Accounting Roundup — Special Edition
Annual Update on Accounting for Income Taxes

January 2014

Annual Update on Accounting for Income Taxes

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

Introduction

Welcome to this special edition of *Accounting Roundup*, which summarizes significant developments that have affected the accounting and financial reporting for income taxes over the past year. Topics covered in this publication include:

- The expiration of various federal tax credits at the end of 2013.
- The deferred tax considerations related to the issuance of the final tangible property regulations.
- The continuing efforts of state and international tax authorities to reform tax law.
- Areas that the SEC focuses on when reviewing a registrant's income-tax-related disclosures.
- EITF standard setting affecting the presentation of unrecognized tax benefits and the accounting for certain types of investments in low-income housing tax credits.
- The FASB's and IASB's joint convergence projects that are nearing completion and the related tax implications, particularly those related to the revenue recognition project.

In addition, this publication includes links to other resources that provide further insight 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. As always, we welcome your feedback. Please send questions and comments to accountingstandards@deloitte.com.

Sincerely,

Deloitte & Touche LLP and Deloitte Tax LLP

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

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Tax Policy and Other Developments

Expired Federal Tax Deductions and Credits

Affects: All entities.

Summary: Numerous temporary business, individual, and energy tax incentives that were extended as part of the American Taxpayer Relief Act of 2012 expired on December 31, 2013. The expiration of these provisions on December 31, 2013, will most likely affect calendar-year taxpayers and fiscal-year filers in different periods. In addition, taxpayers that are projecting tax rates for planning purposes may need to consider the potential impact of these changes.

Major business tax provisions that expired at the end of 2013 include the research and experimentation credit; the subpart F exemption for active financing income and look-through treatment for payments between related controlled foreign corporations; 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements; the new markets tax credit; and the work opportunity tax credit.

Expired energy incentives include the production tax credit for wind; various tax credits for construction of energy-efficient new homes, energy-efficiency improvements to existing homes, and the manufacture of energy-efficient appliances; and various incentives for biodiesel and renewable diesel, alternative fuel, and alternative fuel mixtures.

Implications and Next Steps: Entities should stay abreast of when and if these "extenders" are renewed. Congress has historically addressed tax extenders retroactively after year-end. However, because Ways and Means Committee Chairman Dave Camp (R-MI) and Senate Finance Committee Chairman Max Baucus (D-MT) are committed to dealing with extenders as part of comprehensive tax reform, lawmakers are unlikely to take up the extenders discussion in the near term. That said, Congressman Camp and Senator Baucus may signal their intentions for handling extenders as they release additional discussion drafts and could mark up tax reform legislation in their respective committees. Tax extenders could also be addressed in separate legislation; however, Congress may be less inclined to pursue this option than it was in prior years now that there is no longer the urgency of passing an alternative minimum tax (AMT) patch to drive the extender process.

In addition, the Obama administration and congressional Democrats could push for a tax extender bill that is offset with new tax revenue, which would reopen a long-standing debate over whether certain frequently targeted tax provisions might be repealed to offset the cost of extending other tax provisions.

Other Resources: For more information on tax reform and extenders, see Deloitte's Tax News & Views page.

Tangible Property Regulations

Affects: All entities.

Summary: On September 13, 2013, the U.S. Department of the Treasury and the Internal Revenue Service released:

- Final regulations (the "Final Regulations") that provide guidance on applying Section 263(a) of the Internal Revenue Code (IRC) to amounts paid to acquire, produce, or improve tangible property, as well as rules for materials and supplies (IRC Section 162).
- Proposed regulations (the "2013 Proposed Regulations") addressing dispositions and general asset accounts (IRC Section 168).[2]

These regulations change certain aspects of the temporary and proposed tangible property regulations (the "Temporary Regulations") that were issued on December 23, 2011. In general, such regulations update existing rules and create new rules for entities to apply in determining whether to deduct or capitalize costs of tangible property. The Final Regulations contain rules related to (1) materials and supplies, (2) acquisition and production of tangible property, and (3) improvements to tangible property. The 2013 Proposed Regulations prescribe rules related to dispositions/retirements of tangible property.

[2] The 2013 Proposed Regulations are expected to be finalized in early 2014 and, when the final regulations are issued, entities will need to similarly assess the impact of those final regulations.

The Final Regulations are generally effective for taxable years beginning on or after January 1, 2014. In addition, taxpayers are permitted to early adopt provisions of the Final Regulations for taxable years beginning on or after January 1, 2012. Taxpayers are also permitted, but not required, to apply the 2013 Proposed Regulations to taxable years beginning on or after January 1, 2012. The government expects to issue procedural guidance under which taxpayers will be granted automatic consent to change their accounting methods to comply with the Final Regulations.

Implications and Next Steps: Entities will most likely be required to change tax accounting methods to comply with the Final Regulations. Further, many of the method changes will need to be applied retrospectively and will affect an entity's temporary differences and related deferred taxes under ASC 740. For example, some amounts previously taken as deductions may need to be capitalized into the tax basis of property upon transition, resulting in a positive IRC Section 481(a) adjustment (a "481(a) adjustment") for the retrospective effects of the method change. In general, positive 481(a) adjustments are included in taxable income over four tax years and negative 481(a) adjustments are deducted in a single year's U.S. federal income tax return. A deferred tax liability (DTL) is required for positive 481(a) adjustments and a deferred tax asset (DTA) is required for negative 481(a) adjustments. Note that any positive 481(a) adjustment that must be reported in taxable income over four tax years is a temporary difference that is separate and distinct from any resulting book-tax basis difference in the related underlying asset; therefore, separate deferred taxes should be recognized.

For purposes of applying ASC 740, the Final Regulations are viewed as new tax law. Although the Final Regulations did not become effective until January 1, 2014, ASC 740-10-25-47 requires that the effect of a change in tax law be recognized as of the enactment date. The recognition of the effects of a change in tax law requiring a change in tax accounting method is discussed in ASC 740-10-55-58 through 55-63, which illustrate that the effect of a change in tax law on DTAs and DTLs should be reflected as of the enactment date regardless of a later effective date.

An entity that is required to change its tax accounting methods to comply with the Final Regulations should account for the effect of the tax law changes on the tax accounts in the interim and annual period in which the Final Regulations were issued. At this time, the entity would generally reflect both of the following (along with appropriate disclosures):

- The estimated Section 481(a) temporary difference(s) that will be created when it files one or more Forms 3115 to request the accounting method changes along with a corresponding adjustment to its temporary differences related to the affected property.
- Updates to the liability for unrecognized tax benefits related to any uncertainty in the application of the Final Regulations.

In addition, an entity may need to consider changes to DTAs and DTLs (including the timing of future reversals) resulting from the Final Regulations in determining whether a valuation allowance is needed for the entity's DTAs.

In a classified balance sheet, the current/noncurrent classification of a DTL for the estimated Section 481(a) adjustment should be based on the expected reversal date of that temporary difference, which would be affected by the period in which the entity intends to adopt the Final Regulations. For example, a calendar-year taxpayer whose adoption of the Final Regulations will be effective on January 1, 2014, would include 25 percent of any taxable 481(a) adjustment (or 100 percent of any deductible 481(a) adjustment) in its current taxable income for 2014; thus, 25 percent of the related DTL (or 100 percent of a related DTA) as of December 31, 2013, would be classified as current.

Some entities may find it challenging to determine the impact of the Final Regulations on their interim and year-end financial reporting because of both the timing of the issuance date and uncertainty regarding the interpretation of some aspects of implementation (until the additional procedural guidance is issued). ASC 740 states that the measurement of a tax position should "be based on management's best judgment given the facts, circumstances, and information available at the reporting date." Although

additional analysis of existing information would not typically constitute new information for purposes of adjusting prior estimates, if subsequent administrative guidance changes the initial assessment of the impact of the Final Regulations on DTAs and DTLs, changes resulting from that additional guidance would be accounted for in the period in which the additional guidance becomes available.

Other Resources: For more information about the tangible property regulations, see Deloitte's *Deconstructing the Tangible Property Final and Re-proposed Regulations: Understanding How the New Guidance May Affect Your Company*.

Changes in Domestic State Tax Rates, Laws, and Regulations

Affects: All entities.

Summary: In addition to the U.S. federal government, various state tax jurisdictions have recently been changing their tax rates and laws. The economic downturn left many tax jurisdictions in a significant budget shortfall. In 2012, many jurisdictions ramped up efforts to increase tax revenue by enacting new legislation. In 2013, some jurisdictions continued their attempts to collect more tax revenue by mandating higher tax rates, while other jurisdictions provided some relief to taxpayers by decreasing tax rates and offering additional exemptions. Some tax jurisdictions have focused on other tax regulation changes, including (1) providing for an elective single-sales-factor apportionment for eligible manufacturing corporations and (2) modifying the sales-and-use tax exemption.

The table below summarizes a selection of the more significant domestic state tax law changes that occurred during 2013. For more information on a change that occurred in a specific tax jurisdiction, including the change's background, tax implications, and links to additional resources, click on that jurisdiction's link to go to the applicable Deloitte *Multistate Tax Alert*.

<table>
<tr><th colspan="2">Select State Tax Jurisdictions</th></tr>
<tr><th>Tax Jurisdiction</th><th>Summary</th></tr>
<tr><td>District of Columbia</td><td>In November 2012, the mayor of the District of Columbia signed Bill 19-0747, the Technology Sector Enhancement Act of 2012 (the "Act"), which introduced a number of changes to the treatment of qualified high-technology companies, including an expansion of the five-year franchise tax exemption to qualifying taxpayers regardless of location in the district. The Act was submitted to Congress in January 2013 in accordance with the District of Columbia Home Rule Act and became law in March 2013 (Law #L19-0211). The Act's provisions are effective for tax years beginning on or after January 1, 2012, but certain changes could affect tax periods before January 1, 2012.

For a discussion of the ASC 740 implications related to this change, see Deloitte's June 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of California</td><td>The California legislature has passed Assembly Bill (AB) 93, which phases out the California enterprise zone tax credit and replaces it with a new economic development program consisting of a hiring tax credit, a statewide partial sales-and-use tax manufacturing exemption, and an incentive fund. AB 93 reflects many of the changes publicly advocated by Governor Brown. California currently offers income tax credits to taxpayers located in specific geographic areas called enterprise zones. Under AB 93, the enterprise zone incentives are no longer effective as of January 1, 2014, and are replaced by three new incentives:

1. A credit under the personal income tax and the corporation tax for the hiring of certain qualified employees by taxpayers located in certain current enterprise zones as well as certain census tracts that will be designated.
2. A 4.19 percent statewide sales-and-use tax exemption for manufacturing and biotechnology equipment, including research and development (R&D) equipment.
3. A negotiated incentive fund, administered by the Governor's Office of Business and Economic Development, to provide tax credits for retaining existing, and attracting new, business activity throughout California.

For a discussion of the ASC 740 implications related to this change, see Deloitte's September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
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<tr><th colspan="2">Select State Tax Jurisdictions (continued)</th></tr>
<tr><th>Tax Jurisdiction</th><th>Summary</th></tr>
<tr><td>State of Illinois</td><td>In August 2013, the governor of Illinois signed House Bill 3157, an omnibus income tax bill that amended several sections of the Income Tax Act. House Bill 3157 allows the director of the Illinois Department of Revenue to permit or require a taxpayer to use an alternative apportionment method if the statutory apportionment provisions do not fairly represent the market for the taxpayer’s goods, services, or other sources of business income. Under the bill, the revised statutory language is effective for tax years ending on or after December 31, 2008. The effective dates of the changes to the alternative apportionment provision mirror the dates on which the sourcing of services changed in Illinois from cost of performance to market sourcing.

For a discussion of the ASC 740 implications related to this change, see Deloitte’s September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of Louisiana</td><td>In June 2013, a bill was passed to establish the Louisiana Tax Delinquency Amnesty Act of 2013 (the “Act”). The Act, which is effective immediately, requires the Louisiana Department of Revenue to establish a tax amnesty program for a period of at least (1) two months before December 31, 2013; (2) one month between July 1, 2014, and December 31, 2014; and (3) one month between July 1, 2015, and December 31, 2015.

For a discussion of the ASC 740 implications related to this change, see Deloitte’s September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of Minnesota</td><td>In May 2013, the governor of Minnesota signed House Bill 677, which amends Minnesota tax law by:
• Eliminating certain corporate income tax subtraction modifications, adopting a Finnigan sales factor sourcing rule, and modifying the use of the R&D credit.
• Creating a new fourth-tier individual income tax bracket for high-income earners and increasing the AMT rate.
• Repealing the provisions of Minnesota tax law that incorporate the Multistate Tax Compact.
• Expanding the sales tax base to include certain services, expanding the definition of nexus, and providing an up-front exemption for purchases of capital equipment.

For a discussion of the ASC 740 implications related to this change, see Deloitte’s June 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of Missouri</td><td>In July and August 2013, the governor of Missouri signed three separate bills that affect Missouri tax law:
• House Bill 128, which creates a new elective single-factor apportionment formula based on sales for the corporate income tax.
• Senate Bill 23, which enacts a new remote seller affiliate nexus and “click-through” nexus provisions with respect to the sales/use tax law.
• House Bill 184, which eliminates and replaces certain economic incentives programs with the Missouri Works Economic Incentive Program.

All three bills became effective in August 2013.

For a discussion of the ASC 740 implications related to this change, see Deloitte’s September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
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<tr><th colspan="2">Select State Tax Jurisdictions (continued)</th></tr>
<tr><th>Tax Jurisdiction</th><th>Summary</th></tr>
<tr><td>State of New Mexico</td><td>In April 2013, the governor of New Mexico signed House Bill 641, which modifies New Mexico tax law by:
• Phasing in, over five years, reductions in the corporate income tax rate.
• Requiring combined reporting for certain unitary corporations engaged in retail sales.
• Phasing in, over five years, elective single-sales-factor apportionment for eligible manufacturing corporations and eliminating throwback for electing corporations.
• Amending the gross-receipts tax deduction for tangible property consumed in the manufacturing process.
• Extending the high-wage-jobs tax credit and tightening the criteria for qualification.
• Allowing municipalities and counties to impose a local-option gross-receipts tax.
• Expanding the scope of the film production tax credit and requirements for eligibility.
For a discussion of the ASC 740 implications related to this change, see Deloitte's June 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of North Carolina</td><td>In July 2013, the Tax Simplification and Reduction Act (the "Act") was passed in an effort to boost the state's economy. The Act changes the corporate income tax, individual income tax, and sales-and-use tax. One of these changes would extend the expiration of the R&D tax credit, previously set for January 1, 2014, until January 1, 2016.
For a discussion of the ASC 740 implications related to this change, see Deloitte's September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of Pennsylvania</td><td>In July 2013, the governor of Pennsylvania signed House Bill 465 into law as Act 52. Act 52 introduced several changes to the corporate net income tax, including a related-party expense addback, market sourcing for service revenue, and increased net operating loss (NOL) deductions.
The current net loss deduction limitation (the greater of $3 million or 20 percent of Pennsylvania taxable income) is increased to the greater of $4 million or 25 percent of Pennsylvania taxable income for tax years beginning after December 31, 2013, and to the greater of $5 million or 30 percent of Pennsylvania taxable income for tax years beginning after December 31, 2014.
The provisions related to market sourcing for service revenue are effective for tax years beginning on or after January 1, 2014, while the related-party expense addback is effective for taxable years beginning after December 31, 2014.
For a discussion of the ASC 740 implications related to this change, see Deloitte's September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of Texas</td><td>In June 2013, the governor of Texas signed House Bill 500 and House Bill 800 into law. In addition to temporary tax rate reductions for 2014 and, potentially, 2015, these bills contain several new provisions that affect various industries and taxpayers and introduce changes that may apply to a wider range of taxpayers, such as:
• A new tax credit for certified rehabilitation of certified historic structures.
• A new tax credit and sales/use tax exemption for R&D activities.
• Changes to the determination of total revenue and cost of goods sold.
• A deduction of relocation costs for entities moving to Texas after September 1, 2013.
For a discussion of the ASC 740 implications related to this change, see Deloitte's September 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
<tr><td>State of Virginia</td><td>In January 2013, the Virginia Department of Taxation issued final guidelines related to the manufacturer's election to use single-sales-factor apportionment for corporate income tax purposes. The election, codified in Va. Code Ann. Section 58.1–422, allows qualifying manufacturers to use a modified apportionment factor for tax years beginning after July 1, 2011.
For a discussion of the ASC 740 implications related to this change, see Deloitte's June 2013 Accounting for Income Taxes — Quarterly Hot Topics.</td></tr>
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Select State Tax Jurisdictions (continued)	
Tax Jurisdiction	**Summary**
State of Wisconsin	In June 2013, the Wisconsin governor signed Assembly Bill 40, which amends Wisconsin tax law by: • Updating references to the IRC and conforming to federal depreciation and amortization. • Repealing several income tax credits. • Indicating the eligibility of partnerships, limited liability companies, and S corporations to compute and pass through research credits. • Modifying various individual income tax provisions, most notably by reducing the individual income tax rates. • Eliminating the economic development surcharge for individuals, estates, trusts, and partnerships. • Providing new exemptions for taxpayers engaged in certain commercial printing activities and for printing services that result in advertising and promotional direct mail. • Modifying the sales/use tax exemption for R&D activities. • Reforming the sales/use tax treatment of taxable products provided under a lump-sum contract. • Amending various administrative provisions (e.g., decreasing the interest rate for refunds and establishing penalties for negligent and fraudulent income and franchise refund claims). For a discussion of the ASC 740 implications related to this change, see Deloitte's September 2013 *Accounting for Income Taxes — Quarterly Hot Topics*.

Implications and Next Steps: Income tax rates and laws are constantly changing, and such changes could meaningfully affect an entity's income tax accounting in its financial statements. To receive timely updates on changing tax rates, laws, and regulations, subscribe to receive Deloitte's *State Tax Matters* and *Accounting for Income Taxes — Quarterly Hot Topics*.

Changes in International Tax Rates, Laws, and Regulations

Affects: All entities.

Summary: Several international jurisdictions have been active recently in changing their tax rates and laws. The focus of international jurisdictions has been to continue to provide incentives to attract businesses to their country through various tax credits. The table below summarizes a selection of the more significant international tax law changes that occurred during 2013. For more information on a change that occurred in a specific tax jurisdiction, including the change's background, tax implications, and links to additional resources, click on that jurisdiction's link to go to the applicable *Global Tax Developments Quarterly* publication.

Select International Tax Jurisdictions	
Tax Jurisdiction	**Summary**
France	On December 30, 2013, the finance bill for 2014 was enacted; most of the bill's provisions became effective before the end of 2013. The bill's most significant changes include an exceptional tax on high remuneration paid by companies, a restriction on the deduction of interest paid between related parties when the interest is not subject to a certain level of taxation at the level of the recipient, and an increase of the corporate tax surcharge for companies with gross revenue exceeding €250 million (calculated on a consolidated basis when a French consolidated group is in place) from 5 percent to 10.7 percent. Several other provisions that were initially included in the draft finance bill were invalidated by the French Constitutional Court on December 29, 2013, and were consequently not adopted. Most notably, the court rejected the new definition of "abuse of law," the new rules regarding the transfer of functions and risks abroad for transfer pricing purposes, the requirement to disclose tax schemes, and the penalty rates based on turnover. For a discussion of the ASC 740 implications related to this change, see Deloitte's March 2013 *Accounting for Income Taxes — Quarterly Hot Topics*.

Select International Tax Jurisdictions (continued)	
Tax Jurisdiction	**Summary**
Mexico	In October 2013, the Mexican Senate approved a broad tax reform bill, which was signed into law by the president and published in the Federal Official Gazette on December 11, 2013. On the day after publication in the Federal Official Gazette, December 12, 2013, the tax reform law is considered "enacted" for U.S. GAAP purposes, unless a different date is stated in the law. The tax reform bill contains a number of measures that affect companies doing business in Mexico, including a withholding tax on dividends, limitations to the deduction that an employer can take for an employee's tax-exempt income, and a deduction for payments made to related parties. A significant item related to deferred taxes is the abolishment of the business flat tax. For a discussion of the ASC 740 implications related to this change, see Deloitte's December 2013 *Accounting for Income Taxes — Quarterly Hot Topics*.
Puerto Rico	In June 2013, the governor of Puerto Rico enacted Act 40 of 2013 (also known as the Tax Burden Redistribution and Adjustment Act) as part of Puerto Rico's budget for fiscal year 2013–2014. The provisions of Act 40 include: • Significant changes to the AMT regime applicable to corporations engaged in a trade or business in Puerto Rico. • Significant changes to the rules governing the calculation of the AMT, the most significant of which is a new additional tax on gross income (ATGI), and the introduction of a new tax on related-party transactions. The AMT will be calculated as the greater of (1) AMT net income taxed at an increased 30 percent rate, plus the tax on ATGI, or (2) subject to certain exceptions, 20 percent of expenses incurred or payments made to related parties that are not subject to tax in Puerto Rico (including head-office expenses allocated to a branch), plus 2 percent of the value of personal property purchased from related parties if certain thresholds are met (collectively the related-party AMT), plus the tax on ATGI. On October 14, 2013, the governor of Puerto Rico signed Act 117-2013 into law, which contains technical amendments to Act 40. Act 117-2013 clarifies that, for taxpayers subject to tax under the 1994 Puerto Rico tax code, the ATGI applies in addition to the regular tax and is not part of the AMT. Therefore, an AMT credit is not available to offset regular tax in future years for tax paid on ATGI if a taxpayer is subject to tax under the 1994 Puerto Rico tax code. For a discussion of the ASC 740 implications related to this change, see Deloitte's December 2013 *Accounting for Income Taxes — Quarterly Hot Topics*.
United Kingdom	In July 2013, the UK Finance Act 2013 received Royal Assent, passing into law the introduction of an R&D expenditure credit regime for large companies that was previously announced in the United Kingdom's 2011 Autumn Statement. Companies will have to elect to apply the new R&D expenditure credit regime, since it will operate alongside the existing 30 percent super-deduction regime. The super deduction is 30 percent of qualifying research expenditures. When elected, the new regime applies to expenditures incurred on or after April 1, 2013, and is administered through corporate income tax filings. The R&D expenditure credits are generally calculated at 10 percent of qualifying R&D expenditures and may, in certain cases, be refundable to companies with no tax liability. Alongside the new R&D credit regime, a Patent Box regime, which had previously been enacted by Finance Act 2012, became effective on April 1, 2013. When applicable, this regime provides for an effective 10 percent U.K. tax rate (which is being phased in) on certain income from patents. For a discussion of the ASC 740 implications related to this change, see Deloitte's September 2013 *Accounting for Income Taxes — Quarterly Hot Topics*.

Implications and Next Steps: Income tax rates and laws are constantly changing, and such changes could meaningfully affect an entity's income tax accounting in its financial statements. To receive timely updates on changing tax rates, laws, and regulations, subscribe to receive Deloitte's *Global Tax Developments Quarterly* and *Accounting for Income Taxes — Quarterly Hot Topics*.

SEC Developments

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

Affects: Domestic SEC registrants and foreign private issuers.

Summary: Below is a summary of tax-related themes of the SEC staff's recent comments to domestic registrants and foreign private issuers.

Domestic Registrants

The SEC staff's tax-related comments to domestic registrants continue to focus on repatriation of foreign earnings and liquidity ramifications, valuation allowances, the rate reconciliation, and unrecognized tax benefits. The staff continues to ask registrants to provide early-warning disclosures about these items and how they potentially affect the financial statements.

Repatriation of Foreign Earnings and Liquidity Ramifications

ASC 740 requires disclosure of the gross amount of temporary differences for which no DTL has been recognized. In addition, registrants should disclose information about an unrecorded DTL related to the investment in a foreign subsidiary when the earnings of that foreign subsidiary are indefinitely reinvested. That disclosure is either (1) the amount of the unrecorded DTL or (2) a statement that determining that liability is not practicable.

The SEC staff continues to (1) ask for additional information when registrants claim that it is not practicable to determine the amount of the unrecognized DTL and (2) suggest that registrants expand their MD&A disclosures about indefinitely reinvested foreign earnings.

Disclosures in an MD&A liquidity analysis should include the following:

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

Valuation Allowances

The SEC staff continues to focus on valuation risks related to DTAs, often commenting when registrants' filings indicate that no valuation allowance (or an insufficient one) has been recorded. More recently, because of improvement in the economy and the resumption of profitability by some companies, the staff has begun to ask registrants about reversals of, or other changes in, their valuation allowances. The SEC staff has indicated that factors for registrants to consider in determining whether to reverse a previously recognized valuation allowance include (1) the magnitude and duration of past losses, (2) the magnitude and duration of current profitability, and (3) changes in factors (1) and (2) that drove losses in the past and those currently driving profitability.

The SEC staff has pointed out that registrants' disclosures should include a discussion of the factors or reasons that led to a reversal of a valuation allowance that effectively answers the question "Why now?" Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the entity weighted each piece of evidence in its assessment. The staff has also reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

Rate Reconciliation

The SEC staff has requested additional disclosures about the components of the rate reconciliation in the notes to the financial statements and in MD&A. For each significant item, the SEC staff may ask for additional MD&A disclosures about the actual impact on a registrant's historical financial statements and the expected impact on future periods in accordance with Regulation S-K, Item 303(a)(3).

As a result of various tax structures or the locations in which revenues are generated, profits derived from a country with very low tax rates may be disproportionately large in relation to the revenue generated from that country. The SEC staff has asked registrants to explain the impact of such foreign jurisdictions on a registrant's overall effective tax rate. The staff has also commented on the sustainability of the effective tax rate, particularly when the foreign country is experiencing an economic downturn.

Unrecognized Tax Benefits

The SEC staff continues to comment when registrants have failed to provide the disclosures required under ASC 740-10-50-15 and 50-15A about unrecognized tax benefits, which include a tabular reconciliation of such benefits. Registrants that have no unrecognized tax benefits (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 unrecognized tax benefits. Because the guidance on the acceptable level of aggregation of information for these disclosures is not prescriptive and permits judgment, the SEC staff evaluates a registrant's level of disclosure on a case-by-case basis.

Foreign Private Issuers

In its comments to foreign private issuers, the SEC staff has primarily focused on rate reconciliations and the nature of the items disclosed as well as on the completeness and adequacy of disclosures required by IFRSs. More specifically, the staff has focused on the following items:

- The 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.
- The amount of DTAs that was not recognized.
- Income tax consequences of dividends declared.

Implications and Next Steps: An entity should confirm 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 ensure that its recognition of the tax consequences of business transactions 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 publications for additional guidance on the SEC staff's comments on income taxes:

- *SEC Comment Letters — Including Industry Insights: Constructing Clear Disclosures* (updated December 2013).
- *SEC Comment Letter Examples: Income Taxes*.
- *SEC Comment Letters on Foreign Private Issuers Using IFRSs* (updated March 2012).

Tax-Related Themes Discussed at the AICPA Conference on SEC and PCAOB Developments

Affects: All entities.

Summary: On December 9–11, 2013, the AICPA held its annual Conference on Current SEC and PCAOB Developments. In a Division of Corporation Finance panel discussion, the SEC staff discussed its observations on income tax disclosures, namely disclosures about (1) the tax rate reconciliation, (2) valuation allowances, and (3) registrants' assertions that foreign earnings are indefinitely reinvested.

The SEC staff noted the following issues with registrants' tax rate reconciliation disclosures:

- Labels related to reconciling items were unclear, and disclosures about material reconciling items did not adequately describe the underlying nature of these items.

- For material reconciling items related to foreign tax jurisdictions, registrants did not disclose in MD&A (1) each material foreign jurisdiction and its tax rate and (2) how each jurisdiction affects the amount in the tax rate reconciliation.
- Registrants have inappropriately aggregated material reconciling items. The SEC staff reminded registrants that Regulation S-X requires separate-line-item disclosure for reconciling items whose amount is greater than 5 percent of the amount calculated by multiplying the pretax income by the statutory tax rate.
- Amounts reflected in the tax rate reconciliation were inconsistent with related amounts disclosed elsewhere in a registrant's filing.
- Corrections of errors were inappropriately reflected as changes in estimates.

In remarks related to registrants' disclosures about valuation allowances on DTAs, the SEC staff discouraged registrants from providing "boilerplate disclosures" in the critical accounting estimates section of MD&A and instead recommended that they discuss registrant-specific factors (e.g., limitations on their ability to use NOLs and foreign tax credits). The SEC staff also stated that it has asked registrants to disclose the impact of each source of taxable income on their ability to realize a DTA, including the relative magnitude of each source of taxable income. In addition, the staff recommended that registrants consider disclosing the material negative evidence they evaluated, since such disclosures could provide investors with information about uncertainties related to a registrant's ability to recover a DTA.

The SEC staff also reminded conference participants about the disclosures a registrant is required to provide when it asserts that foreign earnings are indefinitely reinvested. These disclosures include (1) the amount of the unrecognized DTL or (2) a statement that estimating an unrecognized tax liability is not practicable. In addition, the staff indicated that it evaluates the indefinite reinvestment assertion in taking into account registrants' potential liquidity needs and the availability of funds in U.S. and foreign jurisdictions.

Throughout the Division of Corporation Finance panel discussion, various SEC staff members reiterated that registrants should assess materiality when considering their disclosures. For example, in its discussion of share-based compensation and disclosures about the impact of new accounting pronouncements (i.e., SAB Topic 11.M[3]), the staff stressed that registrants should avoid disclosing immaterial information. In response to a question about whether the staff's disclosure-related observations are inconsistent with its goal of reducing disclosure overload, the staff noted that its overall objective is to highlight how registrants can disclose material information more clearly and precisely, not add disclosures.

Other Resources: For more information about the 2013 AICPA Conference, see Deloitte's December 16, 2013, *Heads Up*.

Standard-Setting Developments

Income Tax Accounting Topics Addressed by the EITF

FASB Accounting Standards Update No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists — *a Consensus of the FASB Emerging Issues Task Force*

Affects: Entities with unrecognized tax benefits that also have tax loss or tax credit carryforwards in the same tax jurisdiction as of the reporting date.

Summary: On July 18, 2013, the FASB issued ASU 2013-11 in response to a consensus reached at the EITF's June 11, 2013, meeting. The ASU provides guidance on financial statement presentation of an unrecognized tax benefit when an NOL carryforward, a similar tax loss, or a tax credit carryforward exists. The FASB's objective in issuing this ASU is to eliminate diversity in practice resulting from a lack of guidance on this topic in current U.S. GAAP.

[3] SEC Staff Accounting Bulletin Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period" (SAB 74).

Under the ASU, an entity must present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, in the financial statements as a reduction to a DTA for an NOL carryforward, a similar tax loss, or a tax credit carryforward except when:

- An NOL carryforward, a similar tax loss, or a tax credit carryforward is not available as of the reporting date under the governing tax law to settle taxes that would result from the disallowance of the tax position.
- The entity does not intend to use the DTA for this purpose (provided that the tax law permits a choice).

If either of these conditions exists, an entity should present an unrecognized tax benefit in the financial statements as a liability and should not net the unrecognized tax benefit with a DTA. New recurring disclosures are not required because the ASU does not affect the recognition or measurement of uncertain tax positions under ASC 740. This amendment does not affect the amounts public entities disclose in the tabular reconciliation of the total amounts of unrecognized tax benefits because the tabular reconciliation presents the gross amounts of unrecognized tax benefits.

Implications and Next Steps: The ASU's amendments are effective for public entities for fiscal years beginning after December 15, 2013, and interim periods within those years. Nonpublic entities may wait until fiscal years, and interim periods within those years, beginning after December 15, 2014, to adopt the amendments. Early adoption is permitted for all entities.

The amendments should be applied to all unrecognized tax benefits that exist as of the effective date. Entities may choose to apply the amendments retrospectively to each prior reporting period presented.

Other Resources: For more information, see Deloitte's July 22, 2013, *Heads Up* and June 2013 *EITF Snapshot*.

FASB Accounting Standards Update No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects — *a Consensus of the FASB Emerging Issues Task Force*

Affects: Entities that invest in limited liability entities that pass income tax credits through to their investors.

Summary: In January 2014, the FASB issued ASU 2014-01, which modifies the criteria an entity must meet to account for a low-income housing tax credit (LIHTC) investment by using the measurement and presentation alternative in ASC 323-740. This method permits an investment's performance to be presented net of the related tax benefits as part of income tax expense. The ASU is likely to increase the number of LIHTC investments that would qualify for this method. The new guidance also simplifies the amortization method an entity uses when it qualifies for and elects to apply the accounting permitted under ASC 323-740 by establishing a proportional-amortization method[4] that replaces the effective-yield method previously required.

Under the ASU, entities are permitted to apply, as an accounting policy election, an alternative measurement and presentation method to LIHTC investments if the following conditions are met:

- "It is probable that the tax credits allocable to the investor will be available."
- "The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity."
- "Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment)."
- "The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive."
- "The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment."

[4] ASC 323-740-35-2 states that under the proportional-amortization method, "the investor amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits allocated to the investor."

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

- "The reporting entity is in the business of entering into those other transactions."
- "The terms of those other transactions are consistent with the terms of arm's-length transactions."
- "The reporting entity does not acquire the ability to exercise significant influence over the operating and financial policies of the limited liability entity as a result of those other transactions."

Finally, the ASU:

- Requires an entity to (1) evaluate its eligibility to use the measurement and presentation alternative in ASC 323-740 at the time of initial investment on the basis of facts and conditions that exist as of that date and (2) reevaluate those conditions if either of the following occurs: "(a) [a] change in the nature of the investment (for example, if the investment is no longer in a flow-through entity for tax purposes)" or "(b) [a] change in the relationship with the limited liability entity that could result in the reporting entity no longer meeting the conditions" described in ASC 323-740.
- Requires an entity to test an LIHTC investment accounted for under the alternative method for impairment when it is more likely than not that the investment will not be realized and to measure an impairment loss as the amount by which the investment's carrying amount exceeds its fair value.
- Does not prescribe where an entity would present investments accounted for under the measurement and presentation alternative in its statement of financial position.
- Requires an entity to "disclose information that enables users of its financial statements to understand the nature of its investments in qualified affordable housing projects, and the effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations."

Implications and Next Steps: For public entities, the ASU is effective for annual periods beginning after December 15, 2014, and interim periods therein. For nonpublic entities, the ASU is effective for annual periods beginning after December 15, 2014, and interim and annual periods thereafter. Early adoption is permitted.

Entities that applied the effective yield method to account for LIHTC investments under the alternative in ASC 323-740 are permitted to continue to do so, but only for investments already accounted for under that method. Otherwise, the guidance in the ASU must be applied retrospectively to all periods presented.

Although the scope of the ASU is limited to LIHTC investments, the FASB has directed its staff to perform pre-agenda decision research on the applicability of the guidance in ASC 323-740 to other types of tax credit investments, not just investments in qualified affordable housing projects. On the basis of that research, the Board will decide whether to address this issue and, if so, whether to add it to the FASB's or the EITF's agenda.

Other Resources: For more information about ASU 2014-01, see Deloitte's January 21, 2014, journal entry.

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

Affects: All entities.

Summary: The FASB and IASB are expected to complete their joint projects on revenue recognition; financial instruments; and, potentially, leases in the coming year. Below is a brief summary of the potential tax implications of each of these projects.

Implications and Next Steps: *Revenue Recognition*

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the methods taxpayers use for financial reporting purposes and, if so, a taxpayer generally applies the revenue recognition methods it uses in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the IRC does not require entities to use any particular underlying financial accounting method (e.g., U.S. GAAP) to determine their taxable income, entities must make appropriate adjustments (on a Schedule M) to properly account for income taxes.

The FASB's and IASB's joint revenue recognition standard,[5] which the boards are expected to finalize and issue in the near future, may change the timing and, in some cases, the amount of revenue recognition for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income because companies are often permitted to use the same methods for tax purposes as they use for financial reporting purposes. For example, under federal tax principles, income is generally recognized no later than when it is received. However, there are a few limited exceptions that allow a taxpayer to defer revenue recognition (one or two years or longer) for advance payments. Under one of these exceptions, a taxpayer can defer revenue recognition for advance payments for one year to the extent that the revenue is deferred under the method used for the taxpayer's applicable books and records.

The proposed standard may affect the timing and measurement of revenue for contracts with advance payments and thus may accelerate revenue recognition for contracts with multiple performance obligations, which could have an impact on current taxable income.

In addition, a few of the concepts in the proposed standard may give rise to or affect the measurement of certain temporary differences. These concepts include:

- Revenue recognition upon a transfer of control that results in changes in book revenue recognition (and contract assets and contract liabilities).
- Potential changes in the timing of revenue recognition for contracts that include variable consideration or a significant financing component.
- Capitalization of certain costs incurred to obtain or fulfill a contract, some of which currently may be deductible for tax purposes.

The tax implications associated with implementing the proposed standard will be based on an entity's specific facts and circumstances. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the proposed standard so that they can analyze the tax ramifications and facilitate 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 must obtain consent from the IRS commissioner. In addition to selecting alternative tax accounting methods, if a taxpayer is applying its book method and the book method changes, the taxpayer may have to secure the commissioner's consent to change to the new book method. A taxpayer that chooses not to secure consent to change its tax accounting method may have to maintain its current tax accounting method and may need to keep additional records as a result. Additional record keeping will also be required when the revenue recognition method required by the proposed standard is not a proper method for tax purposes. There are generally two procedures a taxpayer uses to gain the commissioner's consent to change its tax accounting method. Certain tax accounting method changes require the IRS to review an application before granting consent. Other tax accounting method changes provide automatic consent if the taxpayer complies with certain terms and conditions.

The following are a few questions for an entity to consider in planning for the transition:

- Will potential changes to the timing or measurement of U.S. GAAP or IFRS revenue or expense recognition affect the timing of revenue or expense recognition for income tax purposes?
- If the financial statement modifications in revenue recognition methods under the proposed standard are favorable and permissible for tax purposes, is an entity required to request a formal change in tax accounting method from the tax authorities?

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

- If the financial statement modifications are unfavorable or impermissible for tax purposes, will the entity need to maintain certain legacy U.S. GAAP or IFRS accounting method records (i.e., records in accordance with the revenue recognition guidance that will be superseded by the proposed standard)?
- When the amount of revenue in a contract with multiple performance obligations is allocated to the separate performance obligations under the proposed standard, are there specific contractual terms that may result in a difference between the allocations for tax and book accounting purposes?
- To the extent that tax accounting methods differ from financial reporting accounting methods, are there any new data or system requirements that need to be considered?
- Are there any cash tax implications related to foreign controlled entities that, for example, maintain statutory accounting records under IFRSs?
- If there is a cumulative adjustment to the opening balance upon adoption of the proposed standard at a foreign operation, should the U.S.-based parent entity reassess its indefinite reinvestment assertion and reevaluate the amount of DTLs established, if any?
- What is the effect on a multinational entity's transfer pricing strategy, especially when the transfer pricing is based on the amount of revenue recognized for financial reporting purposes?
- Should there be a change in the financial statement presentation for sales taxes collected that are remitted to a tax authority on the basis of the principal-versus-agent guidance in the proposed standard?
- Although the impact on state taxable income generally is the same as that on federal taxable income, what other state tax implications should an entity consider?

In certain industries, the proposal may also have a significant impact on other taxes such as sales, excise, industry-specific gross receipts, telecommunications, utility, business and occupation, and other specialty taxes. For example, for an arrangement that includes discounted tangible personal property (TPP), the proposed standard may require entities to change the manner in which they allocate revenue between the sale of the TPP and the sale of related services (as opposed to using the invoicing and contract treatment). In such cases, part of the amount historically recognized as service revenue over the life of the related service agreement most likely will be reallocated to product revenue. This reallocation of revenue could affect the amount of some taxes or fees collected or reported by the vendor.

Taxes or fees that are at risk for overcollection or underreporting are those that are based solely on either sales of services or sales of products (when the other category is generally excluded from the tax or fee base). For example, a vendor's customer tax billing systems often are designed to automatically collect these taxes and fees on the basis of the billed amounts. If the legal base of the tax or fee is the amount recognized for services (and sales of TPP are excluded from the base), there is a risk that the tax/fee will be overcollected from customers on the basis of the invoiced amounts. In contrast, if the legal base of the tax or fee is the amount billed, there is a risk that the tax/fee will be underreported if, after the adoption of the proposed standard, the vendor uses only the service revenue amount recognized as a source for tax base data.

The final standard is expected to be issued in the first quarter of 2014 and will be effective in 2017 for public entities and 2018 for nonpublic entities. For more information about the boards' revenue recognition project, see the project page on the FASB's Web site.

Financial Instruments

The FASB's and IASB's project on accounting for financial instruments (AFI) is divided into three major components: classification and measurement, impairment, and hedge accounting. The FASB released for public comment proposed ASUs on impairment[6] on December 20, 2012, and classification and measurement[7] on February 14, 2013. The FASB received more than 500 total comment letters on these exposure drafts (EDs) and began redeliberating each of the proposals during 2013. Although the FASB is expected to issue final standards in 2014, the Board has not yet set effective dates for them. The FASB has not spent significant time on hedge accounting and has not yet indicated its plan for doing so.

[6] FASB Proposed Accounting Standards Update, *Financial Instruments: Credit Losses.*

[7] FASB Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities.*

For tax purposes, AFI can be quite complex, involving differences in character (capital vs. ordinary) and timing (e.g., mark to market vs. cost). The following factors must also be considered:

- 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 to AFI for book purposes may be indicative, but is not determinative, of the tax treatment; differences are common.
- Fair market value measurement requirements under the IRC (e.g., IRC Sections 475 and 1256) differ from the fair value measurement requirements under ASC 820.

Lease Accounting

On May 16, 2013, the FASB and IASB issued a revised joint ED[8] on lease accounting. The ED, released by the FASB as a proposed ASU, introduces a new accounting model that would require lessees to recognize substantially all leases in the statement of financial position by recording a "right-of-use" asset and a related lease liability. The boards received more than 600 comment letters on the ED and expect to begin redeliberations in the first quarter of 2014. On the basis of this timeline, a final standard could be issued sometime in 2014 but is not expected to be effective any sooner than January 1, 2017.

Many entities have accounted for leases as operating leases 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. 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. Entities also need to consider the potential state tax issues that may arise, including how the classification of the right-of-use asset (tangible vs. intangible) may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

Other Resources: See the following publications for additional guidance on the FASB's and IASB's joint projects:

- March 5, 2013, *Heads Up*, "Boards Preparing to Issue Final Standard on Revenue Recognition."
- December 6, 2013, *Heads Up*, "Boards Review Feedback on the Revised Leases Exposure Draft."
- August 20, 2013, *Heads Up*, "Boards Discuss Constituent Feedback on Impairment Proposals."
- August 2, 2013, *Heads Up*, "Stakeholders Divided on FASB Classification and Measurement Proposal."
- January 2014 *Power & Utilities: Accounting, Financial Reporting, and Tax Update*.
- December 2013 *Insurance: Accounting and Financial Reporting Update*.
- November 2013 *Investment Management: Accounting and Financial Reporting Update*.
- November 2013 *Banking & Securities: Accounting and Financial Reporting Update*.
- November 2013 *Real Estate: Accounting and Financial Reporting Update*.

Post-Implementation Review of Statement 109

Affects: All entities.

Summary: On November 19, 2013, the Financial Accounting Foundation (FAF) issued its post-implementation review (PIR) report on FASB Statement 109.[9] The key objectives of the PIR were to (1) determine whether Statement 109 accomplished its stated purpose, (2) evaluate implementation of the standard as well as the ongoing costs and related benefits of complying with it, and (3) provide feedback to improve the standard-setting process.

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

[9] FASB Statement No. 109, *Accounting for Income Taxes*.

As part of the PIR process, the FAF considered survey responses from nearly 1,000 stakeholders, including financial statement users and preparers, accounting practitioners, and academics.

The PIR team concluded that:

- "Statement 109 adequately resolved the issues underlying its stated need but may not have reduced the complexity of accounting for income taxes. It is not clear whether the complexity is a result of Statement 109's requirements, factors occurring after the issuance of Statement 109 (for example, significant changes in the business environment and tax laws, along with increased foreign operations by U.S. companies), or both."
- "Information resulting from the application of Statement 109 provides investors with decision-useful information, although certain income tax information may not be sufficiently aligned with investor needs. For example, income tax information may not be detailed enough for users to (a) analyze the cash effects associated with income taxes, particularly current period taxes paid by jurisdiction (e.g., U.S. and foreign), and estimate future tax payments and (b) analyze earnings determined to be indefinitely reinvested in foreign subsidiaries."
- "Most of Statement 109's requirements are understandable, can be applied as intended, and enable income tax information to be reported reliably. The following aspects of income tax accounting are the most challenging for stakeholders: intraperiod tax allocations, accounting for intercompany transfers of assets, and accounting for earnings determined to be indefinitely reinvested in foreign subsidiaries (and the related disclosures)."
- "Statement 109 did not result in any significant changes in operating or financial reporting practices, nor did it have any significant unanticipated consequences."
- "Stakeholders incur significant ongoing costs to comply with Statement 109. Some of the costs relate to factors arising after the issuance of Statement 109, including the introduction of the Sarbanes-Oxley Act of 2002 and an increase in complexity of business transactions, U.S. and foreign tax laws, and business conducted in foreign jurisdictions by U.S. companies."

In a December 3, 2013, response letter, the FASB acknowledged the PIR team's findings and said that it would conduct further outreach to explore the specific concerns raised and determine whether there are any cost-effective solutions. The FASB indicated that it would reach out to financial statement users, preparers, auditors, and others and would focus on concerns regarding:

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

The FASB further indicated that it would also seek input regarding the priority of addressing these concerns compared with other potential priorities on its technical agenda.

Implications and Next Steps: The results of the FASB's outreach regarding these concerns, as well as their perceived priority, remain to be seen. However, in 2013, the Financial Accounting Standards Advisory Council, the FASB's primary advisory group, conducted a survey on future topics for the FASB's technical agenda. Survey results indicated that the accounting for income taxes was not a top priority (it only ranked tenth overall).

Even if a new project is not added to the FASB's agenda in response to the PIR concerns, some of the projects viewed as a priority by survey respondents could have income tax accounting implications. For example, the Board's disclosure framework project could ultimately alter the disclosure requirements in existing standards, such as ASC 740.

Hot Topics

Accounting for Impaired Debt Securities

Affects: Entities with holdings of impaired debt securities.

Summary: Over the past year, interest-rate volatility has increased because of, among other factors, the impact of monetary policy. This increased volatility could lead reporting entities to recognize significant unrealized losses in accumulated other comprehensive income (AOCI) for debt securities classified as available for sale under ASC 320.

If an unrealized holding loss on a debt security would be tax-deductible if realized, the difference between the carrying amount of the debt security and its tax basis is a deductible temporary difference that gives rise to a DTA. The temporary differences associated with unrealized gains and losses on debt securities, however, are unlike other types of temporary differences because they do not affect cumulative comprehensive income or the tax return if the securities are held until recovery of the debt securities' amortized cost.

If an unrealized loss from a debt security is recorded in other comprehensive income (OCI) and a tax benefit for that loss can be recognized in the same period, the tax benefit would also be recorded in OCI in accordance with the intraperiod tax allocation rules in ASC 740-20-45.

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

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

Selection of either alternative is an accounting policy decision that, once made, must be consistently applied.

Implications and Next Steps: The FASB has expressed a view on this issue in its project on classification and measurement of financial instruments but has not reached a final decision. Affected entities should monitor whether the Board's final standard on this topic, which is expected to be issued this year, provides clarifying guidance on this issue.

Internal Controls

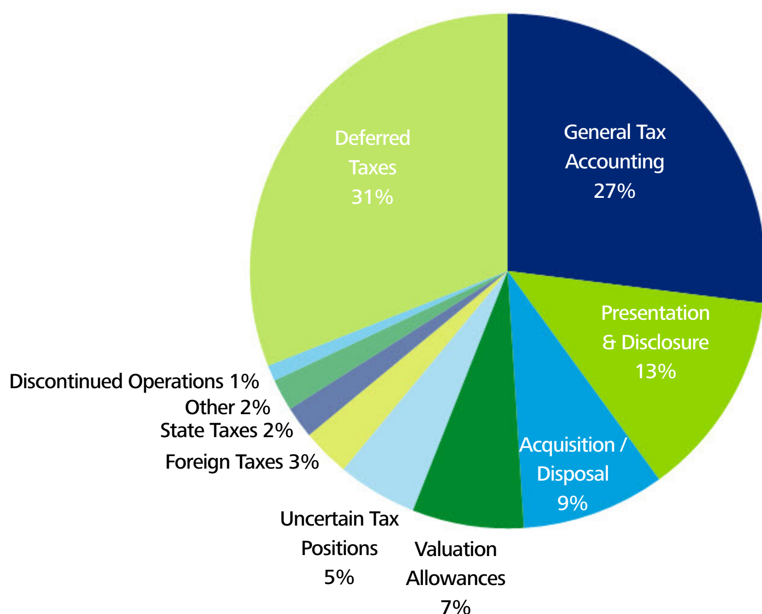
Affects: All entities.

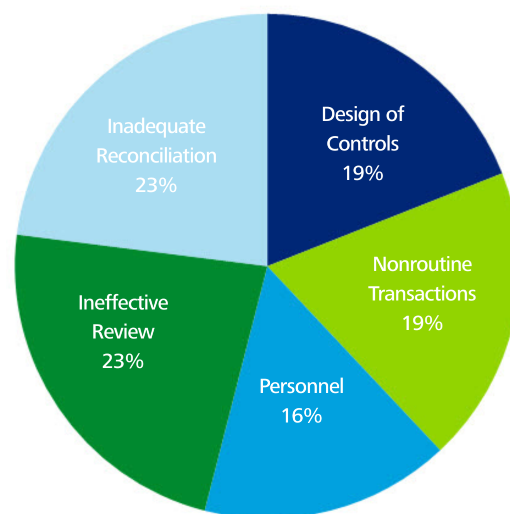
Summary: Regulators and the auditing profession continue to focus on internal controls:

- On October 24, 2013, the PCAOB issued a staff audit practice alert on deficiencies the PCAOB has noted in inspection reports related to audits of entities' internal control over financial reporting (ICFR). Topics covered in the alert include (1) internal control audits and auditors' risk assessments; (2) selection of controls for testing; (3) "testing management review controls"; (4) IT considerations, "including system-generated data and reports"; (5) rollforwards for "control testing performed at an interim date"; (6) "using the work of others"; and (7) "evaluating identified control deficiencies." Auditors have been carefully applying this practice alert in planning and performing audits.
- At the 2013 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff indicated that in reviewing registrants' filings, it looks for indicators of potential ICFR deficiencies. Common indicators include disclosures about changes in ICFR and corrections of errors. If indicators are observed, the SEC staff routinely asks registrants about management's consideration of such indicators in relation to its conclusions about the effectiveness of ICFR (i.e., whether a material weakness should have been disclosed). Entities preparing their year-end reports should remain alert to this potential focus area.
- On May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released an updated version of its *Internal Control — Integrated Framework* (the "2013 Framework"). COSO's primary objective in updating and enhancing the framework is to address the significant changes to business and operating environments that have taken place over the past 20 years. While the fundamental concepts in the 2013 Framework are similar to those in the original framework issued in 1992 (the "1992 Framework"), the 2013 Framework adds or expands discussions about each component and principle. The 2013 Framework also creates a more formal structure for designing and evaluating the effectiveness of an entity's ICFR by (1) using 17 principles to explain the concepts underlying the five components of ICFR and (2) creating a more formal way of designing and evaluating ICFR in accordance with the principles. Unlike the 1992 Framework, the 2013 Framework explicitly includes the concept of considering the potential for fraud risk in the assessment of risks to the achievement of an organization's objectives. COSO provides a transition period — from May 14, 2013, to December 15, 2014 — for entities to move to the 2013 Framework.

The design and effectiveness of controls over the accounting for income taxes deserve significant attention, since errors in the accounting for income taxes remain a leading cause of restatements. In 2012, errors specific to the accounting for income taxes were the second most common cause of restatements and, as a percentage of total restatements, reached their highest level in over 10 years.[10] Deloitte's further analysis of restatements related to income tax accounting in 2012 examined the source of the restatements and, when applicable, the nature of the internal control failure that caused a material weakness.

[10] *2012 Financial Restatements: A Twelve Year Comparison*, Audit Analytics.





Implications and Next Steps: In implementing the 2013 Framework, entities will need to take a fresh look at their internal controls in many key areas, including the accounting for income taxes. Generally speaking, the impact of the 2013 Framework on management's assessment of the effectiveness of ICFR will depend on how a company applied and interpreted the concepts in the 1992 Framework. The existing system of internal control may or may not clearly demonstrate that all the relevant principles are present and functioning.

Other Resources: For more information about the 2013 Framework, see Deloitte's June 10, 2013, *Heads Up*.

PCAOB Proposal on the Auditor's Report

Affects: Entities whose financial statements are subject to audits under PCAOB standards.

Summary: On August 13, 2013, the PCAOB issued Release 2013-005,[11] which proposes two new auditing standards on the auditor's reporting model and on the auditor's responsibilities for other information included in annual reports filed with the SEC. While retaining the current "pass/fail" approach to the audit report, the PCAOB's proposal represents the most significant expansion of tailored information provided about a financial statement audit by auditors to the user community in the profession's history.

Significant proposed changes include the addition in the auditor's report of a new section in which critical audit matters (CAMs) would be communicated. The proposal defines CAMs as matters addressed during the audit of the financial statements that:

- "[I]nvolved the most difficult, subjective, or complex auditor judgments";
- "[P]osed the most difficulty to the auditor in obtaining sufficient appropriate evidence"; or
- "[P]osed the most difficulty to the auditor in forming the opinion on the financial statements."

The release gives several examples of the communication of CAMs in an auditor's report, including one in which an auditor cites detailed information contributing to its conclusion that management's evaluation of the realizability of deferred taxes is a CAM. This information includes the significant judgment exercised in weighing positive and negative evidence as well as other company-specific factors (e.g., increased competition, growing production/development costs, and a dependency on "next generation" products).

[11] PCAOB Release No. 2013-005, *Proposed Auditing Standards — The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards.*

Implications and Next Steps: The PCAOB received over 200 comment letters during the comment period, which ended on December 11, 2013, and will be holding a public roundtable in early 2014 to discuss the comments received.

Other Resources: For more information about the proposal, see Deloitte's September 5, 2013, *Heads Up*.

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