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June 2010

Accounting Developments

FASB Issues Exposure Draft on Accounting for Financial Instruments (update on previously reported topic)

On May 26, 2010, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update exposure draft, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. The objective of the proposed guidance is to provide an improved and consistent financial reporting model for the recognition, measurement, and presentation of financial instruments in an entity's financial statements. Comments on the exposure draft are due by September 30, 2010.

The exposure draft has a paragraph that would require a specific approach when evaluating the need for a valuation allowance for deferred tax assets (DTAs) related to unrealized losses from available-for-sale (AFS) or held-to-maturity (HTM) debt securities. To date, the SEC staff has accepted two alternative approaches when the entity has the intent and ability to hold the debt security until recovery. For additional discussion with respect to the two approaches (or views), please see **Accounting for Income Taxes Quarterly Hot Topics, March 2010 Issue**. Paragraph 35 of the exposure draft states (*emphasis added*) "an entity shall evaluate the need for a valuation allowance on a deferred tax asset related to a financial instrument for which qualifying changes in fair value are recognized in other comprehensive income *in combination with the entity's other deferred tax assets*. The proposal effectively eliminates the alternative view of assessing the need for a valuation allowance separately from an entity's other DTAs. This alternative view presumed that, if the entity asserted that the debt security was held to recovery, the DTA would be realizable because no tax loss would ever be incurred and therefore there was no risk of a tax loss expiring unused. Until the FASB finalizes this project and updates the related codification through the issuance of a finalized Accounting Standards Update, an entity should continue to follow the accounting policy it has elected.

Given the similarities between Accounting Standards Codification (ASC) Topic 740 and International Accounting Standard (IAS) 12, *Income Taxes*, a similar question on DTAs related to investments in debt securities arises under IAS 12. The International Accounting Standards Board (IASB) staff presented a similar question to the International Financial Reporting Standards (IFRSs) Interpretations Committee (IFRIC or "the Committee"), a Committee that provides interpretations on IFRSs, regarding whether to recognize a DTA related to unrealized losses on available-for-sale debt securities under IAS 12 (note – the process of determining "whether to recognize" a DTA under IFRS is the equivalent of evaluating the need for a valuation allowance under GAAP since a DTA is recognized under IAS 12 only to the extent that it is probable (which is generally interpreted to be *more likely than not*) that taxable profit will be available against which the deductible temporary difference can be utilized. The Committee received a request for guidance relating to how an entity determines, in accordance with IAS 12, whether to recognize a DTA relating to unrealized losses on AFS debt securities. The request asks if an entity's ability and intent to hold the AFS debt securities until the unrealized losses reverse is a tax planning opportunity. If so, it questions whether recognition of a DTA relating to the unrealized losses can be assessed separately from the recognition of other DTAs.

The IFRIC tentative agenda decisions noted that the Committee reviewed the matter and tentatively decided that this item should not be added to the Committee's agenda. The tentative decision, including recommended reasons for not adding the item to the Committee's agenda, will be reconsidered at the Committee meeting in July 2010. The **Committee report** states that "…the objectives of IAS 12 and the deferred tax recognition principle relating to deductible temporary differences are based on recovering or settling the carrying amount of the asset or liability at the reporting date. The Committee also noted that, in the context of the fact pattern in the request, the entity's actions to hold the AFS debt securities to maturity do not meet the definition in paragraph 30 of IAS 12 of a tax planning opportunity. In addition, the approach in paragraphs 24-31 of IAS 12 requires an entity to assess the probability of reali[z]ing deferred tax assets on a combined basis that is consistent with the rules established by the taxation authorities." The Committee noted that IAS 12 provides sufficient guidance on the recognition of deferred tax assets relating to AFS debt securities and that it does not expect diversity in practice. Consequently, the Committee tentatively decided not to add this issue to its agenda.

Federal

Potential 1245 Recapture in the Stock of a Subsidiary

Under ASC 740, an excess of financial reporting over the tax basis in a domestic subsidiary is not treated as a taxable temporary difference when there is a tax-free means by which the parent can recover its investment in the subsidiary and the entity intends to use that means. Under U.S. tax law, those means typically entail selling assets and then executing a nontaxable liquidation or, alternatively, executing a nontaxable liquidation and then selling the assets of the subsidiary. The following discussion addresses a unique fact pattern under which the two approaches noted above might produce significantly different tax results. Understanding that there might still be a tax-free means for a U.S. parent to recover its investment in a domestic subsidiary and that there is a distinction between the two approaches is important when determining whether a deferred tax liability should be recognized for the excess of financial reporting basis over tax basis in affected domestic subsidiaries.

When a corporation realizes cancellation of debt (COD) income that is excluded under Internal Revenue Code (IRC) Section 108(a), the corporation (P) is required to reduce its tax attributes pursuant to IRC Sections108(b) and 1017 by the amount excluded (e.g., net operating losses, tax credits, basis reduction, etc.). If P is required to reduce the basis in the stock of a subsidiary (S), then S in turn may be required to reduce its tax attributes pursuant to IRC Sections 108(b) and 1017.

P is generally required to recapture a portion of any subsequent realized gain in the S stock under IRC Section 1245 as ordinary income to the extent that the reduction of the S stock basis exceeds the reduction in S's tax attributes caused by the excluded COD income (the "potential IRC Section 1245 recapture"). For example, a subsequent liquidation of the subsidiary under IRC Section 332 that would eliminate the S stock would cause a recapture of gain under IRC Section 1245 to the extent that the fair market value of the S stock exceeds its basis in the hands of P at the time of the liquidation, up to the amount of the potential IRC Section 1245 recapture. However, part or all of the potential IRC Section 1245 recapture in the S stock may be eliminated or mitigated by selling the S assets prior to liquidating S (since the gain that would have been realized had the S been liquidated is eliminated by the investment account adjustment related to the taxable income from the sale of assets).

ASC 740 Implications: ASC 740-30-25-7 provides "whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference shall be assessed." The paragraph further provides that an excess financial reporting basis over the tax basis of an investment "is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the entity expects that it will ultimately use that means." One example would be a tax-free liquidation of an 80-percent-or-more-owned subsidiary.

A corporation should assess whether or not it can recover the reported amount of its investment in a subsidiary tax-free. If the investment cannot or is not expected to be recovered tax-free, a deferred tax liability should be provided for the excess financial reporting basis over the tax basis of an investment in a subsidiary. A corporation with a potential IRC Section 1245 recapture is not precluded from asserting that its investment in a subsidiary can be recovered tax-free because the potential IRC Section 1245 recapture in the subsidiary's stock can be eliminated as described above.

Codification of Economic Substance Doctrine

In connection with the codification of the economic substance doctrine in the Health Care and Reconciliation Act of 2010, IRC Section 6662 was amended to impose a strict liability penalty for an underpayment attributable to any disallowance of claimed tax benefits if a transaction lacks economic substance or fails to meet the requirements of any similar rule of law. The penalty rate is 20 percent of the underpayment, but increased to 40 percent if the taxpayer does not disclose the relevant facts on its return. There is no reasonable cause exception available to reduce the penalty. The provisions would apply to transactions entered into after the date of enactment, March 30, 2010.

ASC 740 Implications: Companies should consider this new provision when determining the amount of penalties related to unrecognized tax benefits associated with transactions entered into after March 30, 2010.

International

House Passes Amendment to Extenders Legislation

On May 28, 2010, the House passed the recently proposed amendment to H.R. 4213 entitled the "American Jobs and Closing Tax Loopholes Act" (the "proposed extenders"). The proposed extenders retroactively extends the research and development credit, the Section 954(c)(6) controlled foreign corporation (CFC) look-through rule and the active financing exception of Sections 953 and 954, among many other expiring provisions for one year. To pay for these tax incentives, the extenders also include a number of revenue offsets. Among the revenue offsets are several international tax provisions, some of which would fundamentally reform the current foreign tax credit (FTC) rules. Some of the most significant international tax provisions include:

- Rules to prevent splitting FTC from foreign income.
- Denial of foreign tax credits related to asset tax basis step-up transactions.
- Separate application of FTC limitation to items resourced under tax treaties.
- Denial of use of Section 956 "hopscotch" rule for FTC purposes.
- Modifications to the interest allocation rules concerning U.S. activities conducted by foreign subsidiaries.
- Restrictions on redemption transactions executed by CFCs indirectly owned by foreign parent corporations.
- Repeal of 80/20 rules.

Many of these new provisions are proposed to be effective as of May 21 2010; in certain structures, however, these provisions may restrict the use of foreign tax credits attributable to undistributed earnings of a post-effective date distribution of prior years' earnings until those earnings are distributed. The extenders, as of the time this newsletter was written, are pending approval by the Senate. Should any of the Senate amendments successfully pass, the extenders package would be required to return to the House for an additional vote. For additional tax discussion regarding the extenders, please see **U.S. Tax Alert - 21 May 2010: Ways & Means releases Extenders Bill**.

ASC 740 Implications: At the time this newsletter was being finalized, the extenders legislation had not been enacted. ASC 740-270-25-5 provides "the effects of new tax legislation shall not be recognized prior to enactment." The international revenue raisers, if approved, may have both current and deferred income tax consequences for multinational corporations. Pursuant to ASC 740, the effects of a change in tax law on deferred tax assets and liabilities must be included in income from continuing operations in the interim and annual period that includes the enactment date. Several of the proposals either defer or deny FTCs in respect of unremitted foreign earnings. To the extent those FTCs have been taken into account in calculating beginning of the year deferred taxes on outside basis differences, a discrete adjustment will be required in the interim period that includes the enactment date. Further, to the extent FTCs were anticipated in the current year, the annual effective tax rate (AETR) will need to be adjusted in the period that includes the effective date, or the enactment date, whichever is later.

Multistate

District of Columbia Tax Law Changes

On December 18, 2009, Mayor Adrian Fenty signed the "Fiscal Year 2010 Budget Support Act of 2009" (the "Act"), thereby making permanent the emergency legislation enacted previously by the Council of the District of Columbia ("D.C. Council"). The Act became effective in the District of Columbia ("District") on March 2, 2010, following the required 30-day period for United States Congressional review. The Act includes a provision mandating that the D.C. Council amend the D.C. Code to enact required unitary combined reporting. Thus, the Act does not itself implement combined reporting. However, assuming that the D.C. Council amends the D.C. Code, mandatory combined unitary reporting would apply to tax years beginning after December 31, 2010. Until the tax code is actually amended, existing law provides for separate returns.

In addition, the Act broadens the District's related-party addback statute to include interest expense that is not attributable to intangibles. This change applies retroactively to tax years beginning after December 31, 2008. Additionally, the new law decouples from IRC Section 108(i) deferral treatment of qualified discharge of indebtedness income. Although the Act is silent regarding the effective date of this change, the Office of Tax and Revenue has indicated, informally, that this law change became effective on August 26, 2009. However, the instructions that accompany 2009 D.C. Form D-20 reference decoupling from IRC Section 108(i), thus suggesting that this change may apply beginning January 1, 2009.

For additional details, please refer to **Multistate Tax: External Alert – March 25, 2010**.

ASC 740 Implications: ASC 740-270-25-5 provides "the effects of new tax legislation shall not be recognized prior to enactment." As noted previously, the Act does not itself enact combined reporting because the D.C. Council must first amend the D.C. Code as mandated by the legislation. Assuming that the D.C. Code is amended, the effect of the change in tax law on deferred tax assets and liabilities must be included in income from continuing operations in the interim and annual period that includes the enactment date. Further, the estimated AETR will need to be adjusted in the period that includes the effective date, or the enactment date, whichever is later.

Regarding the other income tax law changes contained in the Act, namely, expansion of the intercompany addback provisions and decoupling from IRC Section 108(i), the tax effects of these changes should be accounted for in the reporting period that includes March 2, 2010, (the date that the Act became enacted upon expiration of the 30-day period for U.S. Congressional review). Because the law changes are retroactively effective, the tax effect of the adjustment to the current year AETR and deferred taxes both will be reported in the period of enactment. Companies should consult with their advisers for further guidance regarding the financial statement impact of these law changes.

State Amnesty Programs

During the second quarter of 2010, a number of states (Florida, Kentucky, New Mexico, and Pennsylvania) have implemented various types of amnesty programs applicable to income taxes, including:

- Florida – Recently adopted law requires the Florida Department of Revenue (“Department”) to implement an amnesty program that will be in effect for a three-month period beginning July 1, 2010, and ending on September 30, 2010. Taxes covered by the program are those due prior to July 1, 2010, and include corporate income and emergency excise taxes, state and local sales and use taxes, and certain other taxes and surcharges administered by the Department. An eligible taxpayer who participates in the program and complies with the related requirements will receive a complete waiver of penalties. Also, a participating taxpayer will receive a partial waiver of interest, with the applicable waiver percentage dependent on whether the taxpayer is under audit, inquiry, examination, or civil investigation initiated by the Department.
- Kentucky – A new law adopts an “expedited protest resolution” program wherein certain tax assessments that, as of January 19, 2010, have been under protest yet have not been the subject of a final Kentucky Department of Revenue ruling may be considered “satisfied and paid in full” if qualified taxpayers pay the entire amount of assessed tax, exclusive of all interest and penalties, on or after the effective date of this new law and by close of business on July 30, 2010.
- New Mexico – Pursuant to recently enacted law, the New Mexico Taxation and Revenue Department announced that New Mexico’s tax amnesty period runs from June 7, 2010, to September 30, 2010, offering a “limited-time opportunity to avoid penalties and interest.” Taxes covered by the amnesty are those due prior to January 1, 2010. Qualifying taxpayers that enter into an amnesty agreement will not be assessed penalties, and if they pay the resulting assessment of taxes due within 180 calendar days of assessment, no interest will be due.

For additional information on these state amnesty programs, please visit **http://www.deloitte.com/us/tax/stm**.

ASC 740 Implications: Companies should consider these amnesty programs when determining the amount of penalties and interests related to unrecognized tax benefits. As required by ASC 740-270-25, a change in tax law is accounted for in the period that includes the enactment date.

Controversy

HIRE Act Incorporates Provisions Intended to Curb Offshore Tax Evasion

The Hiring Incentives to Restore Employment Act (the “HIRE Act”) was signed into law on March 18, 2010. The HIRE Act includes a number of provisions intended to curb offshore tax evasion. These provisions impose increased information reporting requirements, as well as a separate set of penalties for non-compliance. One of these provisions results in changes to statute of limitations on assessments.

The HIRE Act amends Section 6501(e) to extend the statute of limitations on assessments to six years for significant omissions of income attributable to foreign assets. Under the new law, a significant omission of income attributable to foreign assets exists if there is an omission from gross income that (1) is attributable to one or more assets with respect to which information is required to be reported under Section 6038D (or would be required if not for the $50,000 threshold and without any exceptions that may be provided in the regulations to Section 6038D), and (2) is in excess of $5,000.

The HIRE Act also amended Section 6501(c)(8), which provides an exception to the general rule that taxes are to be assessed within three years after a taxpayer's return is filed. Prior to its recent amendment, Section 6501(c)(8) extended the assessment statute if a taxpayer failed to provide information about certain cross-border transactions until three years after the required information was actually provided to the IRS.

The HIRE Act added the words "tax return" such that the relevant portion of the provision now reads as follows: "…the time for assessment of any tax imposed by this title with respect to any tax return, event, or period to which such information relates shall not expire before the date which is three years after the date on which the Secretary is furnished the information required to be reported under such section." The revised provision clarifies that the limitations period will not begin to run until the required information has been furnished to the IRS. In addition, it clarifies that the extension is not limited to adjustments to income related to the information required to be reported.

Sections 6501(e) and 6501(c)(8), as amended, are effective for returns for which the assessment statute of limitations is open after March 18, 2010.

On May 20, 2010, the "The American Jobs and Closing Tax Loopholes Act of 2010," H. R. 4213, ("extenders" bill) was introduced to curtail abuses of the international tax rules, particularly those relating to FTCs. The bill contains a proposal for a technical correction to an amendment made to Section 6501(c)(8) by the HIRE Act. The correction provides that the statute of limitations period would not be tolled (i.e., does not stop running and will expire) if a taxpayer's failure to provide the required forms is shown to be due to reasonable cause and not willful neglect.

For additional information on the HIRE Act, please refer to **IRS Insights, May 2010 issue**.

ASC 740 Implications: Companies should consider the implications of the HIRE Act when determining whether an unrecognized tax benefit should be recognized due to the expiration of a statute of limitation.

Did You Know?

A Tidal Wave of Accounting Changes Is on Its Way

Much of the recent debate in the financial reporting community has focused on when and if registrants (U.S. public entities) should be permitted or required to adopt International Financial Reporting Standards as a basis of reporting. The U.S. Securities and Exchange Commission (SEC) is expected to address the matter sometime next year. In the meantime, the FASB and IASB have been working both individually and jointly on a number of projects that, if finalized, would bring about a seismic shift in the accounting and financial reporting landscape, the likes of which U.S. entities have never before experienced.

While the FASB and IASB have been working together for more than a decade, their more recent collaborative efforts have been under the auspices of a "Memorandum of Understanding" (originally the Norwalk Agreement that was signed in 2002). Recently, the two boards announced that many of the joint projects are expected to be completed by the end of 2011. So, regardless of whether the SEC sets a date for registrants to convert to IFRS, all users of GAAP can anticipate being affected by the changes expected as a result of these efforts. Major projects include:

<u>Joint FASB/IASB Projects</u>

- Presentation of financial statements
    - Financial statement presentation
    - Discontinued operations
- Other comprehensive Income

- Financial instruments
  - Accounting for financial instruments
  - Offsetting
- Financial instruments with characteristics of equity
- Leases
- Revenue recognition
- Consolidation
- Fair value measurements

FASB Only Projects

- Disclosure of certain loss contingencies
- Going concern

To learn more about the proposed changes and the expected timeline, please see **Accounting Roundup – Special Edition**.

ASC 740 Implications: While it is still too early to determine exactly how these changes might impact the calculation and presentation of an entity's tax accounts and related disclosures in the financial statements, the implications are likely to be significant and include changes to book/tax differences and income tax accounts. With so many aspects of accounting changing in a short period of time, tax departments should be involved in the process, participate in system modifications, and take necessary steps to preserve the data necessary to support the entity's tax filings. We will continue to follow these projects and report potential accounting for income tax implications.

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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