

## The Move to IFRS: Tax Implications

The move to International Financial Reporting Standards (IFRS) from current Canadian Generally Accepted Accounting Principles (Canadian GAAP) will fundamentally change the way Canadian companies report their business results. The move could affect the measurement and reporting of income taxes for financial statement purposes and the calculation of Canadian taxes payable. This *Tax Memo* will consider these possibilities under three headings:

- Financial Statement Effects
- Accounting for Income Taxes
- Computation of Taxes Payable

**Appendix A** provides a detailed comparison of the IFRS and Canadian GAAP frameworks for measuring and reporting income taxes, while **Appendix B** provides an example of the differing frameworks. For information on a wide range of IFRS issues, visit [www.pwcifrs.ca](http://www.pwcifrs.ca).

The proposed effective date for adopting IFRS is still to be finalized. On April 7, 2008, the Accounting Standards Board (AcSB) released for comment its long-awaited exposure draft proposing to replace the existing Canadian GAAP with IFRS. The AcSB proposed that IFRS will be effective for interim and annual financial statements for fiscal years beginning on or after January 1, 2011, with earlier adoption permitted.

IFRS will be mandatory for publicly accountable enterprises (PAEs), which are all Canadian reporting entities other than:

- private enterprises;
- not-for-profit organizations;
- public sector entities to which the *Public Sector Accounting Handbook* applies.

Although an enterprise that is not a PAE is not required to adopt IFRS, it can elect to do so.

### Financial Statement Effects

Canadian GAAP and IFRS are moving closer to convergence. The basic financial statement elements (i.e., assets, liabilities, revenues, income and expenses) are the same under Canadian GAAP and IFRS (although IFRS may present these amounts differently). There are some significant differences between Canadian GAAP and IFRS; a few examples are shown in the following table. **Appendix A** provides details.

		IFRS
What is affected?	Components of cost	Is more specific (e.g., requires capitalization of interest during construction).
	Valuation	Requires fair value more often (e.g., agriculture). Permits fair value more often (e.g., revaluations of capital assets and investment property).
	Impairment of long-lived assets	Recognizes sooner and more often. Measures differently.
	Debt vs. equity classification	Convertible instruments must meet "fixed for fixed" criteria. Any variability in the conversion price of shares to be issued on conversion leads to full liability treatment.

The overall effect of adopting IFRS depends on each corporation's facts and circumstances. Some industries will be affected more than others. In general, we observe that net income and shareholders' equity may be more volatile under IFRS because of the increased ability or requirement for reporters to use fair value when measuring the accounting carrying value of assets and liabilities.

## Initial adoption

In the year of adoption, companies are generally required to present their financial statements (and comparatives) as if IFRS had always been applied. However, there are some exceptions to this general rule.

For example, companies can elect to re-measure an item of property, plant and equipment to fair value on transition and treat the fair value on that date as “deemed cost” for accounting purposes. This area will require serious thought, because the choices made on transition will have significant implications for future financial statements.

## Accounting for Income Taxes

The International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) are working together on a joint project to make the accounting for income taxes under IFRS and U.S. GAAP converge. This joint project will result in changes to both IFRS and U.S. GAAP. We expect a revised IFRS standard to be released in 2009. For Canadian GAAP, it is expected that this revised IFRS standard will be adopted on convergence in 2011.

This *Tax Memo* focuses on the differences expected to remain between Canadian GAAP and IFRS after the IASB publishes its revised standard in 2009. Because the IASB has yet to publish its exposure draft, the views discussed in this *Tax Memo* may change. Companies planning on early adoption should consider existing IFRS standards when determining differences from Canadian GAAP.

IFRS and Canadian GAAP adopt fundamentally the same method for measuring income taxes for accounting purposes. **Appendix A** to this *Tax Memo* provides a detailed comparison of Canadian GAAP and IFRS with respect to income taxes. In a nutshell, both:

- apply the balance sheet or liability approach to accounting for income taxes that requires an entity to recognize a deferred tax asset or liability for the “temporary differences” arising in respect of its assets and liabilities, operating loss carryforwards and other credits;
- define “deductible temporary differences” and “taxable temporary differences” in a similar way; and
- determine “deferred tax assets” in essentially the same manner.

In recognizing a deferred tax asset, the Canadian GAAP “more likely than not” standard is replaced under IFRS with a “probable” standard. However, the IASB has tentatively agreed to define “probable” as being equivalent to “more likely than not” in its revised standard on income taxes.

## Key differences

Some key differences may arise when an entity adopts IFRS when accounting for income taxes. For example, unlike Canadian GAAP, upon adoption in 2011, IFRS probably will:

- require recognition of deferred taxes for temporary differences that arise on the translation of non-monetary assets that:
  - are re-measured from the local currency to the functional currency using historical rates; and
  - result from changes in exchange rates; (**Appendix B** of this *Tax Memo* includes an example of this difference.)
- require recognition of an income tax asset or liability when a temporary difference arises on the intercompany transfer of assets;
- address the treatment of deductible stock-based compensation (IFRS caps the deferred tax asset at the intrinsic value of the award at the date of measurement); and
- not permit an offset of income tax assets and liabilities of different taxable entities within a consolidated group, unless there is a legally enforceable right to offset and the entities intend to settle these assets and liabilities simultaneously.

Furthermore, while the revaluation of non-depreciable assets under IFRS could create deferred tax assets or liabilities, this is not a possibility under Canadian GAAP, because Canadian GAAP does not currently permit the revaluation of non-depreciable assets. In addition, Canadian GAAP extends its scope to refundable taxes and alternative taxes, as well as the treatment of regulated enterprises; IFRS is silent on these matters.

## Interim reporting

Of particular significance for interim reporting, IFRS treats the initial recognition of a previously unrecognized income tax asset as an adjustment to the estimated average annual effective income tax rate used in determining the interim period tax expense. Under Canadian GAAP, this amount is a separate item of income tax expense.

## Measurement of deferred taxes

IFRS requires deferred taxes to be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Similarly, Canadian GAAP uses the “substantively enacted” criterion in measuring deferred taxes. Therefore, no change is expected on converging with IFRS.

## Computation of Taxes Payable

### Taxable income

The determination of taxable income likely will not be different under IFRS. This is because taxable income is not directly linked to income determined for financial statement purposes. Canadian jurisprudence has confirmed that, in ascertaining profit, the goal is to obtain an “accurate picture” of the taxpayer’s profit for the year. To this end, the taxpayer is free to adopt any method that is consistent with the *Income Tax Act*, established case law principles and well accepted business principles.

### The Canada Revenue Agency’s view

To date, the Canada Revenue Agency (CRA) has not expressed any concerns relating to the move to IFRS and the computation of taxable income. The CRA has stated that “The new accounting standards constitute part of generally accepted accounting principles (‘GAAP’), which is one element to consider in obtaining an accurate picture of profit.”

### Income taxes

Adopting IFRS could affect corporate income tax calculations that rely on balance sheet amounts. For example, the rate of Quebec’s Research and Development Wage Tax Credit is based on an asset test. Further, there could be income tax implications for Canadian-controlled private corporations (CCPCs) that elect to use IFRS. CCPCs must use certain balance sheet amounts, when determining their enhanced federal scientific research and experimental development tax credit and refund rates, as well as the clawback to the federal and all provincial and territorial small business deductions, except Ontario’s.

## Capital taxes

From a capital tax perspective, the move to IFRS can have implications for financial institutions, but generally will not be a concern for other corporations. This is because, for all corporations except financial institutions, provincial capital taxes are scheduled to be eliminated by January 1, 2011, except for Nova Scotia’s, which will be phased out by July 1, 2012.

Capital taxes on financial institutions will continue to be imposed by the federal government and all provinces (except Alberta). This tax will be eliminated during 2010 in British Columbia (where it will be replaced by a minimum tax on paid-up capital) and in Ontario, and by January 1, 2011, in Quebec. Capital for financial institutions capital tax purposes generally includes long-term debt, capital stock and retained earnings.

## International tax issues

In jurisdictions in which statutory accounting is the basis for classifying debt versus equity for tax purposes, financing structures and the effect IFRS has on them will have to be reviewed, to determine the related tax implications. Similarly, in some jurisdictions, the characterization of a transaction as a lease often depends on the accounting for statutory purposes.

Fair value measurement is another important aspect of IFRS. For example, under IFRS, companies can elect to measure property, plant and equipment and investment property at fair value, and certain financial instruments may have to be carried at fair value. These measurements could significantly affect debt-to-equity and other balance sheet ratios, limiting interest deductibility.

Conversion to IFRS is also likely to have important implications for other aspects of international tax planning, such as cash repatriation. The ability to make distributions from foreign affiliates may be affected when the accounting under IFRS results in a significant change to distributable reserves on the statutory books of particular foreign entities.

## For More Help

For help understanding how the move to IFRS will affect how your corporation accounts for income taxes and computes its tax liability, please contact your PricewaterhouseCoopers adviser or any of the following individuals.

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## Appendix A

### Comparison of IFRS expected to be in force in 2011 and Canadian GAAP – Accounting for Income Taxes

The following table is neither a substitute for reading the relevant standards nor a complete list of the principal differences between IFRS and Canadian GAAP.

		IFRS (expected in 2011)	Canadian GAAP
<b>General considerations</b>	General approach	Liability or balance sheet method.	Similar to IFRS.
	Basis for deferred tax assets and liabilities	Temporary differences (i.e., the difference between the carrying amount and tax basis of assets and liabilities; see exceptions below).	
<b>Exception to the balance sheet method</b>	Goodwill	Deferred taxes are not recognized in respect of goodwill that is not deductible for tax purposes.	
<b>Specific considerations</b>	Compound financial instruments	The issuer of a compound financial instrument divides the instrument between liability and equity; however, the tax basis of the liability equals the sum of the liability and equity components. This results in a taxable temporary difference and a deferred tax liability, which is charged to the equity component. Subsequent changes are charged to income.	If the instrument can be settled in accordance with its terms without the incidence of tax, the liability component is considered to have a tax basis equal to its carrying amount – there is no temporary difference.
	Unrealized intragroup profits (e.g., on inventory)	Deferred tax is recognized at the buyer's tax rate.	The buyer is prohibited from recognizing deferred taxes. Any income tax effects to the seller, including taxes paid and tax effects of any reversal of temporary differences, that occur as a result of the intercompany sale are deferred and recognized upon sale to a third party.
	Revaluation of plant, property, equipment and intangible assets	Deferred tax is recognized in equity.	If an entity undertakes a comprehensive revaluation and a future income tax asset is not recognized as of the date of revaluation, the subsequent recognition of the asset is first allocated to reduce unamortized intangibles and then directly to equity, unless the entity applies "fresh start" reporting.
	Foreign nonmonetary assets and liabilities when the tax-reporting currency is not the functional currency	Deferred tax is recognized on the difference between: <ul style="list-style-type: none"> <li>the carrying amount, which is determined using the historical exchange; and</li> <li>the tax basis, which is determined using the exchange rate at the balance sheet date.</li> </ul>	No deferred tax is recognized for differences that: <ul style="list-style-type: none"> <li>relate to assets and liabilities that are re-measured from local currency to the functional currency; and</li> <li>result from changes in exchange rates or indexing for tax purposes.</li> </ul>
	Investments in subsidiaries and joint ventures: treatment of undistributed profit	Deferred tax is recognized unless: <ul style="list-style-type: none"> <li>the parent is able to control the distribution of profit; and</li> <li>it is probable that the temporary difference will not reverse in the foreseeable future.</li> </ul>	Essentially the same as IFRS.
	Uncertain tax positions	IFRS is currently silent on this matter. However, the IASB proposes to make amendments to IFRS to recognize a liability if the entity has a "stand-ready" liability to pay. However, the amount of the liability is uncertain. To measure the liability, a probability weighted average of possible outcomes would be used. No recognition criteria are applied.	Canadian GAAP is silent on this matter.
	Investments subject to significant influence: treatment of undistributed profits	Deferred tax is recognized unless: <ul style="list-style-type: none"> <li>the investor can control the sharing of profits; and</li> <li>it is probable that the temporary difference will not reverse in the foreseeable future.</li> </ul>	No equivalent under Canadian GAAP. However, because investors rarely control an associate, a difference is not likely to arise.

		IFRS (expected in 2011)	Canadian GAAP
<b>Specific considerations</b> (continued)	Share-based compensation	<p>If a tax deduction:</p> <ul style="list-style-type: none"> <li>exceeds cumulative share-based compensation expense – deferred tax calculations, based on the excess deduction, are recorded directly in equity; or</li> <li>is less than or equal to cumulative share-based compensation expense – the deferred taxes are recorded in income.</li> </ul> <p>The unit of accounting is an individual award.</p> <p>If changes in the stock price affect the future tax deduction, the estimate of the tax deduction is based on the current stock price.</p>	No equivalent under Canadian GAAP.
	Taxes on distributions	In some jurisdictions, income taxes are payable at a higher (or lower) rate if part or all of the net accumulated profit is paid out as a dividend to shareholders, or alternatively, income taxes may be refundable (or payable) if a dividend is paid. In these circumstances, deferred taxes are measured using the tax rate applicable to undistributed profits. The income tax consequences of the dividend are recognized when the liability to pay the dividend arises.	Taxes on distributions or on future distributions should be given the same accounting treatment as the distributions themselves. Canadian GAAP is silent regarding what tax rate is applied to these distributions.
<b>Measurement of deferred tax</b>	Tax rates	Tax rates and tax laws that have been enacted or substantively enacted may be used.	Essentially the same as IFRS.
	Recognition of deferred tax assets	Future income tax assets are recognized to the extent that it is more likely than not that the benefits will be realized (the affirmative judgment approach). The impairment approach can also be used.	
	Discounting	Prohibited	
<b>Business combinations – acquisitions</b>	Excess of assigned fair value over the cost of the acquired entity in a business combination (i.e., negative goodwill)	Results in an immediate credit in the income statement. No deferred taxes are recognized for book or tax differences related to negative goodwill.	Upon adoption of the revised business combination standard (CICA 1582) the accounting will be similar to IFRS.
	Previously unrecognized tax losses of the acquirer	A deferred tax asset is recognized if the recognition criteria for the deferred tax asset are met as a result of the acquisition. The offsetting credit is recorded to income.	
	Deferred taxes for the difference between book-basis goodwill and deductible tax-basis goodwill	A deferred tax asset is recognized by means of purchase accounting for the excess of tax-deductible goodwill over book-basis goodwill.	Essentially the same as IFRS.
	Step-up of acquired assets and liabilities to fair value	Deferred tax is recorded unless the tax basis of the asset is also stepped up.	
	Tax losses of the acquiree (i.e., initial recognition)	Requirements for the acquiree are similar to those for the acquirer, except that the offsetting credit is recorded as part of purchase accounting.	
	Subsequent resolution of income tax uncertainties in a business combination	Generally, if the resolution is more than one year after the year in which the business combination occurred, the result is recognized in the income statement.	
	Subsequent recognition of deferred tax assets that were not “probable” at the time of the business combination	<p>Revisions to estimates relating to new information about facts and circumstances existing at the measurement date reduce the carrying amount of goodwill. To the extent that the adjustments exceed the balance of goodwill they are recognized in income.</p> <p>Adjustments subsequent to the measurement period are recognized in the income statement.</p>	Upon adoption of the revised business combination standard (CICA 1582) the accounting will be similar to IFRS.

	<b>IFRS (expected in 2011)</b>	<b>Canadian GAAP</b>	
<b>Presentation of deferred tax</b>	Offset of tax assets and liabilities	<p>Offset current tax assets and liabilities if there is a legal right of set-off and the amounts will be settled net or simultaneously.</p> <p>Offset deferred tax assets and liabilities only if current tax items can be offset and the taxes related to:</p> <ul style="list-style-type: none"> <li>• the same tax authority and same tax entity; or</li> <li>• different entities if it is intended that the amounts will be settled net or simultaneously.</li> </ul>	<p>Tax assets and liabilities should offset if they relate to the same taxable entity and the same taxation authority. However, if an entity classifies assets or liabilities as current and non-current, no offset is permitted.</p> <p>Future income tax assets and liabilities of different taxable entities can be offset if tax planning strategies could be implemented to facilitate the offset and the entities are taxed by the same taxation authority.</p>
	Current and noncurrent	Requires classification of deferred tax assets and liabilities as either current or non-current based on the classification of the related non-tax asset or liability for financial reporting.	Deferred tax assets and liabilities are classified net as noncurrent based on the classification of the related non-tax asset or liability for financial reporting. Tax assets that are not associated with an underlying asset or liability are classified in accordance with the expected reversal period.
	Reconciliation of actual and expected tax expense	Reconciliation is calculated by applying the domestic, federal statutory tax rates to pre-tax income from continuing operations.	Reconciliation is required for public companies only. Otherwise, similar to IFRS.

## Appendix B

### Integrated Foreign Operations

The treatment of integrated foreign operations is different under IFRS than under Canadian GAAP. This appendix illustrates the differences for a company that:

- has a functional currency that is the U.S. dollar; but
- pays its taxes in local currency.

#### Canadian GAAP

The liability method adopted under Canadian GAAP for accounting for income taxes assumes that assets will be recovered and liabilities settled at their carrying amounts.

The carrying amounts of nonmonetary assets and liabilities are based on U.S. dollar amounts that are translated from local currency using historical exchange rates. Deferred taxes are not recognized on the difference arising from re-measurement (i.e., the difference between the historical rate of exchange and the current rate of exchange).

For monetary assets and liabilities of a company, if the company will be taxed on the difference between the local currency amount at which the assets or liabilities were originally incurred and the amount at which they are ultimately settled, the temporary differences for the assets and liabilities should be computed by comparing the book basis in local currency (i.e., the carrying amount in U.S. dollars in the re-measured financial statements, translated to local currency at the current exchange rate) with the tax basis in local currency. A deferred tax asset or liability will be recognized on this exchange rate difference.

#### IFRS

IFRS has no equivalent to the Canadian GAAP exception for nonmonetary assets and liabilities when measuring temporary differences for corporations whose functional currency is not their tax-paying currency.

The following is an example of this GAAP difference:

A Canadian company with a U.S.-dollar functional currency purchased an item of plant and equipment for CA\$5,000 at the start of year 1, when the exchange rate was CA\$1 to US\$1. The asset is depreciated for accounting purposes on a straight-line basis over 10 years, but over 5 years for tax purposes. In year 2, the exchange rate was CA\$1.20 to US\$1 (exchange rates have been embellished to demonstrate the principle).

	Tax basis		Book basis	
	CA\$		CA\$	US\$ CA\$ (Translated at current rates)
<b>Year 1</b>				
Exchange rate (CA\$ per US\$)				\$1.00
Cost	\$5,000		\$5,000	\$5,000
Depreciation rate	20%		10%	
Accumulated depreciation	\$1,000		\$500	\$500
Tax basis or book basis	\$4,000 <b>A</b>		\$4,500 <b>B</b>	\$4,500 <b>C</b>
GAAP temporary difference	-\$500 <b>A-B</b>			
IFRS temporary difference	-\$500 <b>A-C</b>			
<b>Year 2</b>				
Exchange rate (CA\$ per US\$)				\$1.20
Cost	\$5,000		\$5,000	\$5,000
Depreciation rate	20%		10%	
Accumulated depreciation	\$2,000		\$1,000	\$1,000
Tax basis or book basis	\$3,000 <b>D</b>		\$4,000 <b>E</b>	\$4,800 <b>F</b>
GAAP temporary difference	-\$1,000 <b>D-E</b>			
IFRS temporary difference	-\$1,800 <b>D-F</b>			