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March 2010

New Developments

Proposed Change to IRC §139A Enacted on March 23, 2010

In the December 30, 2009, issue, we discussed proposed legislation related to IRC §139A and the ASC 740 implications if enacted as proposed. On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (the Affordable Care Act) that included as a revenue-raising provision the repeal of IRC §139A.

Background:

An employer offering retiree prescription drug coverage that is at least as valuable as Medicare Part D is entitled to a subsidy, the Retiree Drug Subsidy. Employers can deduct the entire cost of providing the coverage, even though a portion is offset by the subsidy. For taxable years beginning after December 31, 2010, the Act repeals the current law permitting deduction of the portion of the expense that is offset by the subsidy. With the change in law, the subsidy “receivable” will remain not taxable, but a corresponding amount of liability will become not deductible. Therefore, the expected future tax deduction will be reduced by an amount equal to the subsidy and the corresponding deferred tax asset (DTA) must be adjusted (reduced in this instance).

ASC 740 Implications: Under ASC 740, the expense or benefit related to adjusting deferred tax liabilities and assets as a result of a change in tax laws must be recognized in income from continuing operations for the period that includes the enactment date, March 23, 2010. Therefore, the expense resulting from this change will be recognized in the first quarter of 2010 even though the new law is effective for tax years beginning after December 31, 2010 (however, the deferred tax asset is not adjusted for the part of the OPEB obligation that is expected to be settled prior to the effective date of the new law).

In addition, in the event that there is a valuation allowance recorded against the DTA, the adjustment to the DTA will not result in an immediate deferred tax expense, as the decrease to the DTA will be offset by a corresponding decrease in the valuation allowance. However, the expense related to the change in the law has only been deferred since the amount of valuation allowance that can be reversed to tax benefit at a later date (if and when the company returns to profitability) has been permanently reduced.

What’s Next: If the supplemental reconciliation package the House sent to the Senate (Reconciliation Act) on March 21, 2010, is passed and enacted into law as currently drafted, the effective date will be postponed to taxable years beginning after December 31, 2012. If the Reconciliation Act is enacted in the same period as the Affordable Care Act, the ASC 740 implications discussed above would still apply, albeit the adjustment to the DTA (if not fully offset by a valuation allowance) will be for a different amount due to the different effective date. If the Reconciliation Act is enacted in a subsequent period, companies will need to adjust the DTA again (this time favorably) to account for the postponement of the effective date.

For additional details, please refer to Deloitte's **Financial Reporting Alert 10-3**.

Accounting Developments

Valuation Allowance on a Deferred Tax Asset Related To Debt Securities

A debt security classified as available for sale (AFS) or held to maturity (HTM) accounted for under ASC 320, Investments – Debt and Equity Securities, may result in the recognition of unrealized holding gains or losses in other comprehensive income (OCI) as the fair value of the security changes over the contractual term of the investment. If an unrealized holding loss is tax deductible when realized, the difference between the carrying amount of a debt security and its tax basis is a deductible temporary difference. However, when an enterprise has the intent and ability to hold the debt security until recovery of its amortized cost, increases in the security's fair value up to its amortized cost basis[1] will reverse the unrealized loss recorded in accumulated other comprehensive income (AOCI) over the contractual life of the investment, resulting in no cumulative change in the enterprise's comprehensive income or future taxable income. In this respect, the temporary differences associated with unrealized gains and losses on debt securities are unlike other types of temporary differences because they do not affect the income statement or the tax return if held until recovery of the debt securities' amortized cost.

If an unrealized loss from a debt security classified as AFS or HTM is recorded in OCI[2] and a tax benefit for that loss can be recognized in the same period, the tax benefit would also be recorded in OCI, in accordance with the intraperiod tax allocation rules under ASC 740-20-45.

To date, the SEC staff has accepted two alternative views of an entity when evaluating the need for a valuation allowance related to a DTA recognized as a result of an unrealized loss on a debt security that is recognized in OCI when the entity has the intent and ability to hold the debt security until recovery.

> **Alternative View 1**: if an entity has the intent and ability to hold the debt security until recovery of its amortized cost, increases in the security's fair value up to its amortized cost basis will reverse the unrealized loss recorded in AOCI over the contractual life of the investment, resulting in no cumulative change in the entity's comprehensive income or taxable income. Accordingly, the DTAs related to these securities should be excluded from other DTAs being evaluated for realization because the DTA recognized for unrealized losses of a debt security included in OCI does not require a source of future taxable income for realization (since the accounting assertions would imply that the unrealized loss will never be realized and therefore no tax loss will ever be reported on any tax return).
>
> **Alternative View 2**: even if the entity has the intent and ability to hold the debt security until recovery, the DTAs related to the tax basis in excess of the financial reporting basis equal to the amount recorded as unrealized losses in OCI cannot, under ASC 740, be excluded from the normal assessment of realizability for all DTAs. In other words, while the ability and intent to hold a debt security until recovery implies a source of future taxable income for this particular deductible temporary difference, this fact should not be considered in isolation. Rather, this source of future income must be combined with the entity's other sources of future taxable income and the DTAs combined with the other DTAs when assessing the realizability of the total DTAs of the entity. If the future income (inclusive of the expected recovery of value related to the AFS securities) is not sufficient to realize the DTAs, a valuation allowance is required.

[1] ASC 320-10-20 defines amortized cost basis as the amount for which an investment is acquired, adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings (less any cumulative-effect adjustments), foreign exchange and fair value hedge accounting adjustments.
[2] Unrealized losses that are other-than-temporary impairment losses from, for example, anticipated credit losses, are recognized in the statement of operations.

For many entities that have cumulative losses in recent years (as discussed in ASC 740-10-30-21), the application of Alternative View 1 may result in a net DTA related to the debt securities even though the net DTA for all other items is offset by a valuation allowance, while the application of Alternative View 2 may result in a single net DTA that is completely offset by a valuation allowance.

The Financial Accounting Standards Board (FASB), during its March 3, 2010, meeting, tentatively decided in favor of Alternative View 2. In other words, their tentative view is that the assessment of the need for a valuation allowance for a DTA relating to debt securities classified as AFS should be done in combination with other deferred tax assets of the entity. This decision was made as part of the FASB's *Accounting for Financial Instruments* project, which will not be finalized for some time. Refer to the FASB's website for a summary of the project and expected timing.

The FASB staff acknowledges that public feedback on this issue has been mixed, reflecting the fact that there is diversity in practice for this aspect of tax accounting. Until the FASB finalizes this project and updates that codification through the issuance of an Accounting Standards Update (ASU), an entity should continue to follow the accounting policy it has elected. An exposure draft on the *Accounting for Financial Instruments* project, when released, will allow the public an opportunity to comment on the FASB's tentative decision before it is finalized.

Federal

Loss on Worthless Securities

Section 165(g)(3) of the Internal Revenue Code allows a loss on worthless securities to be deducted (referred to as a worthless stock deduction) against a domestic corporation's ordinary income if the corporation (foreign or domestic) whose securities are worthless is "affiliated" with the domestic corporation. For purposes of section 165(g)(3), a corporation is treated as affiliated with the taxpayer only if (A) the taxpayer owns directly stock in such corporation, meeting the requirements of section 1504(a)(2), and (B) more than 90 percent of the aggregate of its gross receipts for all taxable years have been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities (the gross receipts test). If the gross receipts test is not met, then the loss on worthless securities is a capital loss.

In order to meet the gross receipts test, the IRS has permitted taxpayers to include the historic gross receipts of former corporations that transferred their assets to such corporation tax free pursuant to sections 332 or 368. To prevent duplicative inclusion of the transferor corporation's gross receipts, the Service also ruled that the taxpayer's subsidiary was required to eliminate the intercompany distributions received from the transferor corporations prior to the tax-free asset transfer. See PLRs 200710004 and 2010006003 for examples of favorable private letter rulings.

ASC 740 Implications: For financial reporting purposes, a deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting (outside basis deductible temporary difference) of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the *foreseeable future* (ASC 740-30-25-9 formally included in FAS 109, par. 34). The term foreseeable future is not specifically defined in ASC 740 but is generally interpreted in practice to be within 12 months from the financial reporting date. If a company is expecting a worthless stock deduction for one of its subsidiaries, it may be appropriate to recognize the deferred tax asset for the outside basis deductible temporary difference of an investment in the subsidiary in a reporting period prior to the actual worthless stock deduction being taken on the tax return. Whether or not the deduction is ordinary (i.e., can be deducted from the entity's ordinary income) or capital may impact the assessment of the need for a valuation allowance against the related deferred tax asset. In addition, the character of the expected (or historical) worthless stock deduction should be evaluated as a tax position using the recognition and measurement of ASC 740-10 to determine if an unrecognized tax benefit should be recorded and/or disclosed.

International

Cost-Sharing Agreements and Share-Based Compensation Costs

The U.S. Court of Appeals for the Ninth Circuit on March 22, 2010 issued its new opinion in *Xilinx Inc. v. Commissioner*, holding that stock-based compensation (SBC) need not be included in the research and development cost base of companies that have entered into a cost sharing arrangement (CSA) under Treas. Reg. Sec. 1.482-7, prior to its amendment in 2003.

Prior to issuing its new opinion, on January 13, 2010, The Ninth Circuit issued a one-page order by which it withdrew the May 27, 2009, majority opinion and dissent in *Xilinx Inc. v. Commissioner*, in which the appeals court had held that: (1) related companies in a cost sharing agreement to develop intangibles must share all costs related to the joint venture, even if unrelated companies would not do so; (2) stock options for which companies claim tax deductions are a cost under former reg. section 1.482-7(d)(1); and (3) such costs are “related to” the intangible product development, as part of the compensation package offered to employees involved in activities under the joint venture.

Background:

In *Xilinx Inc. v. Commissioner*, the U.S. Court of Appeals for the Ninth Circuit overturned a landmark U.S. Tax Court transfer pricing case, *Xilinx Inc. v. Commissioner* 125 T.C. 37 (2005), in which the taxpayer prevailed in the Tax Court involving the 1995 cost-sharing regulations. The 1995 cost-sharing regulations required that all costs (except as specifically excluded by the regulations) should be shared among related parties engaged in an intangible development activity. The Tax Court held that the all cost requirement in the 1995 regulations was contrary to the arm’s length standard required by Treas. Reg. §1.482-1(b) since unrelated parties would not agree to share SBC costs.

ASC 740 Implications: Companies with periods ended on or after January 13, 2010, but before March 22, 2010, should determine whether the withdrawal provides new information that may impact the analysis of uncertain tax positions based on the company’s specific facts and circumstances. Similarly, companies with periods that include March 22, 2010, should determine whether the new Ninth Circuit opinion provides new information that may impact the analysis of uncertain tax positions based on the company’s specific facts and circumstances. Any change in the unrecognized tax benefits resulting from the withdrawal or decision should be accounted for in the period that includes the date the new information became available.

With respect to SBC, if a company determines that the court’s recent decisions result in the recognition of additional tax benefit, it must determine whether any of the additional tax benefit relates to excess tax benefit – that is, tax benefit in excess of the amount recognized for book purposes. Under US GAAP, excess tax benefit of equity compensation generally must be recognized as additional paid-in capital (APIC). However, some companies may have originally recognized the excess tax benefit as an increase to APIC when the tax position was taken in the tax return, and may have subsequently derecognized some portion or all of the excess tax benefit as an increase to income tax expense in the period including May 27, 2009, when the Ninth Circuit overturned the U.S. Tax Court transfer pricing case. If a company in this situation (i.e., that recognized a tax expense for the derecognition of the benefit previously recognized to APIC) determines that the court’s recent decisions result in a recognition of excess tax benefit that was previously recognized in APIC, it should recognize the excess tax benefit as a decrease in income tax expense and not an increase to APIC because the company’s APIC already reflects the excess tax benefit of the equity compensation.

For additional details, please refer to Deloitte’s **Transfer Pricing Alert 10-005**.

Lapse of IRC Section 954(c)(6)

IRC Section 954(c)(6), Look-Thru Rule for Related Controlled Foreign Corporations (the look-thru rule), enacted by the Tax Increase Prevention and Reconciliation Act of 2005 and amended by the Tax Relief and Health Care Act of 2006, the Tax Technical Corrections Act of 2007, and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, is effective for taxable years of a foreign corporation beginning after December 31, 2005, and before January 1, 2010, and to taxable years of U.S. shareholders with or within which such taxable years of the foreign corporation's year-end. For calendar year-end foreign corporations, this provision lapsed on December 31, 2009. While a proposal to extend the look-thru rule retroactively to January 1, 2010, was in both the House and Senate bills, as of the date this publication went to press, the extension has not been enacted.

For periods in which it is effective, the look-thru rule generally excludes from U.S. federal income tax certain dividends, interest, rents, and royalties received or accrued by one controlled foreign corporation (CFC) of a U.S. multinational enterprise from a related CFC that would otherwise be taxable pursuant to the subpart F regime. For a U.S. company asserting the indefinite reversal exception under ASC 740-30-25-17 for the nonrecognition of deferred taxes relating to undistributed foreign earnings, its effective tax rate is generally reduced below the statutory rate for every dollar of earnings that are not subject to current U.S. tax. Accordingly, the look-thru rule operates to reduce the global effective tax rate for certain companies by reducing the amount of subpart F income that would otherwise be subject to U.S. taxation.

ASC 740 Implications: Absent any tax planning or restructuring measures[3], and unless and until the proposal to extend the look-thru rule is enacted, U.S. companies that are utilizing the indefinite reversal exception will have to account for tax consequences of the lapse of the look-thru rule. Specifically, in the first quarter of 2010 for a calendar-year end corporation, based on the guidance in ASC 740-270, *Income Taxes: Interim Reporting*, the U.S. company should include in its estimated annual effective tax rate (AETR) the tax expected on the amount of subpart F income that would be recognized for the current year, assuming the look-thru rule is not extended. Companies should be prepared to compute the estimated AETR without the benefit of the look-thru rule until that provision is re-enacted beginning with first quarter of 2010.

The lapse of the look-thru rule is also expected to impact the ability of some U.S. companies to assert that certain undistributed earnings are subject to the indefinite reversal criteria. For example, U.S. Company (USP) has a CFC (CFC1) which owns a CFC in another jurisdiction (CFC2). USP asserts that its investment in CFC1 is subject to the indefinite reversal criteria. The earnings of CFC2 increase CFC1's book basis in CFC2 and USP's tax basis in CFC1. Absent the look-thru rule, distributions from CFC2 to CFC1 would be subject to U.S. taxation pursuant to subpart F. In this situation, the company would need to assert that CFC2's earnings are subject to the indefinite reversal exception in order to maintain its assertion that USP's investment in CFC1 meets the exception. Companies should continue to evaluate their deferred tax position with respect to these basis differences in light of the lapse of the look-thru rule.

If an extension of the look-thru rule is enacted later in 2010, a corporation should account for the enactment in accordance with the guidance set forth under ASC 740-270, *Income Taxes: Interim Reporting*. Accordingly, for current taxes payable or refundable, the AETR is adjusted to reflect the new tax law in the period that the new tax law is *effective*. In addition, deferred taxes are adjusted for changes in tax law discretely in the interim period that includes the enactment date. These rules sometimes result in accounting for a change in tax law in more than one quarter. However, if the extension (if and when enacted), is retroactive to January 1, 2010, then the impact on the current year AETR and on the opening deferred taxes will both be reported in the period of enactment.

[3] Different views might exist as to whether "tax planning" that is appropriate to consider when computing the annual effective tax rate includes the tax effects of restructurings or whether those tax effects should be reflected in the period in which the restructuring has been completed.

If the extension of the look-thru rule is not enacted before the end of the first quarter, an entity should consider including in the financial report an explanation of the impact of the lapse reflected in the first quarter financial report. Furthermore, an entity should consider disclosing what the expected impact would be if the proposed extension is enacted in a subsequent period.

Multistate

Oregon Corporate Income Tax Law Change

On January 26, 2010, Oregon voters approved two measures that impose tax increases for individuals and corporations. These increases were originally contained in two Oregon House Bills signed by Governor Ted Kulongoski on July 20, 2009. Under Oregon law, the measures became effective 30 days after the date of voter approval, or February 25, 2010. However, the provisions generally apply retroactively to tax years beginning on or after January 1, 2009.

One of the measures made significant changes to Oregon's corporate tax regime, amending the state's minimum tax provisions and increasing corporate income tax rates. The amended law imposes the minimum tax on C corporations doing business in Oregon by applying a sliding scale as determined based on Oregon sales, up to a maximum tax of $100,000 per affiliated group filing a single consolidated Oregon return. Prior to the tax law change, the minimum tax in Oregon was $10 per corporation doing business in the state. The amended minimum tax is effective for tax years beginning on or after January 1, 2009.

In addition, the amended law creates graduated corporate income tax brackets, replacing the historical flat tax rate of 6.6 percent.

For tax years beginning on or after January 1, 2009, and before January 1, 2011:

- Corporate taxable income up to $250,000 will be taxed at 6.6 percent, and
- Corporate taxable income exceeding $250,000 will be taxed at 7.9 percent.

For tax years beginning on or after January 1, 2011, and before January 1, 2013:

- Corporate taxable income up to $250,000 will be taxed at 6.6 percent, and
- Corporate taxable income exceeding $250,000 will be taxed at 7.6 percent.

For tax years beginning on or after January 1, 2013:

- Corporate taxable income up to $10 million will be taxed at 6.6 percent, and
- Corporate taxable income exceeding $10 million will be taxed at 7.6 percent.

For additional details, please refer to **State Tax Matters, Issue 2010-5**.

ASC 740 Implications: Because the minimum tax is based on gross Oregon sales and not "income," the minimum tax is outside the scope of Accounting Standards Codification Topic 740, *Income Taxes* (FASB Statement No. 109, *Accounting for Income Taxes*). With respect to the increase in corporate income tax rates, companies are required to adjust deferred tax assets and liabilities for the effect of a change in income tax law in the period that includes the enactment date of the tax law change. ASC 740-10-30-9 provides that "entities for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized." An entity that does not expect the graduated tax rates to be a significant factor should measure the deferred tax liabilities or assets using the enacted rate that is expected to be applicable in the year the deferred tax liabilities or assets are expected to be realized or settled. Accordingly, the enactment of the Oregon corporate income tax law changes may have financial statement implications in the reporting period that includes January 26, 2010 (i.e., the date Oregon voters approved Measure 67).

Colorado New Law Temporarily Limits NOLs and Related Changes

A bill signed by the Colorado governor on February 24, 2010, limits the maximum amount of net operating losses (NOLs) that a corporation may claim for state corporate income tax purposes to $250,000. Under Colorado law, NOLs are carried forward on a post-apportionment basis. The bill became effective on February 24, 2010, and is applicable for tax years commencing on or after January 1, 2011, but prior to January 1, 2014. In addition, all NOLs disallowed in a given tax year due to this $250,000 cap may be carried forward for one additional year from the time otherwise prescribed under state law. In Colorado, NOLs can generally be carried forward 20 years for tax years beginning on or after August 1997. Also, the law allows an additional net operating loss equal to 3.25 percent per annum to be added to the allowable net operating loss for each year the use of the NOL is deferred by the $250,000 limit. Detailed regulations are expected to be released in the future.

For additional details, please refer to **State Tax Matters, Issue 2010-9**.

ASC 740 Implications: The effects of a change in tax law must be recognized in the period that includes the enactment date. Companies should assess whether it is more likely than not that some portion of the available NOLs will not be realized on account of the tax law change and record any related change to the valuation allowance in the period of enactment in income from continuing operations. For example, a company may have relied on the existence of taxable temporary differences scheduled to reverse in tax years commencing on or after January 1, 2011, but prior to January 1, 2014, as a source of taxable income to recognize the benefit of an NOL deferred tax asset previously determined readily available in those years. However, as a result of the new NOL limitation, the amount of the reversing taxable temporary differences that is in excess of $250,000 in each tax year commencing on or after January 1, 2011, but prior to January 1, 2014, may no longer be an available source of taxable income for purposes of recognizing the benefit of the remaining NOL (under this circumstance – a net deferred tax liability is recognized when the DTA is fully valued). At the time this publication is being written, details of the application of the new tax law are not entirely clear and future guidance from Colorado is expected.

Controversy

IRS Announcement 2010-9

On January 26, 2010, the IRS issued **Announcement 2010-9** which describes proposed changes to tax return reporting requirements for certain business taxpayers. Specifically, the IRS is considering requiring businesses with over $10 million in assets to annually report uncertain tax positions on their tax returns. Taxpayers would be required to file a schedule with their return that provides a "concise description" of these positions and information about their magnitude. Taxpayers would not, however, have to disclose risk assessments or tax reserve amounts, according to the announcement. The reporting requirements are expected to be effective for the 2010 tax year returns filed in 2011.

Under the proposed reporting requirement, taxpayers would have to report positions for which a tax reserve must be established under ASC 740-10 (formerly FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*[4]), or other accounting standards, as well as positions for which the taxpayer or a related entity has not recorded a tax reserve because (1) the taxpayer expects to litigate the position; or (2) the taxpayer has determined that the Service has a general administrative practice not to examine the position. The Service is also considering various options for penalties or sanctions that may be imposed when a taxpayer fails to make adequate disclosure of the required information.

[4] The IRS announcement referred to FIN 48, but on July 1, 2009 the FASB released the Accounting Standards Codification (ASC) which superseded all U.S. GAAP existing at that time and replaced it with various sections of the codification. The guidance from FIN 48 was incorporated in ASC 740, Income Taxes.

On March 5, 2010, the Service issued **Announcement 2010-17**, stating that it continues to work on developing the proposal contained in Announcement 2010-9, including development of the schedule and implementing instructions. The Service's target date for releasing a draft schedule based on the proposal described in Announcement 2010-9 along with draft instructions, is early April 2010. To allow taxpayers and practitioners the opportunity to provide comprehensive comments both on the proposal and on the implementing schedule and instructions, the time for submitting comments in response to Announcement 2010-9 is extended to June 1, 2010.

ASC 740 Implications: This reporting requirement does not change the company's obligation around financial reporting.

Did You Know?

Venezuela's Highly Inflationary Economy Could Impact Your Financial Statements

ASC 830-10-45-11 (formerly paragraph 11 of Statement 52) provides that the financial statements of a foreign entity in a highly inflationary economy should be remeasured as if the functional currency were the reporting currency at the end of the reporting period. It further defines a highly inflationary economy as one with a cumulative inflation rate of approximately 100 percent or more over a three-year period. ASC 830-10-45-12 (formerly EITF Topic No. D-55, "Determining a Highly Inflationary Economy Under FASB Statement No. 52") provides additional interpretative guidance on determining whether an economy is highly inflationary. Since 1984, a Consumer Price Index (CPI) has been used to evaluate the inflationary status of the Venezuelan economy. However, the CPI index only reports data for certain cities, not the entire country. A new index, the National Consumer Price Index (NCPI), which covers the entire country of Venezuela, began in January 1, 2008. Inflation data is, therefore, not available to compute a cumulative three-year inflation rate for the entire country solely on the basis of the NCPI. Calculation of the three-year cumulative inflation rate based on only the CPI data for the period ending June 30, 2009, indicated a rate that marginally exceeded 100 percent. In contrast, use of CPI data for the periods before January 1, 2008, and NCPI data for the periods after January 1, 2008, indicated a three-year cumulative inflation rate of approximately 97 percent for the same period.

Accordingly, Venezuela could be accounted for as a highly inflationary economy as of July 1, 2009, because the three-year cumulative inflation rate calculated with only the CPI data exceeded 100 percent as of June 30, 2009. If, however, the blended cumulative inflation rate (NCPI and CPI) is used, Venezuela would not be considered highly inflationary as of July 1, 2009, because the three-year cumulative inflation rate would be less than 100 percent. The SEC staff has previously noted that it would not object to either approach for computation of the three-year cumulative inflation rate.

On January 7, 2010, Venezuela's NCPI for December 2009 was released. The cumulative three-year inflation rates for both permissible computations (either CPI or CPI/NCPI) are over 100 percent. Accordingly, entities with a year-end or quarter-end as of December 31, 2009, that have not previously considered Venezuela's economy to be highly inflationary should consider Venezuela's economy to be highly inflationary as of January 1, 2010, and the financial statements of Venezuelan entities will be subject to "remeasurement" rather than "translation," commencing January 1, 2010, using the reporting currency as the functional currency.

In addition to the hyperinflationary economy accounting discussed above, there are other currency related accounting issues related to Venezuela. Under the Venezuelan foreign currency exchange control regulations (exchange regulations), the Central Bank of Venezuela (BCV) centralizes the purchase and sale of foreign currency in the country. Under these regulations, the purchase and sale of foreign currency must be made at the official rate of exchange, which is the rate that is fixed from time to time by the executive branch and the BCV. However, the law provides an exemption for the sale and purchase of certain securities (purchasing in one currency and selling in a different currency permits a company an alternative means of converting from one currency to another). This exemption for transactions in certain securities has created a "parallel" foreign currency exchange market in Venezuela that enables entities to use brokers to obtain foreign currency without having to purchase the currency from the Commission for the Administration of Foreign Exchange (CADIVI) at the official rate.

Because of the restrictions of the currency exchange and the existence of the parallel foreign currency exchange market, questions have arisen with respect to which exchange rate should be used for the accounting of transaction and translation gains/losses. The law, by virtue of the "security" exemption, provides for a parallel exchange mechanism that has an observable market rate. Based on facts and circumstances, this market rate may be appropriate for the remeasurement of foreign-currency-denominated transactions (transactions are to be distinguished from translation) that could be settled through the parallel market mechanism. In contrast, ASC 830-30-45-6 (formerly paragraph 27(b) of Statement 52) indicates that in "the absence of unusual circumstances, the *exchange rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate foreign currency* statements" (emphasis added). The existence of the parallel market generally does not constitute unusual circumstances that could justify the use of an exchange rate other than the official rate for foreign currency translation. However, the SEC acknowledged at the 2009 AICPA Conference that there may be instances in which the parallel rate may be used and the determination should be based on individual facts and circumstances.

For additional details, please read **Venezuela's Currency Exchange Controls and Highly Inflationary Status**.

ASC 740 Implications: When the reporting currency is used as the functional currency, ASC 740-10-25-3(f) (formerly paragraph 9(f) of Statement 109, Income Taxes) states that it prohibits the recognition of a deferred tax liability or asset for certain temporary differences that arise with respect to assets and liabilities that are remeasured from the local currency into the functional currency using historical exchange rates [i.e., nonmonetary items and revenue or expense items related to nonmonetary items] and that result from changes in exchange rates or indexing for tax purposes. Companies should consider the application of ASC 740-10-25-3(f) when applying the accounting for hyperinflationary economy.

Unrelated to income tax accounting but very relevant for those with operations in Venezuela is an SEC staff announcement that was made during the administrative session at the March 18, 2010, EITF meeting. At that meeting, the SEC staff announced its intention to issue a D-Topic (topic) on Foreign Currency Matters. This proposed topic is in response to inquiries received by the SEC regarding foreign-currency issues related to investments in Venezuela, where there is more than one exchange rate. Specifically, the topic addresses disclosure requirements related to the remeasurement of foreign-currency-denominated balances in the financial statements of the Venezuelan subsidiary by using an exchange rate that differed from the exchange rate used by the consolidated U.S. parent to translate the financial statements of the Venezuelan subsidiary.

The SEC staff stated that when reported balances differ from the actual U.S.-dollar-denominated balances (if material), an entity should disclose the following in its financial statements: (1) the rates used for remeasurement and translation; (2) a description of why the actual U.S.-dollar-denominated balances differ from the amounts reported for financial reporting purposes, including the reasons for using two different rates for remeasurement and translation; (3) the magnitude of the difference between the amounts reported for financial reporting purposes and the underlying U.S.-dollar-denominated values; and (4) to the extent possible, the amount that will be recognized through the income statement (as well as the impact on the other financial statements) as part of highly inflationary accounting beginning in 2010. The final version of the topic is not available as of the date this publication went to press; the final topic is expected to be available in early April 2010.

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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