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Accounting Roundup — Special Edition
Changes in the Tax Landscape

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Changes in the Tax Landscape

by Deloitte & Touche LLP's Accounting Standards and Communications Group and Deloitte Tax LLP

Introduction

During 2011, the tax landscape changed significantly, affecting, among other things, the accounting and financial reporting for income taxes — and even bigger changes could be coming. These potential changes are developing on many different fronts. Corporate tax reform has been gaining momentum, including discussion of lowering the corporate tax rate and eliminating "tax expenditures." In addition, the FASB and IASB have continued to work on their four major convergence projects — revenue, leases, financial instruments, and insurance — which are expected to have an impact on the accounting for income taxes. Further, the SEC has been busy with its ongoing project to examine the implications of a transition to IFRSs in the United States and has increased its focus (along with state and federal regulators) on tax transparency, including enhancing the transparency of uncertain tax positions.

Accounting Roundup — Special Edition: Changes in the Tax Landscape summarizes these significant topics and others that have affected tax accounting over the past year. Also included are links to other resources that dive deeper into the topics discussed in the articles. You can also subscribe to receive by e-mail our quarterly publication, *Accounting for Income Taxes Hot Topics*, which highlights certain recent tax and accounting developments that may affect the accounting for income taxes under ASC 740.[1]

We hope that this *Accounting Roundup — Special Edition* helps financial professionals stay up to date on current developments and plan for future changes.

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

Contents

Tax-Related Topics Discussed at the 2011 AICPA National Conference on Current SEC and PCAOB Developments

Affects: All entities.

Summary: On December 5–7, 2011, the AICPA held its annual National Conference on Current SEC and PCAOB Developments. Several tax-related topics were discussed at the conference, including (1) realizability of deferred tax assets (DTAs), (2) effectiveness of internal controls of foreign operations, and (3) income tax disclosures related to foreign operations.

Realizability of Deferred Tax Assets

Mark Shannon, associate chief accountant in the SEC's Division of Corporation Finance, discussed the impact that the current economic environment could have on the assessment of the realizability of DTAs. He pointed out that entities must consider all available evidence, both positive and negative, in determining whether a valuation allowance is needed to reduce a DTA to an amount that is more likely than not to be realized. ASC 740-10-30-21 states that "[f]orming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." However, ASC 740-10-30-22 gives examples of positive evidence that could be used to overcome this negative evidence. One example is "[a] strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition." Mr. Shannon said that some registrants are placing less weight on recent losses when weighing the positive and negative evidence because they view the current economic downturn as an "aberration." However, he stated that while each company's facts and circumstances could differ, in general it would be "pretty difficult to conclude the economic downturn is an aberration." He then reminded participants that overcoming such negative evidence would require significant objective positive evidence.

Effectiveness of Internal Controls of Foreign Operations

Kyle Moffatt, associate chief accountant in the SEC's Division of Corporation Finance, noted that the SEC staff has continued to focus on evaluating registrants' assertions that the internal controls of a foreign operation are effective. While his comments were not specific to income tax accounting, this continues to be one of the leading causes of material weaknesses and restatements. Mr. Moffatt stated that when evaluating whether internal controls are effective, the SEC staff attempts to ensure that management of the foreign operation has the appropriate knowledge and capability to prepare financial statements in accordance with U.S. GAAP. He further indicated that appropriate background may be demonstrated through (1) education and ongoing training in U.S. GAAP, (2) professional qualifications such as a U.S. CPA license, and (3) professional experience as either an auditor or a preparer of U.S. GAAP financial statements. In addition, he noted that the SEC staff has encountered several companies that have reported material weaknesses of internal controls as a result of not having sufficient expertise with U.S. GAAP and that the SEC staff's ultimate goal of focusing on controls is to ensure that entities do have such expertise and capabilities.

Income Tax Disclosures Related to Foreign Operations

Nili Shah, deputy chief accountant in the SEC's Division of Corporation Finance, discussed certain income tax matters related to registrants' significant foreign operations. First, she indicated that when a registrant with significant amounts of cash and short-term investments overseas has asserted that such amounts are permanently reinvested in its foreign operations, the SEC staff would expect the registrant to provide the following disclosures in an MD&A liquidity analysis:

- The amount of cash and short-term investments held by foreign subsidiaries that is not available to fund domestic operations unless the funds were repatriated.
- A statement that the company would need to accrue and pay taxes if repatriated.
- A statement that the company does not intend to repatriate those funds.

Further, Mr. Shannon discussed situations in which profits derived from a country with very low tax rates are disproportionately large compared with the revenue generated from that country. Noting that such occurrences could "be the result of the various tax infrastructures or a possibility in determining where revenue is allocated," he indicated that the SEC staff has previously requested registrants to provide "disaggregated financial information related to pretax income and effective tax rates from particular countries."

Other Resources: For more information about the 2011 AICPA National Conference on Current SEC and PCAOB Developments, including the potential incorporation of IFRSs into the U.S. financial system (the SEC has not yet made a decision on this issue), see Deloitte's December 14, 2011, *Heads Up*.

Tax Accounting Implications of the SEC's IFRS Work Plan

Affects: Public entities.

Summary: In February 2010, the SEC directed its staff to initiate a work plan to help the Commission determine whether and, if so, when and how to incorporate IFRSs into the U.S. financial reporting system. Although the SEC has not yet made a decision, it has made significant progress. In May 2011, the SEC staff issued a paper[2] describing a possible framework for U.S. incorporation of IFRSs. The feedback received on the staff paper generally indicated broad support for a single set of high-quality globally accepted accounting standards as well as agreement with key elements of the approach outlined in the paper. Further, in November 2011, the SEC staff issued two long-awaited papers that analyzed IFRSs in practice[3] and compared various aspects of IFRSs with U.S. GAAP.[4] However, neither of these papers indicated whether and, if so, how U.S. public entities might start applying IFRSs.

The U.S. conversion to IFRSs was a main topic of discussion at the 2011 AICPA National Conference on Current SEC and PCAOB Developments. SEC Chief Accountant Jim Kroeker announced that the SEC staff needs "a few additional months" to complete work on its recommendation to the Commission about whether U.S. companies should adopt the international rules. Mr. Kroeker did indicate that the SEC staff has completed the majority of its fieldwork and that it is expected to finalize its comprehensive report summarizing the progress on its work plan sometime in 2012.

Implications and Next Steps: For both U.S. organizations and their foreign affiliates, the following four tax-related areas could be particularly affected by a conversion from U.S. GAAP to IFRSs:

- *Accounting guidance* — The income tax accounting guidance in U.S. GAAP differs significantly from that in IFRSs on topics including uncertain tax positions, share-based payments, taxable intercompany transactions, and the determination of in-country temporary differences for foreign operations subject to remeasurement. U.S. and international accounting officials have agreed that the existing standards governing the accounting for income taxes should be revised after the current major accounting convergence projects are completed. However, neither board has an income tax project on its current work plan; the timing may depend on the feedback the IASB receives as part of its first formal agenda consultation for its future standard-setting work plan.
- *Local tax compliance* — Each pretax accounting change that an entity makes as a result of the conversion to IFRSs could have an impact on its tax accounting methods, book-tax differences, and cash taxes to the extent that such data are used for tax filings.
- *Global tax and treasury planning* — Many jurisdictions around the world have been moving the basis for statutory reporting toward IFRSs through conversion or convergence. This shift may have a significant impact on global tax and treasury planning, including intercompany financing arrangements, cash repatriation planning, and transfer pricing.
- *Tax department operations* — The adoption of IFRSs may allow an entity's tax department to become involved in enterprise-wide finance transformation planning that can improve automation and efficiency in tax accounting processes. It is critical that these enterprise-wide initiatives be IFRS-ready and fully integrated with tax processes and data requirements.

[2] SEC Staff Paper, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards Into the Financial Reporting System for U.S. Issuers — Exploring a Possible Method of Incorporation.*

[3] SEC Staff Paper, *An Analysis of IFRS in Practice.*

[4] SEC Staff Paper, *A Comparison of U.S. GAAP and IFRS.*

Other Resources: For more information about the SEC's staff papers on IFRSs, see Deloitte's June 1, 2011, *Heads Up* and December 2, 2011, *Heads Up*.

FASB's and IASB's Convergence Projects: Impact on Accounting for Income Taxes

Affects: All entities.

Summary: The FASB and IASB are currently working on four major convergence projects: leases, revenue recognition, financial instruments, and insurance contracts. The following is a discussion of the most significant tax implications associated with the lease, revenue recognition, and financial instruments projects.

Implications:

Lease Accounting

In August 2010, the FASB and IASB (the "boards") issued an exposure draft (ED), released by the FASB as a proposed ASU,[5] that would fundamentally change the accounting for lease arrangements under U.S. GAAP and IFRSs. The ED proposes a model under which essentially all leases would be treated as financing transactions and recognized on the balance sheet. A lessee would recognize an asset for the right to use the underlying asset and a liability to make lease payments. Although the boards have not discussed a potential effective date for the final lease standard, it is expected to coincide with the effective date of a final revenue recognition standard (i.e., no earlier than January 1, 2015).

Many companies have accounted for a lease as either a capital lease or an operating lease for tax purposes. Therefore, under current accounting guidance, an entity may have had operating leases for both book and tax purposes, in which case there would be no existing temporary difference related to lease classification. The ED's proposed changes would most likely give rise to new temporary differences for many entities involved in leasing transactions.

Under U.S. tax law, the classification of leases is generally based on economic factors established by case law and Internal Revenue Service (IRS) administrative rulings; therefore, for many leases, an entity may need to analyze the specific facts and circumstances to establish the appropriate classification, particularly for complex transactions. Because the ED affects all outstanding leases as of the date of initial application, entities will need to be mindful of the significant temporary differences that may arise upon initial application of the final ASU; entities may need to account for such temporary differences on a lease-by-lease basis.

State Taxes

Many states require that a taxpayer use a multifactor apportionment formula, which may include a property factor, to determine its state taxable income. The property factor is often based on financial statement values for property, plant, and equipment, plus an adjustment for leased property that is based on a multiple of annual lease payments (a multiple of eight times net annual rental rate is fairly common). The ED is not clear on whether the right-to-use asset is a component of tangible property, plant, and equipment or an intangible asset for financial reporting purposes. Thus, there may be some ambiguity in many states regarding whether a taxpayer should use the right-to-use book asset or a multiple of the net annual rental rate when calculating the property factor. As the ambiguity is resolved (hopefully before the first year in which the new lease accounting applies), companies should assess whether the combination of the new lease accounting and the state's approach to using that information for apportionment purposes has a material effect on the applicable state rate (i.e., the statutory rate times the apportionment factor) such that remeasurement of deferred taxes would be required (i.e., before the first year in which the new lease accounting is applicable).

Similarly, certain states impose a franchise tax in addition to a corporate income tax. In states in which the franchise tax is based on the amount of assets that a taxpayer has in the state (e.g., North Carolina, Tennessee), the taxpayer's franchise tax liability may be affected by assets capitalized under the expected new lease accounting. State franchise taxes based on book net equity may also be affected by the leased assets and liabilities that would be recorded under the new guidance.

[5] FASB Proposed Accounting Standards Update, *Leases*.

Revenue Recognition

On November 14, 2011, the FASB and IASB jointly issued their revised revenue recognition ED, released by the FASB as a proposed ASU,[6] which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and would supersede most current revenue recognition guidance.

Federal income tax law contains specific rules on recognition of certain types of revenue, such as income from long-term contracts and advance payments for goods and services. Those rules often overlap with a taxpayer's financial reporting policies, in which case the taxpayer simply applies the revenue recognition method it uses in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Because the proposed guidance may change the amount and timing of revenue recognition for entities that maintain their books and records under U.S. GAAP or IFRSs, the accounting proposed in the revised ED may have cash tax implications or give rise to new book-tax differences that will need to be captured, calculated, and tracked through tax accounting processes and systems.

The general rule under federal tax principles is that income is recognized no later than when it is received. There are a few limited exceptions in which a taxpayer is allowed to defer revenue recognition for certain advance payments from customers. To the extent that the new guidance affects the timing and measurement of these advanced payments, there could be an associated tax impact.

The following are a few of the ED's concepts that may have a cash tax impact or change the measurement of certain temporary differences:

- Changes in the timing of book revenue recognition (and contract assets and contract liabilities) that result from when a taxpayer transfers control of goods and services to a customer.
- Contracts that include variable or contingent consideration or a significant financing component.
- Capitalization of certain costs incurred to obtain or fulfill a contract, some of which may be currently deductible for tax purposes.
- Timing of loss deductions related to onerous performance obligations.

The tax implications associated with implementing the new standard will be based on an entity's specific facts and circumstances. Thus, it will be important for tax professionals to understand the financial reporting implications of the ED so that they can properly analyze the tax ramifications and explore possible tax planning, such as the selection of any alternative tax accounting methods that may be available. Before a taxpayer can select a new tax accounting method, however, the taxpayer may be required to obtain approval from the tax authorities. A change in method of tax accounting, including circumstances in which the taxpayer may wish to apply revised book accounting methods, generally requires the consent of the Commissioner of Internal Revenue. Depending on the nature of the accounting change request, such consent may be automatic or may require the issuance of a formal consent letter by the commissioner. Similar implications may arise in foreign jurisdictions that maintain statutory accounting records under IFRSs or U.S. GAAP.

Accounting for Financial Instruments

The FASB's and IASB's financial instruments project addresses the accounting for a broad range of financial instruments, including investments in debt and equity securities, investments in nonmarketable equity securities, loans, loan commitments, deposit liabilities, trade payables, trade receivables, derivatives, and debt liabilities. In May 2010, the FASB released an exposure draft (ED) that would change (1) the classification and measurement of financial assets and financial liabilities, (2) the accounting for impairment of financial assets, and (3) hedge accounting. Since the close of the ED's comment period, the FASB has redeliberated and revised many aspects of its original proposals.

The boards' project on accounting for financial instruments differs from their revenue and leases projects in that they have not been working together on developing an accounting model for financial instruments. Rather, the boards have been separately deliberating certain aspects of the financial instruments project and have been following significantly different timelines. However, while the FASB has continued to make progress on developing a new accounting model for financial instruments, the

[6] FASB Proposed Accounting Standards Update, *Revenue From Contracts With Customers.*

IASB has recently decided to consider changes to the classification and measurement requirements in IFRS 9 in an attempt to reconcile differences between the two financial instrument models and work toward convergence.

For tax purposes, the accounting for financial instruments can be quite complex, involving differences in character (capital vs. ordinary) and timing (e.g., mark to market vs. cost). First, an entity would determine at inception whether instruments will be measured at fair value or cost for tax purposes on the basis of the entity's industry and the business activity (e.g., dealer vs. investor vs. hedger) underlying the entity's investment. Further, this determination is made on a security-by-security basis and, under certain conditions, an entity can elect to measure its investments at fair value for tax purposes though they might otherwise be measured at cost for financial statement purposes. The following factors further complicate matters:

- Gains are taxed as ordinary income or as capital gains depending on the tax classification (again, differences in character).
- The classification or measurement attribute applied in accounting for financial instruments for book purposes may be indicative, but is not determinative, of the tax treatment; differences are common.
- Fair market value measurement requirements under the Internal Revenue Code (IRC) (e.g., IRC Sections 475 and 1256) differ from the fair value requirements under ASC 820.

The FASB's project on the classification and measurement of financial instruments will most likely not affect related rules under the IRC. However, changes in the classification and measurement of financial instruments for book purposes will change. Most notably, certain debt securities held to maturity and measured at amortized cost under existing U.S. GAAP would be measured either at fair value through other comprehensive income or at fair value through net income under the FASB's tentative model. With any change in the accounting principles governing financial reporting, there is the potential for changes in the magnitude, if not the nature, of book-tax differences. Many entities often use elections available under the IRC to achieve consistent treatment for book and tax purposes. Smaller banks, for example, may classify investments at cost in accordance with IRC Section 475(b) yet may use fair value elections pursuant to IRC Section 475(f) to eliminate book-tax mismatches. Along with understanding the changes that may result from the FASB's proposed amendments to the Codification, management will want to consider what tax elections should be made, whether to reduce complexity and book-tax differences, and how to effectively manage the entity's tax obligations.

Other Resources: For more information about the FASB's and IASB's leases, revenue recognition, and financial instruments EDs, see Deloitte's August 17, 2011, *Heads Up*; November 15, 2011, *Heads Up*; and January 5, 2012, *Heads Up*, respectively.

Tax-Related Themes of Recent SEC Staff Comments to Domestic Registrants and Foreign Private Issuers

Affects: Domestic SEC registrants and foreign private issuers.

Summary:

Domestic Registrants

The SEC staff's comments on income taxes, from both a recognition and a disclosure perspective, have focused on repatriation of foreign earnings, disclosures about the rate reconciliation, valuation allowances, and uncertain tax positions. Comments have emphasized risk, including risks that (1) the registrant will have to repatriate earnings to meet current liquidity demands, resulting in additional taxes that may not be accrued for; (2) the historical effective tax rate is not sustainable and may increase materially; (3) net DTAs are not realizable; and (4) tax positions taken during the preparation of returns will ultimately not be sustained. The staff's comments are intended to encourage enhanced disclosures that better inform investors of these risks and often ask registrants to provide early-warning disclosures to help users understand these risks and how they potentially affect future operating results. The following bullets provide additional insight into the SEC staff's comments on these disclosures:

- Under U.S. GAAP, an entity must disclose when a deferred tax liability is not recognized for an investment in a foreign subsidiary because the earnings of that subsidiary are indefinitely reinvested, as well as the gross amount of the temporary difference for which deferred taxes have not been provided. When a registrant believes that determining the deferred tax liability is not practicable, the registrant should state that belief in its disclosures.

- The SEC staff has asked registrants that have significant foreign operations, report little or no income tax provision from these foreign operations, and have significant foreign cash and short-term investments to disclose in MD&A (1) the amount of foreign cash and investments, (2) the amount that is permanently reinvested and not available for domestic use, and (3) a statement that the registrant would be required to accrue and pay taxes if such foreign funds were repatriated. The staff has also requested disclosure of other tax-related matters affecting liquidity, such as when a registrant borrowed funds because it was cheaper to increase debt than to repatriate funds.

  The SEC staff often reminds registrants of the requirement to disclose "the components of income (loss) before income tax expense (benefit) as either domestic or foreign." In certain situations, a further breakdown of the portion attributable to foreign operations (on a country-specific basis) may be necessary. Registrants should also consider whether the sustainability of historical effective tax rates is uncertain and should provide adequate disclosure (e.g., amount of pretax income and country-specific tax effective rates) if the impact on the registrant could be material.

- The SEC staff continues to focus on valuation risks related to DTAs. The staff has commented on the sufficiency of valuation allowances when it appears that DTAs may not be realizable as well as on registrants' support for any reversals of valuation allowances, which has been more frequent over the past year as some companies have returned to profitability.

- The SEC staff continues to comment when a registrant does not provide the tabular reconciliation of uncertain tax positions. A registrant that has no uncertain tax positions or for which such benefits are immaterial should consider disclosing those facts. In addition, the SEC staff expects registrants to provide more transparent disclosures about reasonably possible changes in uncertain tax positions. Because the guidance on the acceptable level of aggregation of information for these disclosures is not prescriptive and allows for judgment, the SEC staff evaluates registrants' level of disclosure on a case-by-case basis. Given the judgment associated with uncertain tax positions and the related disclosures, the SEC staff is expected to continue to closely scrutinize this area.

Foreign Private Issuers

The SEC staff often comments on the completeness and adequacy of the income tax disclosures that registrants are required to provide under IFRSs. More specifically, the staff's comments have focused on the following items:

- Nature of adjustments and reconciling items.
- Specific facts and circumstances related to the timing of adjustments.
- Explanation of changes in applicable tax rates.
- Recognized amounts for each type of temporary difference.
- Income tax consequences of dividends declared.

Implications and Next Steps: An entity should ensure that its financial statements include the required disclosures and that these disclosures enable users to understand the current and future tax consequences of the entity's transactions and related events. The entity should pay particular attention to significant adjustments and reconciling items to ensure that recognition of related tax consequences is consistent with the accounting requirements and that its disclosures about the tax consequences are transparent to financial statement users.

Other Resources: See the following Deloitte resources for additional guidance on the SEC staff's comments related to income taxes:

- *SEC Comment Letters — Including Industry Insights: Improving Transparency* (Updated November 2011).[7]
- *Example SEC Comments: Income Taxes — August 2011*.

[7] Look for an updated version of this publication in the first quarter of 2012.

- *SEC Comment Letters on Foreign Private Issuers Using IFRSs* (Updated December 2009).

Uncertain Tax Positions: Increasing Governance and Transparency

Affects: All entities.

Summary: Over the past several years, the IRS has adopted rules designed to increase tax governance and the transparency of uncertain tax positions being taken by corporate entities. As a result, significant developments have recently occurred at all jurisdictional levels, including international, state, and federal. These developments include:

- Countries have been working together to enhance cross-border tax transparency, including through joint audits of taxpayers.
- Many states have adopted tax amnesty programs and are increasing audits.
- The IRS has initiated Schedule UTP, which requires certain corporate taxpayers to report their uncertain tax positions on their annual income tax returns.

IRS Commissioner Doug Shulman spoke to the American Bar Association in September 2010 and stated that the IRS's goals in requiring the reporting of uncertain tax positions include the following:

- Create certainty sooner for taxpayers
- Cut down the time it takes to find issues and complete an audit, which benefits both the IRS and taxpayers
- Ensure that both the IRS and taxpayer spend more time discussing the law as it applies to their facts, and less time looking for information
- Help prioritize taxpayers for examination
- Help identify issues where there is uncertainty and where we need to develop further guidance
- Help prioritize selection of issues during an audit
- Obtain key information regarding uncertain tax positions without getting into the heads of the taxpayers or their advisors, as it relates to quantifying risk.

Mr. Shulman also spoke at the AICPA Fall Meeting in November 2011 and discussed how the IRS would use Schedule UTP. He described the processes put in place by the IRS, including "a centralized review process in [the Large Business and International (LB&I) Division] to help us to identify trends, understand gaps in guidance and determine the proper treatment of [uncertain tax positions]." He further stated that "[t]his will ensure that procedures are fully in place for how the new schedules will be used by us and that training has been provided to LB&I personnel prior to the release of UTP schedules to the field." In addition, the LB&I commissioner issued a memorandum that contains requirements and procedures LB&I examination teams must follow when reviewing and using Schedule UTP in conjunction with their examination.

Mr. Shulman provided some insight into the first Schedule UTPs that have been received. The IRS has received approximately 1,500 UTP schedules, with about half containing only one uncertain tax position. The top three disclosure topics were research tax credits; allocation of income, including transfer pricing; and trade and business expense.

Implications and Next Steps: Many of these developments could have both direct and indirect effects on financial reporting. For example, entities will need to consider amnesty programs when determining the amount of uncertain tax positions, and related penalties and interests, recorded for income taxes accounted for pursuant to U.S. GAAP. Taxpayers must also consider amnesty programs for nonincome taxes when determining the amount of loss contingencies, including penalties and interest, that may need to be recognized. Adjustments to uncertain tax positions, contingencies, interest, and penalties that are made as a result of participation in amnesty programs should be recorded in the period in which an original or amended tax return is filed and all necessary actions have been taken to obtain amnesty.

Although Schedule UTP does not change financial reporting requirements under U.S. GAAP, an entity may need to reevaluate uncertain tax positions as a result of some of the above developments. As a reminder, under U.S. GAAP, ASC 740-10-35-2 provides guidance on subsequent measurement of tax positions, stating that "[s]ubsequent changes in judgment that lead to changes in measurement shall result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period."

Another factor that an entity will need to consider is whether a tax position is effectively settled. ASC 740-10-25-10 lists conditions that must be met for a tax position to be considered effectively settled under U.S. GAAP. One of these conditions is that the tax position must be part of a completed examination. However, ASC 740-10-25-11 clarifies that a tax position that is part of an examination "does not need to be specifically reviewed . . . by the taxing authority to be considered effectively settled."

The many changes associated with uncertain tax positions and the related increase in tax transparency will result in an increase in the amount of information that entities will need to evaluate as well as a heightened risk that such entities will be examined by the IRS as a result of their new filings. Therefore, it is more critical than ever for entities to be on alert for new information affecting their uncertain tax positions and to ensure that their documentation supporting the tax positions they have taken is updated in a timely manner.

Other Resources: The following Deloitte publications provide additional guidance on uncertain tax positions:

- *U.S. Tax Reporting Requirements for Uncertain Tax Positions: An Historical Perspective*.
- *Uncertain Tax Positions and the IRS Transparency Initiative: No Holds Barred*.
- *Schedule UTP: The Next Step in Tax Governance and Transparency*.

Internal Controls: Tax-Related Material Weaknesses and Restatements

Affects: All entities.

Summary: While material weaknesses and restatements have generally been on the decline, accounting for income taxes continues to be a challenge for corporate tax departments. The leading cause of tax-related material weaknesses continues to be insufficient review by management (e.g., not enough levels of review, insufficient level of precision or detail, or not enough time for reviews). Other significant causes of material weaknesses include personnel issues (either an insufficient number of personnel on hand during key times of the year or a lack of sufficiently trained personnel), improper treatment and recording of items under U.S. GAAP, inadequate reconciliation of tax accounts, and problems with general procedures and processes.

Moreover, tax-related matters remained one of the top 10 causes of restatements in 2010. The most commonly affected tax-related areas were general accounting for income taxes, deferred taxes, and valuation allowances. In addition to the causes of material weaknesses described above, one of the reasons for tax-related restatements may be the inability of existing systems to obtain tax data, which could necessitate manual steps to create new entries or make last-minute adjustments. The multijurisdictional tax reporting requirements could also increase the complexity of income tax accounting, thereby increasing the risk of error and, ultimately, restatement.

The existence of a material weakness is not restricted to situations in which a restatement occurs; rather, it depends only on the reasonable possibility of a material misstatement. However, a restatement is the most common indicator of the presence of a material weakness. When an entity reassesses its internal controls over financial reporting during the restatement process, it often realizes that a material weakness most likely led to the restatement.

Although income tax accounting can be complex, many errors are caused by simple carelessness and other factors, such as poor coordination between an entity's tax and financial reporting or other departments. For many entities, the core information required by tax departments often resides outside of a structured system or in "nonstandardized" tools (e.g., a spreadsheet on someone's hard drive or an international accounting system designed for local needs).

Implications and Next Steps: Entities should consider leading practices for managing income tax accounting issues and for reducing the risk of tax-related material weaknesses and restatements. These include ongoing training of personnel, beginning the tax provision process early, working effectively with other departments (particularly financial reporting), and reviewing processes regularly for efficiency and effectiveness. Some of today's tax technologies can eliminate the need for manual manipulation of data and reduce overreliance on highly manual controls, which may lower the risk of a material misstatement in the financial statements.

If an entity concludes that there is an error in its prior-period financial statements and that this error requires restatement, it will need to determine whether a material weakness also existed in the prior period and whether it still exists. For example, an entity may question the basis for selection and application of the accounting principle for that situation and whether there was documentation and contemporaneous evidence supporting that position. In these circumstances, the best course of action is for consultations to occur, such as the tax department with finance personnel, finance personnel with SEC counsel, and management with external auditors.

Other Resources: The following Deloitte publications provide additional insight into material weaknesses and restatements:

- November/December 2011 *Audit Committee Brief,* "Tax Complexities Drive Audit Committee Oversight."
- October 2011 *Hot Topics,* "Taxes: What the Audit Committee Should Know."
- *Material Weaknesses and Restatements: Is Tax Still in the Hot Seat?*
- *Putting It All Together: Using Technology to Drive Tax Business Processes*.
- *Tax Provision Software: It's Time to Take Another Look*.

Tax Governance: Board-Level Oversight of Tax Reporting

Affects: All entities.

Summary: Since February 2010, the SEC has required entities to disclose the role of their boards of directors in risk oversight. The purpose of these requirements is to provide investors and other stakeholders with enhanced disclosures regarding board-level risk oversight. Further, in a 2009 speech to the National Association of Corporate Directors, IRS Commissioner Doug Shulman called for increased tax oversight by suggesting that corporate boards (1) set a threshold level for taking a tax position, (2) discourage or eliminate opinion shopping by having an independent firm review major tax positions and having the firm conduct a direct dialogue with the board, and (3) address transfer pricing and the relative profits allocated to low-tax jurisdictions to make sure they reflect real economic contributions made in those jurisdictions. Along with increased oversight, it is important to create an integrated approach to tax and other enterprise risks, since tax risks can affect other aspects of business and vice versa.

Implications and Next Steps: Audit committees and chief tax officers should think broadly about risk and tax risk by (1) establishing appropriate corporate governance, structures, and protocols; (2) acknowledging that tax accounting commonly affects business risks; and (3) focusing on both potential downside tax implications and unrewarded risks (i.e., avoiding penalties) as well as the potential value of risk-taking (i.e., the value gained through appropriate tax planning).

In addition, audit committees may want to consider how well they understand current tax strategies, including the impact on prior years and projections for the future. Management and chief tax officers can play a role in identifying which issues the entity should consider top priorities. Moreover, audit committees can play a leading role in encouraging a risk-intelligent governance approach and, therefore, should encourage entities to understand the regulatory environment and its impact on tax. Leading practices for audit committees include holding tax education sessions, encouraging annual tax updates (or more frequently as transactions warrant), and encouraging the tax department's participation as part of the entity's overall risk management efforts.

When meeting with audit committees, chief tax officers may want to consider discussing a number of topics, including the increased focus on risk disclosures and the IRS commissioner's call for increased oversight of tax matters.

Other Resources: See the following Deloitte publications for more information about oversight of risks related to tax reporting:

- November/December 2011 *Audit Committee Brief,* "Tax Complexities Drive Audit Committee Oversight."
- October 2011 *Hot Topics,* "Taxes: What the Audit Committee Should Know."
- *CFO Insights*, "Board Relations: Have Risk Disclosure Practices Improved?"
- *The Risk Intelligent Tax Executive*.
- Insights Podcast, *Tax Risk: A Call to Action*.

Tax Policy: Call for Fundamental Tax Reform in the United States

Affects: All entities.

Summary: A mounting chorus across the political spectrum is calling for fundamental tax reform. Regarding the corporate income tax, three broad areas of consensus have emerged. First, most, if not all, policymakers believe that the corporate income tax rate must be reduced substantially. Second, in conjunction with lowering the tax rate, reformers are revisiting a host of "tax expenditures" that may be reduced or eliminated. Third, reformers agree that a reexamination of the basis for the U.S.'s taxation of multinational corporations is overdue.

The current debate over tax reform appears to be proceeding on the basis of a view that the tax rate should be in the mid–20 percent range. Given that view, the next major challenge seems to be the determination of what income will be taxed. All else being equal, a low rate implies a large amount of income subject to tax. Unless corporate tax collections are to be reduced overall, agreement on a rate in the mid–20 percent range implies the elimination or substantial restriction of most current-law "tax expenditures."

In addition to curtailing exclusions and deductions, reducing the tax rate to the levels sought by reformers would mean considering other expansions of the amount of income subject to tax and eliminating a host of current-law credits that otherwise would reduce tax. Before expanding the tax base, Congress would need to consider (1) expanding the definition of gross income by limiting exclusions or tax exemptions, (2) eliminating deferrals of income, (3) reducing or eliminating some available deductions from gross income, and (4) delaying the deduction of other amounts.

Implications and Next Steps: Whatever form tax reform takes, the financial statement impact — associated both with the balance sheet accounts related to income taxes and with future income statements — will be significant. Effective stakeholder communications regarding financial statement changes and effective implementation planning for reform can be strengthened through better tax transparency, modeling of reform options, and scenario planning. Once tax reform legislation has been enacted, entities will have to revise earnings projections and update balance sheet accounts for the statutory change.

An entity's principal challenges in preparing for reform include preventing unnecessary costs, effectively engaging in the reform discussions, and preparing key stakeholders for potentially significant changes. Further, in making the transition from old to new systems, entities will need to secure benefits in current tax policy that will become unavailable after reform and take advantage of opportunities presented by the transition. The principal challenges of the post-reform period will include implementing new systems; introducing new or modified products; and reviewing entity, structure, and investment choices for tax efficiency. Tax reform also could be accompanied by new governance requirements.

Given the current political landscape, it seems unlikely that Congress will take action on tax reform until sometime after the 2012 elections. The agenda of the 112th Congress has focused primarily on government spending issues rather than on tax legislation. Perhaps a 2012 election fought over tax and spending reform is a necessary precursor to definitive action. Certainly, Congress will have difficulty pushing through major reform without the active engagement and advocacy of the executive branch.

Other Resources: The following Deloitte publications contain additional information about tax reform:

- *Resetting the Code: Issues in Corporate Tax Reform*.
- October 2011 *Hot Topics,* "Taxes: What the Audit Committee Should Know."

Changes in Domestic and International Tax Rates, Laws, and Regulations

Affects: All entities.

Summary: While U.S. federal tax reform is not imminent until after the 2012 elections, various other tax jurisdictions have been active recently in changing their tax rates and codes. The aftermath of the economic downturn has left many tax jurisdictions (domestic and international) in a significant budget shortfall. Therefore, many of these jurisdictions have been ramping up efforts to increase tax revenue by enacting new legislation that mandates higher taxes and increases enforcement and collection efforts. On the other hand, some tax jurisdictions have actually been becoming more creative in their attempts to increase their tax base through changes in their tax rates and codes, including decreasing rates or completely replacing a tax code.

Implications and Next Steps: Income tax rates and codes are a constant moving target that could have meaningful financial statement implications for an entity's income tax accounting. The tables below summarize some of the more significant domestic and international changes that occurred during 2011. For more information on a change that occurred in a specific tax jurisdiction, please click on that jurisdiction's link to go to the applicable quarterly *Accounting for Income Taxes Hot Topics, International Tax Developments and Applicable Tax Rates,* and *Multistate Tax* newsletters. These newsletters generally provide additional background on these changes, the implications related to accounting for income taxes, and links to additional resources.

For information on other domestic tax jurisdictions, see the "Other Resources" section below the table.

Domestic Tax Jurisdictions

Tax Jurisdiction	Summary
State of Arizona	In February 2011, modifications were made to the state's law that (1) phased in a corporate income tax rate reduction, (2) changed the electable weighted sales factor, and (3) created or modified several tax credits (e.g., new employment, investment in small businesses, university-related research).
State of Illinois	In January and December 2011, the Illinois State Income Act was amended to (1) increase the corporate income tax rate; (2) suspend the net loss carryover deduction for C corporations; (3) tighten the safe harbor on estimated tax payments; (4) modify the definition of an Illinois "unitary business group" to permit full and partial combination of holding companies by "allowing combination of a holding company that would otherwise be a member of a unitary business group with taxpayers that apportion business income" using certain special "one-factor" provisions generally applicable to insurance, financial, and transportation companies; and (5) extend the R&D credit through tax years ending before January 1, 2016, as well as various other credits that were expiring in 2011, 2012, and 2013.
State of Massachusetts	In July 2011, a law was passed that postpones for one year a FAS 109 deduction that was scheduled to begin in 2012. This deduction was part of 2008 combined reporting legislation and is generally limited to public companies that adopted a combined reporting regime for tax years beginning on or after January 1, 2009.
State of Michigan	In May 2011, legislation was passed, which will become effective on January 1, 2012, that replaced the Michigan Business Tax and imposed a 6 percent corporate income tax, while eliminating the election of an equal-weighted three-factor apportionment formula and requiring a single sales-factor apportionment formula.
State of New Jersey	In April 2011, legislation was passed that (1) phases in a single sales-factor apportionment formula that is generally applicable for corporate income tax purposes and (2) creates a modified sales factor (measured by revenue miles) for airlines.
State of Wisconsin	In January 2011, Wisconsin established a 10-year lookback period applicable to certain income and franchise tax nonfilers with Wisconsin nexus. The 10-year lookback period is the maximum period the state would go back to collect tax, interest, and penalties (subject to certain conditions).

Tax Jurisdiction	Summary
District of Columbia	In September 2011, the Fiscal Year 2012 Budget Support Act of 2011 was enacted, approving the city's fiscal year 2012 budget and, for fiscal years beginning on or after January 1, 2011, prescribing mandatory combined reporting for taxpayers engaged in a unitary business. Combined reporting is to be done on the basis of a water's-edge group unless a worldwide group election is made. Among various other changes made by the new law is the adoption of a double-weighted sales apportionment factor.
State of Louisiana	In September 2011, the Louisiana Court of Appeal held that two corporations whose only connection to Louisiana was the holding of limited partnership interests in a partnership with Louisiana operations were not subject to Louisiana Franchise Tax.
State of Tennessee	In November 2011, the Department of Revenue issued a notice stating that, for excise tax purposes, taxpayers for which intangible expenses have been disallowed, or that are concerned about such disallowance, may be able to compromise and settle their liability or potential liability, subject to approval by the Attorney General and the Comptroller.
State of Texas	In November 2011, the Texas Supreme Court upheld the constitutionality of the Margin Tax, ruling that because the tax is imposed at the entity level and does not impose tax on the net income of individual partners of a partnership, it does not violate Texas law.

International Tax Jurisdictions

Tax Jurisdiction	Summary
France	In December 2011, the French government introduced an additional surcharge of 5 percent (based on the income tax due at the standard tax rates) for companies with turnover exceeding 250 million euros. The surcharge applies to taxable income derived in fiscal years closed on or after December 31, 2011, and until December 30, 2013. As a result of the new surtax, the effective tax rate applicable to large profitable companies would be increased to 36.10 percent from the current tax rate of 34.43 percent.
United Kingdom	A 28 percent rate applies to the 2010–2011 financial year ending March 31, 2011. A reduced 26 percent rate is effective for the 2011–2012 financial year ending on March 31, 2012. A 25 percent tax rate will become effective from April 1, 2012. As a result of the mid-year tax rate change, taxpayers with a December 31 year-end would have blended tax rates of 26.5 percent and 25.25 percent, respectively, for 2011 and 2012.
Puerto Rico	In 2010, Puerto Rico introduced a new excise tax on the acquisition of personal property and services. Guidance issued by the IRS in 2011 clarifies that it will not challenge a taxpayer's position that the excise tax is a tax "in lieu of" an income tax (and thus is recorded outside of income tax expense).
Greece	In March 2011, a law was enacted to reduce the corporate income tax rate and abolish the dual rates that apply to distributed and undistributed profits. The new law also eased the rules restricting deductions on payments to certain foreign jurisdictions, postponed the introduction of a capital gains tax on the transfer of shares, and provided an amnesty for income that previously should have been declared.
France, Hungary, Italy, Portugal, and Spain	Recent French, Hungarian, Italian, Portuguese, and Spanish tax legislation amended the rules governing the use of tax loss carryovers. While the new tax loss carryover utilization rules in each of the specific jurisdictions differ, the general premise is that the annual utilization of tax losses carried forward is limited to a certain percentage of taxable income or turnover for a particular year.
India	In April 2011, the President of India signed a new law that included a reduction in the surcharge for domestic companies from 7.5 percent to 5 percent and for foreign companies from 2.5 percent to 2 percent. The alternative minimum tax rate was raised from 18 percent to 18.5 percent. In addition, the tax rate on dividends received by Indian companies from foreign subsidiaries during 2011–2012 decreased from 30 percent to 15 percent.

Tax Jurisdiction	Summary
Italy	In May 2011, the Italian government enacted legislation that allowed taxpayers not engaged in Italian business or entrepreneurial activities (e.g., nonresidents without an Italian permanent establishment) to elect a step-up in the tax basis of participations held in unlisted Italian companies. The election, which is an extension of prior step-up provisions, may be exercised only for participations in unlisted Italian companies held on July 1, 2011. In December 2011, a new notional deduction incentive, Allowance for Corporate Equity (ACE), was enacted. The ACE incentive is an annual deduction from corporate taxable income and is calculated by reference to the increase in an entity's qualifying equity for any given year as compared with its equity balance as of December 31, 2010 (for taxpayers with a calendar year-end). For tax years 2011–2013, the ACE deduction is calculated at 3 percent of applicable equity amounts. The ACE deduction in excess of taxable income can be carried forward indefinitely.
Japan	In June 2011, Japan's government enacted tax reform provisions that include new tax incentives to promote employment and environmental investment, tax credits for certain qualified donations, changes to consumption tax, and new foreign investment incentives. Also included are further extensions of select special measures, such as the 18 percent corporate income tax rate for small and medium-size enterprises until March 31, 2012. In November 2011, Japan's government enacted tax reform that reduces the effective corporate income tax rate in two phases: first by approximately 2.7 percentage points for three years, and thereafter by approximately another 2.3 percentage points; these changes are effective for fiscal years beginning on or after April 1, 2012. In addition, Japan's government amended the rules governing tax loss carryforward utilization. Under these new rules, only 80 percent of a company's taxable income for a fiscal year can be offset by tax losses carried forward. The tax loss carryforward period was extended from the current seven-year period to nine years. The rules apply to fiscal years beginning on or after April 1, 2012.

Other Resources: Deloitte's *Accounting for Income Taxes — International Developments and Applicable Income Tax Rates* and *Accounting for Income Taxes Hot Topics* and *Multistate* archives.

IRS Issues Guidance on Phased-In Approach to Implementing FATCA

Affects: U.S. organizations making payments to foreign entities and non-U.S. financial intermediaries that own or hold any U.S. securities.

Summary: The Foreign Account Tax Compliance Act (FATCA), enacted in 2010 as part of the Hiring Incentives to Restore Employment Act, is intended to help in the identification of U.S. persons concealing assets in offshore accounts or through the ownership of foreign entities. FATCA requires most foreign financial institutions (FFIs) to enter into an agreement with the U.S. Treasury to identify and report information about U.S. persons engaging in such concealment. U.S. organizations (both financial and nonfinancial) dealing with FFIs that have not entered into an FFI agreement, or that are not exempt for some other reason, will be required to withhold 30 percent on most payments of U.S. income as well as on the proceeds from the sale of U.S. securities. While these new requirements go into effect on January 1, 2013, the IRS acknowledged in Notice 2011-53 that FATCA imposes significant requirements on FFIs and other entities to develop the compliance, reporting, and withholding systems necessary to comply with the new rules. Accordingly, the notice provides several transitional reliefs for some of these significant obligations.

Implications and Next Steps: When withholding starts, it will apply to U.S. income and investments of the affected entity as well as to its account holders, debt holders, and shareholders. Thus, the tax liability may be subject to reporting under guidance on accounting for income taxes or loss contingencies. SEC registrants should consider disclosing in MD&A any material anticipated future impact of this legislation on their results of operations, liquidity, and capital resources. They should also consider disclosures in the critical accounting estimates section of MD&A to the extent that the changes could materially affect existing assumptions used in estimating tax-related balances.

Other Resources: Deloitte's FATCA Resource Library.

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Further information about the standard setters can be found on their respective Web sites as follows: www.fasb.org (FASB); www.fasb.org/eitf/agenda.shtml (EITF); www.aicpa.org (AICPA); www.sec.gov (SEC); www.fasab.gov (FASAB); www.gasb.org (GASB); and www.iasb.org — or on www.iasplus.com/index.htm (IASB and IFRS Interpretations Committee).

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