IFRS news

Emerging issues and practical guidance*

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Income tax accounting under IFRS: a look ahead

New exposure draft proposes significant changes to income tax accounting.

Background

The current income tax accounting frameworks under US GAAP and IFRS are both balance sheet liability models, based on the same accounting principles. There are significant differences in the detail, and the two models have different exceptions. The IASB and FASB have worked to eliminate these differences. The resulting exposure draft does not change any of the underlying principles of deferred tax accounting but does eliminate many of the differences between IFRS and US GAAP. The IASB has also attempted to address some of the practical problems with the existing standard.

Key changes

Tax basis

Deferred tax is recognised for the difference between the book value of assets and liabilities and their tax base. The IASB's proposals define tax basis as *'the measurement, under applicable substantively enacted tax law, of an asset, a liability, or other item'.* An asset's tax basis would be determined by the tax consequences of selling the asset for book value at the balance sheet date. A liability's tax basis would reflect the tax consequences of settling the liability at book value.

The proposals simplify the definition of the tax basis to converge with US GAAP. IAS 12, 'Income taxes', requires the tax base to reflect the tax consequences of the expected manner of recovery, which could be use or sale. The impact of the proposals could be significant in territories where there are different tax consequences of using and selling an asset. An entity may have recognised a deferred tax liability in connection with an asset that it does not plan to sell; this is common with an investment property where no tax deduction is available while the property is being used. The proposed model would not require the deferred tax liability to be recorded if a tax deduction was available on sale. This could mean a significant reduction in the deferred tax liability for some entities.

Uncertain tax positions

There is often uncertainty about whether the tax authorities will accept the positions taken in an entity's tax return. The proposed standard requires current and deferred tax assets and liabilities to be measured using the probability-weighted average amount of all possible outcomes, assuming the tax authorities have full knowledge of all relevant information. There would no longer be a probability-based recognition threshold. All possible outcomes must be considered. Any uncertainty about whether the tax authorities will accept the tax return as prepared would be included in the measurement of the tax

At a glance

- The IASB's recent exposure draft proposes significant changes to IAS 12, the current standard on accounting for income taxes.
- The proposals would more closely align IFRS and US GAAP in some areas. For example, the definition of tax basis, the presentation and classification of deferred tax assets and liabilities, and the deferred tax consequences of investments in subsidiaries and associates. The IASB has also proposed significant new guidance in connection with tax uncertainties and the deferred tax consequences of the initial recognition of an asset or liability.
- The exposure draft is open for public comment until 31 July 2009.

assets and liabilities. The proposal also requires additional disclosures for uncertain tax positions.

IAS 12, as currently written, 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 the tax return. That is, deductions might be disallowed or a tax planning arrangement newly legislated against. The liability for an uncertain tax position is usually measured using a probability-weighted average or a single best estimate approach.

PwC observation
The removal of the recognition threshold would be significant for many companies. The proposed approach is likely to result in a need to analyse significantly more of a company's tax positions. Even highly certain tax positions (say a confidence level of 95%) will need to be reviewed and measured, using a probability-weighted average amount of all possible outcomes.

Deferred taxes on initial recognition of an asset or liability

The proposals remove the initial recognition exception in IAS 12 for temporary differences that arise in transactions that do not impact comprehensive income equity, or taxable profit. For example, if the tax basis is higher or lower than the carrying value when an asset is purchased, a temporary difference exists. IAS 12 prohibits recording deferred taxes if the transaction is not a business combination or does not result in a book or tax gain or loss.

The exposure draft proposes that an entity measure the asset or liability using the same assumptions about the tax basis that other market participants use. Deferred taxes would be recognised for any resulting temporary difference, together with a discount or premium on the deferred tax balance for the difference between the consideration paid and the net total of the asset or liability and the related deferred tax. The discount or premium would be presented in the financial statements with the related deferred tax balance and amortised pro rata with changes in the related deferred tax asset or liability.

Example

Entity A pays C1,000 for the shares of a shell company that holds a single asset and is not a business. The transaction is not accounted for as a business combination. The cost of the asset is not deductible for tax purposes in any circumstances, so there is a taxable temporary difference of C1,000 when the asset is first recognised. The entity is subject to a tax rate of 30%.

The proposed accounting requires the entity to record a deferred tax liability of C300 when the asset is first recognised. It would also recognise a discount against the deferred tax liability for C300. The discount would be amortised pro rata with changes in the deferred tax liability. This example assumes that all market participants receive the same tax basis. The situation could be more complex.

PwC observation
The proposed approach is complex and introduces a new concept of a discount or premium on deferred tax balances. The IASB is seeking feedback on whether the new approach would produce a more faithful representation of a transaction's underlying economics.

Investments in subsidiaries

Temporary differences may arise between the carrying amount and the tax basis of investments in subsidiaries and associates or interests in joint ventures. These differences are typically referred to as outside basis differences and can occur for various reasons, including unremitted earnings, impairment of the investment, and changes in foreign exchange rates.

IAS 12 provides an exception that deferred taxes are not recognised if the temporary difference is controlled by the investor and will not reverse in the foreseeable future. The proposals would limit the application of that exception to foreign subsidiaries (and branches), and foreign joint ventures that are essentially permanent in duration. This would align IFRS with US GAAP.

PwC observation
Calculating deferred taxes for outside basis differences in domestic subsidiaries may also be complex, particularly where companies cannot file consolidated tax returns and cannot recover their investment in a tax-free manner. The IASB has not extended the exception in the proposal to domestic subsidiaries. This change may have a significant impact on some companies.

Intraperiod allocation

Intraperiod allocation refers to the process of allocating income tax expense/benefit between continuing operations, discontinued operations, comprehensive income and equity. This can be one of the most complex and counter-intuitive aspects of accounting for income taxes.

IAS 12 and FAS 109 both require the tax effects of items recognised outside continuing operations during the current year to be recorded outside continuing operations.

The IASB is seeking comment on two different models: a model based on the one used in IAS 12 that requires 'backwards tracing', and a model used in FAS 109 that prohibits 'backwards tracing'. The two models are very different but both are complex. Backwards tracing under IAS 12 generally requires the income tax expense/benefit to be allocated where the pre-tax item was initially charged or credited. US GAAP generally requires the same income tax expense/benefit to be recorded in continuing operations.

PwC observation
The IASB acknowledges that both models are complex, can be difficult to use and can seem to produce counter-intuitive results. It concluded that any allocation methodology would be arbitrary to some degree. The FAS 109 methodology is proposed, given the overall context of convergence and because it is more specific than the IAS 12 methodology. Both are exposed for comment.

Presentation

The exposure draft requires deferred tax assets to be recorded in full (ie, gross) and then reduced by a valuation allowance to the highest amount that is more likely than not of being realised. This approach is consistent with US GAAP under FAS 109 and will require companies to identify and measure all unrecognised deferred tax assets.

The proposals also align the classification of deferred tax assets and liabilities to US GAAP requirements. Deferred tax assets and liabilities would be separated into a current and non-current amount based on the classification of the underlying asset or liability. The valuation allowance would be classified as either current or non-current by allocating the valuation allowance pro rata between current and non-current gross deferred tax assets. The classification would be done by individual tax jurisdiction.

Other changes

- Distributed versus undistributed rate – the use of a distributed or non-distributed rate to measure taxes should be based on past practices and expectations of future distributions. IAS 12 requires use of the non-distributed rate.
- Disclosures – the proposals generally retain the disclosure requirements of IAS 12, with some revisions to align more closely with the disclosure requirements of US GAAP.
- Discounting – the proposals retain the prohibition on discounting deferred taxes. The proposals are silent on whether current taxes should be discounted.

Areas unchanged

The exposure draft introduces significant changes and would eliminate a number of differences between IFRS and US GAAP. Some areas will remain unchanged, including accounting for the tax impacts of share-based payments and intragroup transfers of assets. These areas, along with uncertain tax positions, would not be converged with US GAAP under the proposals in the exposure draft.

Comments

Comments on the exposure draft are due by 31 July 2009. The primary purpose of the exposure draft is to solicit feedback from users, preparers and other interested parties before issuing a final standard.

PwC observation
Companies should start assessing the proposed changes now and analyse how the IASB's model might impact their current accounting for income taxes. We encourage companies to engage with the IASB and provide feedback on the Board's proposals.