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September 2010

Accounting Developments

In the June 2010 issue, we reported *Did You Know a Tidal Wave of Accounting Changes Is on Its Way*. The articles below discuss two of such proposed changes, and the related Accounting Standards Codification 740, *Income Taxes*, (ASC 740) implications, as the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) continue their convergence efforts.

FASB Issues Exposure Draft on Accounting for Revenue from Contracts with Customers

On June 24, 2010, the FASB and IASB jointly proposed new revenue accounting rules in an Accounting Standards Update (ASU) exposure draft, *Revenue from Contracts with Customers*. The objective of the proposed guidance is to provide entities with a single comprehensive model to use in reporting information about the amount, and timing of, revenue resulting from contracts to provide goods or services to customers.

Existing guidance in the United States for revenue recognition varies by industry and type of transaction and is unclear in some respects, which has led to many financial statement restatements and Securities and Exchange Commission enforcement cases over the years. The proposed guidance provides a uniform standard which requires, for each contract identified, the allocation of an overall transaction price to individual performance obligations. Revenue is then recognized as the identified performance obligations are met. The model applies to most contracts with customers, with certain exceptions such as leases or insurance contracts.

The establishment of a single accounting standard will likely lead to changes in revenue recognition for financial statement reporting purposes for many entities. For income tax reporting purposes, taxability of revenue is often dependent on the entity's tax accounting method. For cash-basis taxpayers, revenue is generally taxable when received. Accrual-basis taxpayers generally recognize revenue when the "all events" test is met, i.e., when "all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Under this test, revenue is recognized when it is earned, due, or received, whichever is earlier – as long as the amount can be reasonably estimated.

ASC 740 Implications: Given that tax methods generally will not change as a result of this ASU, companies should consider the possible income tax accounting

implications (i.e., changes in the amount of temporary differences, absent the filing of a Form 3115, *Application for Change in Accounting Method*) related to customer contracts for which the timing of revenue recognition does change under the proposed ASU.

For additional information on the proposed ASU, please see Deloitte's *Heads Up* newsletter issued June 28, 2010 - **One Size Fits All: FASB Issues Proposed ASU on Revenue Recognition**.

FASB Issues Exposure Draft on Accounting for Leases

On August 17, 2010, the FASB and IASB jointly issued a proposed ASU exposure draft, *Leases*. The objective of the proposed guidance is to create a new accounting model for all outstanding leases for both lessees and lessors, and to eliminate the concept of an operating lease.

Lessees will recognize a right-of-use asset and a payment obligation liability for all lease contracts. The right-of-use asset is initially measured at the same amount as the payment obligation liability, plus any recoverable initial direct costs (e.g., commissions or legal fees).

Lessors will either account for the lease by derecognition (similar to a sale) of the underlying asset or as a performance obligation, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. If accounted for as a performance obligation, the lessor will recognize an asset for the right to receive lease payments plus any recoverable initial direct costs incurred, which is initially measured in the same amount as a liability equal to the present value of future lease payments.

ASC 740 Implications: The proposed changes in the ASU will likely give rise to changes in the amount of temporary differences for many entities involved in leasing transactions. Generally, entities will record assets and liabilities for financial reporting purposes that will not be recorded for income tax purposes (i.e., the lease continues to be an operating lease for income tax reporting purposes), which will create and/or modify basis differences. For example, in some tax jurisdictions, an entity may have had operating leases for both book and tax, in which case there might be an existing temporary difference for those leases associated with the timing of the recognition of rent expense (i.e., deferred rent recorded for financial statement reporting purposes without a corresponding amount being recognized for tax). In such a case, in connection with adopting the ASU, the entity will record a right-of-use asset, which will represent a future taxable temporary difference, requiring a deferred tax liability; record a payment obligation liability, which will represent a future deductible temporary difference, requiring a deferred tax asset; and remove its deferred rent account, which will eliminate the future deductible temporary difference and the associated deferred tax asset. Because the proposal affects all outstanding leases as of the effective date, entities will need to be mindful of the significant temporary differences that would be expected to arise or be eliminated (as discussed above) upon the initial application of the final ASU, particularly for leases that are currently accounted for as operating leases for both book and tax reporting purposes. In addition, entities that apportion income to state or local tax jurisdictions based in part on a property factor may be impacted by increases in the book basis of assets.

For additional information on the proposed ASU, please see Deloitte's *Heads Up* newsletter issued August 17, 2010 – **FASB Draws a Bright Line Through Operating Leases: Proposed ASU Revamps Lease Accounting**.

International

Obama Signs International Revenue Raisers

In the June 2010 issue, we discussed the proposed legislation related to the international revenue raisers. On August 10, 2010, President Obama signed into law the "Education Jobs and Medicaid Assistance Act" (H.R. 1586), which includes provisions to change certain foreign tax credit (FTC) rules. In addition to having a significant impact on cash taxes for multinationals, these proposals may also have a significant impact on financial statements and disclosures. The most significant changes relate to the ability for a U.S. taxpayer to utilize FTCs in certain situations. Taken together, these rules both limit the amount of FTC that will be available for use in the United States, as well as limit the amount of FTC that can be utilized in a given period.

The majority of the new provisions are effective beginning after December 31, 2010; however, a handful of the provisions are effective for taxable years beginning after August 10, 2010 (e.g., interest allocation rules, FTC limit on items resourced under treaties) or transactions executed after August 10, 2010 (limitations on the application of IRS Section 304(a)).

For an overview of the international tax provisions, please refer to *United States Tax Alert* **"President Obama Signs International Revenue Raisers; JCT Technical Explanation Released"** and **"Changing the rules: Multinational tax hikes pay for spending priorities."**

ASC 740 Implications: The international revenue raisers may have both current and deferred income tax consequences for a multinational corporation. Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations in the period that includes the enactment date of the applicable law change. H.R. 1586 was enacted on August 10, 2010; therefore, any deferred tax adjustments as a result of this law change should be recognized in the period that includes August 10, 2010. In addition, pursuant to ASC 740-270-25-5, for purposes of determining the interim income tax provision, the annual effective tax rate (AETR) is adjusted to reflect tax law changes in the period that the change is both enacted and effective.

Pre-effective date considerations

New Section 909 of the Internal Revenue Code (IRC) contains anti-splitter rules that will prevent a company from recognizing FTCs until the related foreign income has been included on a U.S. tax return. To the extent a parent is not indefinitely reinvesting earnings of a foreign subsidiary, an analysis should be done to determine whether that subsidiary's excess FTCs are being considered in the measurement of a deferred tax liability elsewhere in the group.

When analyzing the need for a valuation allowance for FTCs, companies should evaluate their future repatriation strategy under the new rules in determining whether it is more likely than not that the benefit of any FTCs that remain unutilized after 2010 will be realized. This analysis should include all positive and negative evidence considering two key points. First, the new legislation has introduced several provisions aimed at limiting the amount of FTCs that can be utilized in a particular year, including changes to the interest allocation rules, the 80/20 sourcing rules and the treaty resourcing rules. Second, the lapse of various subpart F exemptions in conjunction with the new limitations on FTCs is likely to produce a flurry of pre-effective date planning, including dividend distributions to lift FTCs for U.S. tax purposes.

Finally, companies that utilize first-tier foreign branches in their splitter structures will need to consider the impact of the new rules on their branch accounting analysis.

Depending on the indefinite reversal position related to the underlying earnings, deferred taxes in the branch may no longer provide a future FTC benefit for the U.S. parent, and the deferred taxes of the parent should be adjusted accordingly.

Post-effective date considerations

These measures are generally proposed to go into effect in taxable years beginning after December 31, 2010, impacting the measure of current taxes payable beginning in 2011. In conjunction with the company's indefinite reversal position under ASC 740-30 (i.e., U.S. parent deferred taxes on the outside basis difference in certain foreign subsidiaries are often not recognized due to the indefinite reversal criteria), the effective tax rate of companies that utilize FTCs from splitter structures and certain IRC Section 956 distributions against other foreign-source income (such as dividends from other subsidiaries, or foreign sales income) is likely to increase.

Further, the measures include the denial of the FTC with respect to taxes on income not subject to U.S. taxation by reason of a covered asset acquisition that results in a step-up in tax basis of the acquired entity's assets for U.S., but not foreign, tax purposes (e.g., qualified stock purchases to which Section 338(a) applies). In such a case, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes, so that the U.S. taxable income from the assets tends to be lower than the foreign tax base upon which the foreign income tax is calculated. Consequently, companies that step up the basis of acquired assets in a non-taxable transaction will permanently lose a FTC for the foreign taxes paid in relation to that step-up, resulting in a permanent increase in the effective tax rate for highly acquisitive companies.

United Kingdom Corporate Income Tax Rate Reduction Receives Royal Assent

The United Kingdom enacted a portion of its Emergency Budget 2010 on July 27, 2010, when the Finance (No. 2) Act received Royal Assent. Effective from April 1, 2011, the main rate of corporate income tax rate is reduced from 28 percent to 27 percent. Other notable proposed changes in the Budget, which have not yet been enacted, include a one-percent reduction in the corporate income tax rate for the next three years, bringing down the tax rate to 24 percent by April 1, 2014, reduction of the corporate tax rate for companies with profits below a certain limit to 20 percent, and reduction of the writing-down allowances for new and unrelieved expenditures on plant and machinery and certain other assets.

ASC 740 Implications: Pursuant to ASC 740-10-45-15, a company with operations in the United Kingdom should adjust its deferred tax assets and liabilities for the effect of the change in tax rate in the period that includes the enactment date of July 27, 2010. In computing the effect of the tax rate change, a detailed scheduling of the timing of the reversals of the underlying temporary differences may be necessary in order to determine the applicable tax rate to measure the deferred tax assets and liabilities. Because the new rate is effective for income earned from April 1, 2011, companies that do not have a March 30, 2011 year-end may need to apply two different tax rates to income earned in the reporting period that includes the effective date of the tax rate change.

Multistate

California Amends Sales Factor Cost of Performance Rules for Services and Intangibles to Include Payments Made to Agents and Independent Contractors

On June 17, 2010, the Office of Administrative Law approved the California Franchise Tax Board's (FTB) adoption of amendments to its corporate franchise tax sales factor "cost of performance" regulation applicable to sales of services and intangibles. California Government Code Section 11343.4 requires that a regulatory

change is effective 30 days after it is filed with the Secretary of State. Therefore, the change became effective on July 19, 2010. The amended regulation applies retroactively to taxable years beginning on or after January 1, 2008. As amended, California's cost of performance regulation considers activities performed on behalf of a taxpayer by an agent or independent contractor in determining the state to which receipts from sales, other than sales of tangible personal property, should be assigned.

California Revenue and Taxation Code (RTC) Section 25136 sets forth the manner in which sales, other than sales of tangible personal property, are included in the numerator of the sales factor for corporate franchise tax apportionment purposes. Under this statute, sales are assigned to California if the income-producing activity is performed in California. If the income-producing activity is performed both in and outside California, the entire sale is assigned to California if the greater proportion of income-producing activity (as measured by costs incurred[1]) is performed in California than in any other state. Prior to the amendments, California's Regulation 25136 defined "income-producing activity" as transactions and activity directly engaged in by the taxpayer, and specifically stated that activities performed on behalf of a taxpayer by an independent contractor were excluded.

Under amended Regulation 25136, the taxpayer is required to consider payments made to agents[2] and independent contractors when determining the state in which the greater proportion of the income-producing activities occurs, based on the costs of performance. The definition of "income-producing activity" is expanded to include the rendering of personal services by an agent or independent contractor acting on behalf of the taxpayer, and the utilization of tangible and intangible property by an agent or independent contractor in performing a service on behalf of the taxpayer. In addition, the taxpayer's "cost of performance" is defined to include payments made by the taxpayer to an agent or independent contractor for the performance of personal services, and the utilization of tangible and intangible property that gives rise to the particular item of income.

For additional details, please refer to **Multistate Tax: External Alert – June 29, 2010**.

ASC 740 Implications: The amendments to the sales factor cost of performance rules could impact the apportionment factor. Companies should consider these amendments when calculating the current income tax provision and measuring deferred tax assets and liabilities. If a company previously provided an unrecognized tax benefit (UTB) for this issue, the UTB may need to be re-assessed considering the amended regulation. Additionally, if an amended return is expected to be filed, the company should reflect the tax effect of the amended return in the period the company has the intent and ability to file.

Massachusetts Tax Law Change

On August 5, 2010, Massachusetts enacted several tax law changes, including the following that could have financial statement implications:

- Treatment of exempt income for purposes of water's-edge combined reporting – The new law added a subparagraph to the existing statute that

[1] The term "cost of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

[2] FTB Legal Ruling 2006-2 indicates that activities performed on behalf of a taxpayer by certain agents may have been includable in the overall cost of performance analysis even before Regulation 25136 was amended.

provides that where a combined group determines its taxable income or loss on a water's-edge[3] basis, any item of income of a non-U.S. corporation member that is exempt from federal income tax by virtue of a federal income tax treaty shall not be included in the combined group's taxable income. Any items of expense and apportionment factors related to such item of exempt income are likewise excluded in the determination of taxable net income or loss.

- However, the item of exempt income will be taken into consideration for purposes of determining whether the non-U.S. corporation is includable in the water's-edge group. Under the existing statute, the group is defined to include foreign entities that fall within one of the following categories: (1) the average of the corporation's property, payroll, and sales factors within the United States is 20 percent or more; or (2) more than 20 percent of the entity's income is earned, directly or indirectly, from intangible property or service-related activities the costs of which are deductible for federal income tax purposes by other members of the group. The amended law provides that items of exempt income will be taken into account in determining whether the non-U.S. corporation falls within one of these categories. If a non-U.S. corporation is includible in the water's-edge group under either of these categories, it shall be included in the combined group only to the extent of its items of income described in that category that are not exempt from federal income tax by virtue of a federal tax treaty.

These changes are effective for tax years beginning on or after January 1, 2009.

- Carryover of net operating losses (NOLs) – Prior to the current law changes, Massachusetts generally allowed companies to carry forward NOLs for five years but did not permit carryback. The new law continues these rules for losses sustained in taxable years prior to January 1, 2010. However, losses sustained in any taxable year beginning on or after January 1, 2010, may be carried forward for 20 years and may not be carried back. The new law further provides that a corporation may not carry forward losses incurred in years before it became subject to tax in Massachusetts. These changes are effective for tax years beginning on or after January 1, 2010.
- Amendment of the Economic Opportunity Area Credit – The current law provides that if eligible property is disposed of or ceases to be used exclusively in a certified project in an economic opportunity area before the end of its useful life, portions of the credit taken in any prior year that exceed the allowable credit (recomputed giving consideration to its early retirement) must be recaptured and repaid as additional tax due in the year the property is disposed of or ceases to be used exclusively in a certified project within an economic opportunity area. The new law amends the existing language to provide that the expiration of a project's certification shall not trigger recapture of the credit. This change is effective January 1, 2011.

For additional details, please refer to **Multistate Tax: External Alert – August 9, 2010**.

ASC 740 Implications: The change to the water's-edge combined reporting could impact the current tax provision, inventory of temporary differences, and

[3] Many of the states that permit or require corporations to file tax returns based upon a combined report either require that such reporting be made based on the domestic group, and/or permit a "water's edge" election. "Water's-edge" refers to the territorial borders of the United States and includes corporations domiciled or doing significant business therein. A water's-edge group is often a subset of a multinational unitary business. As such, the election provides entity-based exceptions to the pure application of unitary principles.

measurement of deferred tax assets and liabilities. The change to the NOL carryover period should be considered when determining the need for a valuation allowance for losses incurred in tax years beginning on or after January 1, 2010. Pursuant to ASC 740-10-45-15, when deferred tax accounts are adjusted for the effect of a change in tax law, the effect shall be included in income from continuing operations in the period that includes the enactment date of the applicable law change. As noted previously, the Act was enacted on August 5, 2010; therefore, any deferred tax adjustments as a result of this law change should be recognized in the period that includes August 5, 2010. In addition, pursuant to ASC 740-270-25-5, for purposes of determining the interim income tax provision, the AETR is adjusted to reflect tax law changes in the period that the change is both enacted and effective.

State Amnesty Programs

Illinois – An Illinois amnesty program will commence October 1, 2010, and will run through November 8, 2010. During this period, amnesty will generally be granted if an eligible taxpayer reports and pays an eligible liability on either an original return (in the case of prior non-filing) or files an amended return to make corrections. The amnesty will apply to liabilities for taxes collected by the Illinois Department of Revenue for any "taxable period ending after June 30, 2002 and prior to July 1, 2009." The primary benefit for a taxpayer claiming amnesty under the program will be the abatement of all interest and penalties and a bar against civil or criminal prosecution for liabilities reported under amnesty. If a taxpayer fails to report and pay eligible tax liabilities under the amnesty program, the taxpayer will be subject to a doubling of the interest and penalties otherwise due on those tax liabilities.

For additional details, please refer to **Multistate Tax: External Alert – August 17, 2010**.

Kansas – A Kansas tax amnesty program commenced September 1, 2010, and will run through October 15, 2010, for certain delinquent tax liabilities (income, withholding, state and local sales and use, privilege, severance, estate, liquor, cigarette and tobacco products, and mineral severance) administered by the Department of Revenue. The program applies only to tax liabilities due and unpaid for tax periods ending on or before December 31, 2008. Amnesty applies to interest and penalties if the delinquent tax liability is paid in full during the amnesty period.

For additional details, please refer to **Multistate Tax: External Alert – August 30, 2010**.

ASC 740 Implications: Companies need to consider these amnesty programs when determining the amount of penalties and interests related to their unrecognized tax benefits. Generally, adjustments to UTBs as a result of participation in these amnesty programs should be recorded in the period that an original or amended tax return is filed unless the company can avail itself of the amnesty while under audit. For example, the Kansas program specifically excludes the participation of a company that is currently under audit. In addition, companies should also consider the financial reporting impact of non-participation in the program (e.g., doubling of the existing interest and penalties in Illinois, etc.).

Controversy

Relief Available for Issues Related to IRC Section 367 Gain Recognition Agreement Filings

On July 26, 2010, the Large and Mid-Size Business (LMSB) Deputy Commissioner International issued a directive (LMSB-4-0510-017) to LMSB Industry Directors (referred to as "LMSB directive" or the "directive") that provides taxpayers an opportunity to correct errors and omissions with respect to IRC Section 367 gain

recognition agreements (GRAs) and subsequent filings. The directive's relief does not, however, extend to situations where a taxpayer wholly failed to timely file an initial GRA.

IRC Section 367 generally imposes a tax on any unrealized appreciation (a toll charge) if a taxpayer has an outbound transfer of property across international boundaries, unless an exception applies. Entering into a GRA may avoid triggering gain recognition for certain transfers of stock or securities to a foreign corporation.

Under a GRA, the U.S. transferor agrees in general that, if the transferee corporation disposes of the stock or securities within five years, the U.S. transferor will amend its tax return for the year of the original transfer and be subject to taxation. GRAs should be filed by the due date of the transferor's income tax return for the taxable year that includes the date of the transfer and require detailed information regarding the transaction. Additionally, the U.S. transferor must include with its timely-filed return for each of the five full taxable years following the taxable year of the initial transfer a certification ("annual certification") that includes certain information, such as whether a gain recognition event has or has not occurred during such taxable year.

The LMSB directive states that examiners should accept as timely-filed certain corrected or late-filed GRA documents (but as noted above – not an original GRA) that are submitted to the IRS in the manner described in the directive. In connection with these corrections, no explanation of the reasons for failing to timely file or comply with the regulations is required.

The documents subject to the LMSB directive are:

- A timely-filed document that purports to be a GRA but that does not contain all of the information required under Treas. Reg. Section 1.367(a)-8(c)(2), and
- All certifications and filings required during the GRA term. These related filings include:
    - a "new" or "successor" GRA;
    - any required waiver of the period of limitations on assessments of tax; or
    - any other information required under Treas. Reg. Section 1.367(a)-8.

To obtain relief for filings covered by the LMSB directive, a taxpayer must:

1. File an amended return that includes the complete and accurate filings that should have been included with the original return for the affected tax year with the statement "Filed pursuant to Directive of Examination Action with respect to Certain Gain Recognition Agreement" on the first page of the amended return.
2. File a Form 8838, *Consent to Extend the Time to Assess Tax Under IRC Section 367* – Gain Recognition Agreement (Note that this extension can keep the statute of limitations open longer than would otherwise occur under the GRA rules), with the amended return extending the assessment statute of limitations for any federal income tax due relating to the transfer to the later of:
    a. The close of the eighth full taxable year following the taxable year during which the initial transfer occurs, or
    b. Three years from the date the required information is provided to the IRS under the directive.

3. Comply with the notice requirements in Treas. Reg. Section 1.367(a)-8(p)(2)(ii)(A) and (B), requiring notice and a copy of the amended return to a taxpayer's current IRS examination team, if any, or to the LMSB Director having jurisdiction over the return (if the taxpayer is not currently under exam).

Taxpayers meeting the requirements of the LMSB directive that have reasonable cause requests pending with the IRS may use the directive procedures if they withdraw their request for reasonable cause. Moreover, taxpayers meeting the requirements of the directive that have been denied reasonable cause can re-submit their requests under the directive.

For additional details, please refer to **IRS Insights – September 2010** and contact **Thomas Cryan**.

ASC 740 Implications: Companies meeting the requirements of the LMSB directive should consider the corrective actions taken or expected to be taken and the related financial reporting impacts, including the amount of UTBs, penalties, and interest accrued and disclosed in their financial statements. For example, a taxpayer meeting the requirements of the LMSB directive and intending to take the required corrective actions should be able to decrease the amount of UTB liability in its financial statements related to a Section 367 transaction. However, the taxpayer should also consider how the required extension of the statute of limitations under the directive may change its ASC 740-10-50-15(d) disclosure, which requires a taxpayer to disclose UTBs for which a significant increase or decrease within 12 months of the reporting date is reasonably possible. Changes in UTBs, penalties, and interest should be accounted for in the financial reporting period including July 26, 2010, the date LMSB-4-0510-017 was issued.

Did You Know?

Disclosures for Certain Loss Contingencies May Soon Resemble UTB Disclosures

When the FASB required increased transparency for UTBs, they indicated that similar disclosures may eventually be required for contingent liabilities. The FASB has issued an exposure draft of an ASU that does just that, including the requirement to prepare a reconciliation of the beginning-to-ending balance that is similar to the tabular reconciliation disclosure required for public entities under ASC 740 for uncertain tax positions.

On July 20, 2010, the FASB issued a proposed ASU exposure draft, *Disclosure of Certain Loss Contingencies*, which is applicable to all loss contingencies under ASC 450-20 and ASC 805. The objective of the proposed guidance is to increase the amount of information available to users of financial statements regarding an entity's loss contingencies by (1) expanding the scope of disclosure requirements to include certain remote contingencies, (2) increasing qualitative and quantitative disclosures to enable users to assess "the nature, potential magnitude, and potential timing (if known)" of loss contingencies, and (3) requiring a tabular reconciliation of loss contingencies recognized.

Although income tax contingencies are not impacted by the proposed ASU, disclosures for other taxes such as sales and use, property, or franchise taxes not measured by income would be affected. Tax practitioners may be called upon to assist in assessing the likelihood of certain contingent items related to non-income taxes.

For additional information on the proposed ASU, please see Deloitte's *Heads Up* newsletter issued July 20, 2010 – **Raising the Volume on the Remote: FASB Proposes Guidance on Expanded Disclosures for Certain Loss Contingencies**.

Deloitte's Financial Reporting for Taxes 2010 Training

Professionals continue to face significant challenges in financial accounting and reporting for income taxes. Deloitte's 2010 training program can help you stay informed. The next session, running from December 6-10 in Phoenix, includes both one- and two-day courses. Courses are designed for clients and other corporate finance and tax professionals. We encourage you to **register** early due to limited meeting space and number of reserved hotel rooms.

Talk to Us

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