



A look ahead to income tax accounting under IFRS

We can help you

To discuss the impact that these proposals may have on your company's financial statements please call your usual PwC contact or:

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In March the IASB issued an Exposure Draft on 'Income Tax'. The proposals in the Exposure Draft are intended to align more closely the accounting for Income Taxes under IFRS with US GAAP and to clarify aspects of accounting under IAS 12.

The IASB proposals retain the basic procedures by which deferred tax is calculated, as follows;

- establish the tax base, or tax basis, of an asset or liability (tax base is the IAS 12 term, tax basis is the term used in the IASB proposals),
- compare the tax basis to the carrying value of the asset or liability to get the temporary difference, and
- calculate the deferred tax asset or liability by applying the appropriate tax rate(s) to the temporary difference.

However, the proposals significantly change the rules used to establish the tax basis of an asset and in some situations the selection of the appropriate tax rate used to calculate the deferred tax.

Compared to IAS 12, the IASB proposals could give rise to both a different temporary difference and a different tax rate to apply to that temporary difference in order to calculate any deferred tax.

As discussed below, the IASB proposals would also introduce changes not only in various areas of

deferred tax, but also in accounting for the uncertainty that can pertain to the tax liability due to the tax authorities.

Establishing the tax basis

The IASB's proposals include a revised definition of 'tax basis' being 'the measurement under applicable substantively enacted tax law, of an asset, a liability or other item'. Currently under IAS 12 an asset's tax base is determined based on the expected manner of recovery of the asset. Depending on management's future intentions for the asset, the tax base may be based on;

1. the tax consequences of selling the asset, or
2. the tax consequences of using the asset, or
3. the tax consequences of using the asset and selling the asset at a future date.

Under the IASB's proposals an asset's tax basis would always be determined by the tax consequences of selling the asset for book value at the balance sheet date. Under the proposals the expected manner of recovery of the asset would no longer impact on the calculation of the tax basis. The impact of the proposals could be significant in tax jurisdictions, such as Ireland, where there can be different tax consequences of using and selling an asset.

Example

Calculating the tax basis of a non-industrial property

A number of years ago a company bought a non-industrial property for €1 million and its carrying value at 30 June 2009 is €5 million. The company intends to use the property for the duration of its useful economic life. If the property was sold for €5 million at 30 June 2009 an amount of €1 million would be deductible against the proceeds in arriving at taxable profit, being its original cost (indexation ignored). There are no capital allowances available on the property.

As the expected manner of recovery of the asset is ‘use’ and no tax deduction is available on use of the asset, the tax base of the non-industrial property under IAS 12 is €0. Thus, the temporary difference is €5 million and a deferred tax liability is calculated based on that temporary difference of €5 million.

Under the IASB proposals the tax basis of the property would be the amount that would have been deductible in arriving at taxable profit if the property was sold for its carrying value at the balance sheet date, regardless of management’s intentions for the property. The tax basis in this situation would therefore be €1 million. Thus, the temporary difference would be €4 million and the deferred tax liability would be calculated based on that temporary difference of €4 million.

Measuring deferred tax

The IASB proposal is that where a tax deduction is available only on the sale of an asset (not also on its use), the tax rate used to calculate the deferred tax on any temporary difference associated with that asset is the tax rate applicable on sale of the asset.

However, where the tax deduction available on the sale of the asset is **also** available on the use of the asset (e.g. by capital allowances), the tax rate used to calculate any deferred tax depends on the manner in which the carrying amount of the asset is expected to be recovered.

This contrasts with IAS 12, under which deferred tax is measured using the tax rate that is consistent with the manner in which the entity’s management expects, at the balance sheet date, to recover the carrying amount of the asset, irrespective of whether the tax deduction available on sale is also available on use. (This means that the rate used can be a combination of use and sale rates.)

Example

Calculating deferred tax on the temporary difference (where a tax deduction is available only on sale)

In the example above, the temporary difference under IAS 12 is €5 million and the temporary difference under the IASB proposals would be €4 million.

Under IAS 12, the deferred tax liability on the temporary difference of €5 million would be calculated at the tax rate applicable to the use of the asset – which in this case would be 12.5%.

As the tax deduction of €1 million available on the sale of the asset is not available on the use of the asset, the deferred tax liability under the IASB proposals is calculated at the sale rate, which currently in Ireland is 25%.

Example

Calculating deferred tax on the temporary difference (where the same tax deduction is available on sale or use)

A company has an item of machinery that qualifies for capital allowances. It has owned the machinery for a number of years. Its carrying amount is €10 million and its tax basis is €6 million. The company expects to use the machinery for the whole of its useful life.

The corporation tax rate is 12.5% and the capital gains tax rate is 25%.

Under IAS 12 and the IASB’s proposals the temporary difference would be €4 million (carrying amount of €10 million less tax basis of €6 million). The carrying amount is expected to be recovered through use. Therefore, the relevant tax rate is 12.5% and the deferred

tax liability under both IAS 12 and the IASB's proposals would be €500,000.

Example

Calculating the deferred tax on the temporary difference (where the same tax deduction is available on sale or use and the asset has been revalued)

A company has a factory building that qualifies for capital allowances. Its cost was €10 million, its carrying amount is €11 million and its tax basis is €7 million. The company expects to use the building for the whole of its useful life.

The corporation tax rate is 12.5% (excluding manufacturing relief) and the capital gains tax rate is 25%.

The temporary difference would be €4 million under IAS 12 and the IASB's proposals.

As the full carrying amount of the asset is expected to be recovered through use, the rate used to calculate the deferred tax liability is 12.5% and the deferred tax liability under IAS 12 and the IASB's proposals would be €500,000.

Investments in subsidiaries

Temporary differences may arise between the carrying amount and the tax basis of investments in

subsidiaries, associates or joint ventures for various reasons such as unremitted earnings, impairment and changes in foreign exchange rates. IAS 12 currently provides an exception whereby deferred taxes on temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures are not recognised if the temporary difference is controlled by the investor and it is probable that the temporary difference will not reverse in the foreseeable future. The IASB's proposals would limit the application of that exception to foreign subsidiaries (and branches) and foreign joint ventures that are essentially permanent in duration. The permanent nature of an investment could be evidenced by specific plans for reinvestment of the undistributed retained earnings of the foreign subsidiary or joint venture.

This approach can be expected to increase the deferred tax liability in cases where foreign subsidiaries or joint ventures have undistributed earnings that would be taxed on distribution, where the tougher new conditions are not met.

Initial recognition exception

A temporary difference can arise when a company initially recognises an asset or liability, where the amount attributed to the asset for

tax purposes is different from the financial statement carrying amount. Where the asset does not arise from a business combination and does not affect either accounting profit or taxable profit, under IAS 12 no deferred tax is recognised if that temporary difference arises on the initial recognition of the asset. This is because of the specific 'initial recognition exception' in IAS 12.

The IASB's proposals would remove the initial recognition exception in IAS 12.

The Exposure Draft proposes that where a temporary difference arises on the initial recognition of an asset, the initial carrying amount of the asset should be measured using the same assumptions about the tax basis that other market participants in the same jurisdiction would use (i.e. excluding entity-specific tax effects). Deferred tax would be recognised on the temporary difference i.e. the difference between that market participant carrying amount and the tax basis.

This would represent quite a change in accounting, as the carrying amount of the asset on initial recognition under IAS 12 would equal the consideration paid, irrespective of whether that cost has been affected by entity-specific tax effects.

Where the initial carrying amount together with the deferred tax does not equal the consideration given for

the asset (i.e. the cost) a discount or premium would be recognised against the deferred tax and that discount or premium would be reduced on a pro rata basis with changes in the related deferred tax.

Example

Temporary difference on initial recognition

A company pays €1 million for the shares of a company holding a single intangible asset which is not regarded as a business. There are no tax deductions available for the asset in any circumstance. Consequently the tax basis is €0 and the temporary difference on initial recognition is €1 million. The relevant tax rate is 25% and under the IASB's proposals this gives rise to a deferred tax liability of €250,000 when the asset is first recognised.

The company would also recognise a discount against the deferred tax liability of €250,000, resulting in a net carrying amount for deferred tax on this asset of €0. The discount would be amortised to profit or loss pro rata with changes in the deferred tax liability.

Application of the IASB's proposals in the scenario above does not result in a different balance sheet position to that which would currently exist under IAS 12. However, there are situations where the amount that a company is willing to pay for an asset is influenced by



the associated tax attributes. For example, a company may negotiate a lower purchase price for an asset with a low tax basis if that asset could have been obtained in a transaction that provided the buyer with a higher tax basis.

Example

Temporary difference on initial recognition

A company pays €1 million for the shares of an entity that has a single asset, rather than purchasing the asset outright, and consequently cannot avail of any tax deduction on the use or sale of the asset. The purchase is not a business combination and does not affect taxable or accounting profit. Any market participant could have purchased the asset outright for €1.2 million and availed of an equivalent tax deduction on a sale of the asset. The tax rate is 25%.

Under IAS 12 no deferred tax would arise as a result of this transaction as the initial recognition exception would be applied. The asset would be recognised at €1 million, being the cash amount paid.

Under the IASB's proposals the company would record the asset at €1.2 million reflecting the higher value that is available to market participants. The tax basis is nil, so the temporary difference is €1.2 million. A deferred tax liability

of €300,000 ($€1.2\text{million} \times 25\%$) would be recognised. This leaves a difference between (i) the consideration paid of €1 million and (ii) the net of the amount recognised for the asset (€1.2 million) and the deferred tax (€300,000). The difference is €100,000 and would be presented in the balance sheet along with the deferred tax liability as an offsetting discount.

Dr Asset	€1,200,000
Cr Cash	€1,000,000
Dr Deferred tax discount	€100,000
Cr Deferred tax liability	€300,000

This approach can be described as an 'adjusted fair value approach' with the amount of the asset or liability that gives rise to the temporary difference on initial recognition being adjusted to remove entity-specific tax effects.

The IASB acknowledges that there may be difficulties in assessing what the amount would be had the same tax basis been available to the company as to a market participant, but considers that companies 'would be able to estimate how entity-specific tax effects have affected the transaction price'.

Uncertain tax positions

The IASB's proposals address the question of how to account

for uncertainties about whether the tax authorities will accept the company's computation of its tax liability. The proposals would require current and deferred tax balances to be measured using a probability-weighted average amount of all possible outcomes, assuming the tax authorities have full knowledge of all relevant information. IAS 12 currently does not address uncertain tax positions. In practice, liabilities for uncertain tax positions are recognised when it is probable the tax authorities will disagree with the position taken on a tax return. Such a liability is currently measured using a probability-weighted average or a single best estimate approach.

Example

Uncertain tax position

A company takes a tax deduction for an uncertain tax position that results in a potential tax benefit of €1 million and management is 80% certain that position will be sustained.

Potential Benefit	Individual Probability	Probability weighted calculation
€1 million	80%	€800,000
€Nil	20%	-
		€800,000

Under the single best estimate approach the company would recognise the full benefit of the €1

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million of tax deduction. Under a probability-weighted average approach it would recognise €800,000 of a tax benefit, being the €1 million reported tax deduction and an increase to the current tax liability of €200,000 to take account of the uncertain tax position.

The IASB's proposals mean that uncertainty about whether the tax authorities will accept the position taken is included in the measurement of the tax assets and liabilities themselves.

This approach can be expected to increase the tax liability where a company has tax uncertainties that it had not previously recognised on the basis that these uncertainties were not likely to crystallise as tax payable.

The proposals also introduce specific disclosure requirements in relation to areas of estimation uncertainty relating to tax, (for example, the effects of unresolved disputes with the tax authorities).

The proposals do not include any exemption from disclosing the information required on the basis that such disclosure may prejudice the position of the entity in a dispute.

Presentation and disclosure

Under IAS 1 all deferred tax balances are classified as non-current. The IASB's proposals would mean that deferred tax balances are classified as current or non-current based on the financial statement asset or liability generating the temporary difference. Deferred tax balances that are unrelated to financial statement assets and liabilities (e.g. unused tax losses) are classified based on their expected reversal date.

Other Areas

The Exposure Draft also proposes a number of other changes in other areas of tax accounting such as investment tax credits, distributions to shareholders and the allocation of income tax charges to performance statements.

Concluding Comments

The IASB has requested comments on its proposals by 31 July 2009. It will be interesting to see just how much opposition there will be to them, bearing in mind the other accounting issues, such as fair value accounting and impairment, which many regard as being in more urgent need of the IASB's attention. Nonetheless, now that the IASB's proposals have reached Exposure Draft stage, it is timely for companies to consider whether their tax charges and liabilities would be significantly affected if the proposals were to become mandatory.



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