the two self-compliance methods for a maquiladora to avoid PE status and be deemed to be in compliance with Mexico's transfer pricing rules (i.e., options 2 and 3). Thus, only options 1 and 4 may be used to avoid PE status – apply the safe harbor or obtain an APA. The safe harbor rules provide less flexibility for companies to recognize a lower taxable base corresponding to the maquiladora operations, although it is possible to obtain an APA if a maquiladora does not consider that the results of the application of the safe harbor are consistent with its economic circumstances (e.g., in the case of asset-intensive operations).

    - The maximum period that foreign principals can use a shelter maquiladora to determine whether to maintain their investments in Mexico in a more permanent operation is limited to four years.

ASC 740 implications: A change in tax law must be accounted for in the period in which the law change occurs (i.e., the annual or interim period that includes the date of enactment):

- Pursuant to ASC 740-270-25-5, the tax effect of a change in tax law or tax rates on taxes currently payable or refundable for the current year should be recorded after the effective dates prescribed in the statutes and reflected in the computation of the annual effective tax rate (AETR) beginning no earlier than the first interim period that includes the enactment date of the proposed legislation.

- Additionally, DTAs and deferred tax liabilities (DTLs) should be measured using the enacted tax rate expected to apply in the periods in which the DTA or DTL is expected to be realized or settled. Companies should schedule the reversals of temporary differences in order to determine the applicable tax rate in order to measure DTAs and DTLs. Consideration should be given to elections that are expected to apply in the future and the amounts of expected income or loss in the future years when those temporary differences are expected to reverse.

- For interim purposes, ASC 740-270-25-5 provides that the effect of a change in tax laws or rates on a DTL or DTA shall not be apportioned among interim periods through an adjustment of the AETR. Companies will also be required to consider the intraperiod allocation rules with regard to changes in tax laws or rates.
- Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law or rate, 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 originally recorded other than in continuing operations (e.g., in other comprehensive income or in discontinued operations).

Some examples of ASC 740 implications of the change in tax law are as follows:

- Deferred taxes previously recognized for temporary differences existing under the IETU business flat tax system should be eliminated and deferred taxes should be recognized for temporary differences under the applicable corporate income tax system.
- Parent companies that do not assert indefinite reinvestment with respect to investments in Mexican corporations will need to consider the impact of the change in withholding taxes.
- Foreign resident companies that no longer qualify for protection from permanent establishment status under the maquiladora regime should consider the impact this change will have on deferred taxes.

If applicable, companies should include proper disclosures for the effects of the tax law changes as prescribed in ASC 740-10-50-9(g).

Although this article focuses on tax reform in Mexico, please also look for our upcoming **Global Tax Developments Quarterly** to be published as a more comprehensive source of global tax information that may be considered in conjunction with accounting for income taxes under U.S. GAAP.

Puerto Rico issues technical amendments to Act 40 of 2013, the Tax Burden and Redistribution and Adjustment Act, including a clarification regarding the additional tax on gross income

On June 30, 2013, the governor of Puerto Rico enacted Act 40 of 2013 (Act 40), 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. For additional information on the changes to the AMT regime included in Act 40, see the **September 2013 Accounting for Income Tax Quarterly Hot Topics** newsletter.

Act 40 makes significant changes to the rules governing the calculation of the AMT, the most significant of which is a new additional tax on gross income (ATGI), and also introduces a new tax on related party transactions. Accordingly, the AMT will be calculated as the greater of the following items:

- AMT net income taxed at an increased 30% rate, plus the tax on ATGI; or

- Subject to certain exceptions, 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 tax on ATGI.

On October 14, 2013, the governor of Puerto Rico signed Act 117-2013 (the Act) into law, which provides technical amendments to Act 40. In particular, the Act clarifies that, for taxpayers subject to tax under the 1994 Puerto Rico tax code, the ATGI applies in addition to the regular tax and is not part of the AMT. Therefore, an AMT credit is not available to offset regular tax in future years for tax paid on ATGI if a taxpayer is subject to tax under the 1994 Puerto Rico tax code.

Corporations that are subject to tax under the 2011 Puerto Rico tax code may claim an AMT credit to offset regular tax liabilities in the future for any AMT liabilities paid (including AMT paid based upon payments to related parties or ATGI).

When the original 2011 Puerto Rico tax code was enacted, corporations automatically became subject to the 2011 Puerto Rico tax code rather than remaining subject to the 1994 Puerto Rico tax code. Corporations that wanted to remain subject to tax under the 1994 Puerto Rico tax code had the option of electing to do so (Option 94 Election). Corporations that made the Option 94 Election will remain subject to tax under the 1994 Puerto Rico tax code for five years beginning in 2011.

Act 40 also amended the 2011 Puerto Rico tax code to allow corporations that made the Option 94 Election to revoke it and, therefore, be subject to the 2011 Puerto Rico tax code beginning in 2013. Additional guidance has not yet been provided regarding how to revoke the Option 94 Election.

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."

ATGI is 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 tax on ATGI does not fall within the scope of ASC 740.

However, the fact that the AMT (including the ATGI) can reduce future regular tax liabilities for corporations under the 2011 Puerto Rico tax code raises a question regarding whether an alternative view exists that the ATGI could be considered within the scope of ASC 740 even if the taxable base does not meet the definition of "taxable income." The reason for allowing the ATGI component of AMT to be included with income taxes for corporations under the 2011 Puerto Rico tax code is its integration with the regular tax system. Under ASC 740, integrated AMT systems (like in the United States.) 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. Accordingly, corporations under the 2011 Puerto Rico tax code might treat the ATGI as a tax within the scope of ASC 740 in a manner similar to how the U.S. AMT is accounted.

Companies that made the Option 94 Election should not account for the ATGI as a tax within the scope of ASC 740 since the ATGI is considered an additional tax and is not part of an integrated AMT system. Companies that intend to revoke the Option 94 Election should continue to account for the ATGI as a tax that is outside the scope of ASC 740 until further guidance is provided regarding how to revoke the Option 94 Election.

Companies are encouraged to consult with their attest provider.

Controversy

IRS memorandum provides implementation guidance for Appeals Judicial Approach Culture (AJAC) project

Background

On July 18, 2013 the IRS released a memorandum[9] (Memo) issued by the Director, Policy, Quality and Case Support to IRS Appeals Employees regarding the implementation of the AJAC Project. This project is designed to promote a quasi-judicial approach to handling of cases by the IRS Office of Appeals (Appeals).

Summary

Appeals is designed to provide an independent forum for taxpayers and the IRS to resolve disputes outside of litigation. Its mission is to resolve disputes in a fair and impartial basis to both the Government and taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.[10]

The IRS has recently updated its policy to provide that Appeals Officers a) will not raise any new issue and b) will not reopen an issue on which the taxpayer and the IRS are in agreement. Previously, Appeals Officers could raise a new issue if the grounds were substantial and the potential impact upon the tax liability was material. The Memo provides an updated policy statement, along with interim guidance to effectuate this change.

To implement this policy, the Memo provides interim guidance in the form of updated Internal Revenue Manual (IRM) provisions related to various Appeals functions.[11] One example of this change is contained in Conference and Issue Resolution – General Guidelines, as set forth in I.R.M. 8.6.1.6.2. This provision has been updated to state:

1. Appeals will not raise new issues and will focus on dispute resolution efforts on resolving the points of disagreement identified by the parties. The Appeals process is not a continuation or extension of the examination process.

While Appeals may not raise new issues, it is allowed to consider alternative or new legal arguments that support the parties' positions for purposes of hazards of litigation analysis. The new guidance also provides that the discussion of new case law (or other authorities) which support a previously raised theory or argument does not constitute a new issue.

[9] Control No. AP-08-0713-03

[10] I.R.M. 8.1.1.1(1).

[11] The Memo contains guidance on Collection Due Process cases, Offers in Compromise, Collections Appeals Process, Docketed Cases and Examination.

However, Appeals may only utilize evidence within the case file to evaluate such theories. For cases that are not fully developed by Compliance and where the taxpayer has not presented new evidence or information, Appeals will attempt to settle the case based upon the actual hazards. Finally, it should be noted that this new policy does not preclude a taxpayer from raising an affirmative issue; it merely prevents Appeals from raising new issues.[12]

The Memo provides interim guidance to effectuate the new policy as of July 18 and contains updated IRM provisions related to the various workflows within the Appeals, including Collection Due Process, Offers in Compromise, Collection Appeals Programs and Examination cases.

ASC 740 implications: Under ASC 740-10, entities are required to evaluate tax positions taken or expected to be taken and record an unrecognized tax benefit for benefits that are not more likely than not of being sustained on examination based solely on the technical merits.

To the extent that the more-likely-than-not threshold is not met in a particular period, ASC 740-10-25-8 provides that entities should recognize the benefit of such position in the first interim period in which the statute for assessment expires, the position is effectively settled, or the more-likely-than-not threshold is met. Pursuant to ASC 740-10-25-10, effective settlement requires the following conditions be met:

a. A taxing authority has completed its examination procedures including all appeals and administrative reviews.

b. An entity does not intend to appeal or litigate any aspect of a position contemplated in the exam.

c. It is “remote” that a taxing authority would examine or reexamine any aspect of the position.

With respect to 740-10-25-10(a), prior to the issued guidance in the Memo, new issues could be identified or settled issues could be reopened during the appeals process, making it difficult to conclude than an issue was effectively settled until the appeals process was complete. The implementation of the AJAC project should be considered when applying the effectively settled criteria. Entities should consider whether all administrative reviews have been completed in order to satisfy the relevant effectively settled criteria. The facts and circumstances related to each position differ and, as such, consideration should be provided to each aspect of the IRS examination process, including the potential for the case to go to the Joint Committee on Taxation for review after the appeals process.

The AJAC implementation guidance is considered new information with respect to the assessment of an entity’s uncertain tax positions. Under ASC 740-10-25-14, the evaluation of new information may lead to subsequent changes in judgment as it relates to a particular position. Discussion with an entity’s attest firm is advised.

Pursuant to ASC 740-10-25-15, a change in judgment that results in subsequent recognition, derecognition or a change in measurement of a position taken in a prior annual period must be recognized as a discrete item in the period in which the new information becomes available, which in this case is an entity’s interim or annual period that includes July 18, 2013.

[12] I.R.M. 8.6.1.6.1.

Did You Know?

U.S. Tax Reform

Tax reform staff discussion drafts

Senate Finance Committee Chairman Max Baucus, D-Montana, released three "staff discussion drafts" of amendments to the tax code. Each draft, while not introduced as a bill, contains statutory language indicating one or more directions that Baucus may contemplate in a large-scale rewrite of the tax law. Baucus wants the drafts "to spur a conversation about areas where Republicans and Democrats may be able to reach agreement on how to fix the broken tax code." To that end, Baucus has issued a request for comments from stakeholders and the public on specific technical and policy issues raised in the discussion drafts. The three drafts cover:

Tax administration

Chairman Baucus says that this draft, based in part on provisions in Senate bills introduced by other Senators in the last several years, would simplify the tax filing process, provide the IRS new tools to combat tax-related identity theft, and reduce the tax gap. Among other things, this draft would:

- Accelerate the due date for partnership income tax returns from April 15 to March 15, delay the due date for S corporation returns to March 31, and delay the due date for C corporation income tax returns to April 15. In addition, the draft would accelerate deadlines for filing information returns, such as Forms W-2 and 1099.
- Impose new reporting requirements on banks, mortgage lenders, life insurance companies, colleges and universities, and require more coordination between the Forms 1099 and 1040 Schedule Cs filed by sole proprietorships.
- Allow the IRS to impose a levy of up to 100% on payments to Medicare providers that are seriously delinquent, as defined, in their taxes.

Cost recovery and tax accounting rules

This draft, also based in part on previously-introduced Senate bills, proposes significant changes to the cost recovery and tax accounting rules including, among other things, replacing current-law depreciation rules, eliminating the like-kind exchange rules and the last-in, first-out (LIFO) method of accounting, as well as requiring taxpayers to amortize half their advertising expenses.

International business tax reform

This draft proposes to fundamentally change the way that U.S.-based multinationals avoid international double taxation of foreign income. Other international tax provisions would also be modified by the draft.

House Ways and Means Committee Chairman Dave Camp, R-Mich., released his own discussion draft on international tax reform two years ago, but it differs significantly from the Baucus proposal. (For prior coverage of Camp's discussion draft, see the **December 2011 Accounting for Income Taxes Quarterly Hot Topics**)

The Baucus staff discussion draft proposes ending deferral on a newly defined class of controlled foreign corporation (CFC) income under one of two options – referred to as "Option Y" and "Option Z" – and then exempting the rest, even if repatriated. Existing categories of Subpart F income would generally be eliminated or, in the case of "foreign personal holding company income" and "insurance income," modified. No foreign taxes paid by the CFC would be "deemed paid" by the U.S. shareholder upon the actual repatriation of earnings. U.S. shareholder interest expense apportioned to the U.S.-tax exempt income of its CFCs would be nondeductible.

Option Y – Option Y would generally treat an item of CFC income as Subpart F income (i.e., income currently taxed in the hands of the CFC's U.S. shareholder) if the item is subject to an effective foreign income tax rate less than 80% of the maximum U.S. corporate tax rate ("Low Taxed Income"). The U.S. shareholder of the CFC would be allowed a deduction of 20% of the amount of Low Taxed Income included in the shareholder's income.

The combination of the threshold tax rate (80% of the U.S. rate) and the 20% deduction seems intended to require a "minimum worldwide tax rate" (i.e. combined foreign and U.S. tax rates) for income of foreign subsidiaries. Although this minimum is based on a percentage of the U.S. domestic corporate tax rate, the draft does not specify what the post-tax-reform domestic rate should be. Further, the percentages themselves are bracketed in the discussion draft, meaning that 80% is not a hard target and can be changed.

Under Option Y, CFC income falling within anther definition of Subpart F income (e.g., foreign personal holding company income or insurance income) would not benefit from the 20% deduction, and these fully taxable categories of Subpart F income would include a new category called "U.S. related income," defined as the sum of "imported property income" and "U.S. services income." Imported property would be defined as property which is imported into the United States by a CFC or related person. Imported property income would include income derived in connection with producing, selling, leasing, or licensing imported property. U.S. services income would be income derived in connection with services provided with respect to persons or property located within the United States, or with respect to U.S. risks.

In addition to the foreign tax credit "basket" for passive income, Option Y would create new baskets for (1) Subpart F income attributable to insurance income, (2) Subpart F income attributable to U.S. related income, (3) Subpart F attributable to Low Taxed Income, and (4) foreign branch income. A U.S. shareholder's "deemed-paid" foreign taxes on Subpart F income would no longer be computed on the "pooled" basis of present law.

With respect to distributions of CFC income that is not Subpart F income under Option Y, 10% U.S. corporate shareholders would generally receive a 100% dividends received deduction (DRD) for the "foreign-source portion," rather than the 95% DRD in Camp's discussion draft. Unlike the Camp draft, the Baucus draft disallows the U.S. shareholder interest expense deductions for interest expenses apportioned to the non-Subpart F (i.e., U.S.-tax exempt) income of its CFCs.

Option Z – Option Z allows for reduction, but generally not the elimination, of worldwide tax on "active foreign market income" (AFMI)

The U.S. shareholder of a CFC would owe current U.S. tax, subject to allowable foreign tax credits, on the shareholder's pro rata share of:

- 60% of the CFC's net AFMI; and
- All of the CFC's net "nonactive income" (which would include "passive income").

(Similar to the percentages in Option Y, Option Z's 60% figure is bracketed in the discussion draft.) All of the CFC's foreign earnings would be free of U.S. tax when distributed, and a portion of gains and losses on CFC stock would be exempt from U.S. tax. Thus, similar to Option Y, Option Z would generally have the effect that all CFC income is taxable overall to the extent of at least a fixed percentage of the U.S. tax rate. The imposition of any tax by a foreign country on AFMI would generally result in a higher overall worldwide tax burden on such income, but if the foreign tax rate is less than the U.S. corporate rate, then such higher burden would generally be limited to 40% of the foreign tax imposed. The burden of the other 60% of the foreign tax would generally be offset by the U.S. foreign tax credit.

AFMI would be the opposite, in some ways, of “U.S. related income”: AFMI is defined as income attributable to “economically significant activities” with respect to a “qualified trade or business” (a foreign production or service providing trade or business), derived in connection with property sold for use, consumption, or disposition outside the United States, or services provided outside the United States with respect to persons or property located outside the United States. “Passive income” would be a variant of present law foreign personal holding company income and insurance income.

“Deemed-paid” credits for foreign taxes paid by the CFC would be allowed against U.S. tax on these Subpart F inclusions, excluding credits for the foreign taxes on the 40% of net AFMI that escapes Subpart F income status. Option Z would impose a new foreign tax credit “basket” for Subpart F income from AFMI. Deemed-paid taxes would no longer be computed on a pooled basis. U.S. shareholder interest expense apportioned to the non-Subpart F (i.e., U.S.-tax exempt) income of its CFCs would be disallowed.

Transition to the proposed new system for previously deferred income – Under either Option, the U.S. corporate shareholder of a CFC would include in income the CFC’s accumulated deferred foreign income as of the end of its last year beginning before 2015, but the tax rate on this inclusion would be 20%. The tax would be reduced by deemed-paid foreign taxes in the same proportion that the 20% rate bears to the U.S. shareholder’s U.S. income tax rate. The tax would be payable in up to eight annual installments.

Other international tax changes – The draft would also make other changes to the foreign tax credit and Subpart F rules; modify the “check-the-box,” “PFIC,” and source-of-income rules; and repeal the “DISC” and “dual consolidated loss” rules. The draft would make important changes in the taxation of U.S. income of foreign persons by loosening the “FIRPTA” rules, but at the same time repealing the “portfolio interest exception” from 30% gross-basis U.S. tax on U.S. source interest (but without overriding treaty exemptions from such tax). The draft would deny U.S. deductions for payments to related persons in connection with an arrangement that reduces foreign income tax (on, say, the recipient of the payment) and that involves either: hybrid transactions, instruments or entities; exemption arrangements; or conduit financing arrangements. The draft also includes provisions similar to previous proposals disallowing deductions for reinsurance premiums paid to related persons, taxing dispositions of partnership interests by a foreign person, and making clarifications applicable to Sections 367 and 482.

Reduction in corporate tax rate – The reforms suggested by Chairman Baucus are intended to raise enough revenue from corporations in the long term to finance a significant reduction in the corporate tax rate.

ASC 740 implications: If the discussion documents released by Chairman Baucus were to be incorporated into a bill and enacted in its current form, there could be significant consequences to both current and deferred taxes under ASC 740. The measurement of current and DTLs and DTAs is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated (ASC 740-10-30-2(a)).

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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