

Income Tax Accounting under IFRS: A look ahead*

Exploring the IASB's proposal



About this series

The IASB has proposed significantly changing the current IFRS standard on accounting for income tax. This is the first article in a series that explores how the proposed changes might impact companies. Each article focuses on a particular aspect of the IASB's proposal. The articles can be found at www.pwc.com/usifrs/tax.

Background

In an effort to develop a common set of high-quality global standards, the IASB and FASB have worked to eliminate differences between the IFRS and US GAAP income tax standards. One result of that effort is the IASB's proposal to make certain changes to IAS 12.¹

Although the FASB deliberated amending FAS 109, it suspended those deliberations in late 2008, stating that the board will revisit its convergence strategy (i.e., its strategy for eliminating differences between US GAAP and IFRS), in light of the possibility that some or all US public companies will be permitted or required to adopt IFRS in the future.

As part of reviewing its convergence strategy, the FASB plans to solicit input from US constituents through an "Invitation to Comment." Upon completing its review, the FASB will decide whether and how to proceed with eliminating remaining differences between FAS 109 and IAS 12.

Given the focus by both boards on resolving differences in their income tax accounting standards, we believe it is important for US companies to understand the IASB's proposed changes, regardless of whether they report under IFRS or US GAAP. Toward that end, we have prepared this series of articles. In the articles, we raise questions that companies may want to consider when thinking about how the proposed guidance could impact them.

Snapshot of the proposed guidance

The following table compares the IASB's proposal with the current guidance in IAS 12 and FAS 109. Companies should refer to the full proposal for further details.

Area	Current IAS 12	US GAAP	IASB's proposal
Tax basis	Tax basis is based on the expected manner of recovery. Assets and liabilities may have a dual manner of recovery (e.g., through use and through sale). In that case, the carrying amount of the asset or liability is bifurcated, resulting in more than a single temporary difference related to that item.	Tax basis is a question of fact under the tax law. It is determined by the amount that is depreciable for tax purposes as well as the amount that would be deductible upon sale or liquidation of the asset. ²	Tax basis is determined under the tax law. For an asset, it is the amount deductible against taxable income assuming the asset's carrying value is recovered through sale. For a liability, it is its carrying amount less (plus) any amounts deductible against (included in) taxable income. The intent is to adopt the US GAAP approach that is applied in practice.
Intercompany transfers of assets	Any associated current and deferred taxes are recognized at the time of the transaction.	The buyer is prohibited from recognizing the related deferred taxes. Any income tax effects to the seller (including taxes paid and tax effects of any reversal of temporary differences) that result from an intercompany sale are deferred and recognized upon sale to a third party or as the transferred property is amortized or depreciated.	Retains the IAS 12 approach.

¹ The International Accounting Standards Board (IASB) establishes International Financial Reporting Standards (IFRS). The IFRS standard on accounting for income taxes is IAS 12, *Income Taxes*. The Financial Accounting Standards Board (FASB) establishes US generally accepted accounting principles (US GAAP). The US GAAP standard on accounting for income taxes is FAS 109, *Accounting for Income Taxes* which is supplemented by interpretive guidance from both the FASB and the FASB's Emerging Issues Task Force (EITF).

² The guidance comes from EITF No. 98-11 *Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations*

Area	Current IAS 12	US GAAP	IASB's proposal
Foreign nonmonetary assets	<p>Deferred taxes are recognized on the difference between the carrying amount (which is determined using the historical rate of exchange) and the tax basis, which is determined using the exchange rate on the balance sheet date.</p>	<p>Deferred taxes are not recognized for foreign currency movements or for the effects of indexation related to nonmonetary assets and liabilities that are remeasured at historical exchange rates for financial reporting purposes.</p>	Retains the IAS 12 approach.
Share-based compensation	<p>Measurement of the deferred tax asset is based on the expected tax deduction. Unless the deduction is fixed, the deduction is estimated based on the current share price as of the reporting date.</p> <p>The tax effect of any actual or estimated deduction exceeding the compensation charge is recorded in equity.</p> <p>If the actual or estimated tax deduction is less than or equal to cumulative share-based compensation expense, the tax effect is recorded in the income statement.</p>	<p>Measurement of the deferred tax asset is based on the compensation cost recognized for financial reporting purposes. The deferred tax asset is not adjusted for changes in stock price.</p> <p>The tax effect of any tax benefit exceeding the deferred tax asset is recorded in equity. This is determined when the deduction is taken.</p> <p>If the tax benefit is less than the deferred tax asset, the shortfall is recorded as a direct charge to shareholders' equity (to the extent of the available windfall pool) and as a charge to income tax expense thereafter.</p>	Retains the IAS 12 approach.
Investments in entities: deferred tax liability on outside basis difference	<p>A company may avoid recording a deferred tax liability on an outside basis difference if certain criteria are met.</p> <p>The exception applies to domestic and foreign subsidiaries, branches, and associates, and to interests in joint ventures.</p> <p>In general, the exception is conditioned on (1) the company's ability to control the reversal of the temporary difference and (2) the probability that the temporary difference will not reverse in the foreseeable future.</p>	<p>A company may avoid recording a deferred tax liability on an outside basis difference if certain criteria are met.</p> <p>The exception applies only to foreign subsidiaries and foreign joint ventures (that are essentially permanent in duration).</p> <p>To qualify for the exception, companies must overcome the presumption that earnings will be remitted to the parent and reverse the outside basis difference. Companies must have specific plans and evidence of their intent and ability to indefinitely reinvest the earnings and avoid reversal of the temporary difference.</p>	The proposal adopts the US GAAP approach but does not carryover the specific wording from FAS 109.

Area	Current IAS 12	US GAAP	IASB's proposal
<p>Initial recognition exception: A temporary difference may arise upon initial recognition of an asset or liability. If the transaction is (1) not a business combination and (2) affects neither accounting profit nor taxable profit at the time of the transaction, special consideration is necessary.</p>	<p>No deferred tax is recognized in a transaction that (1) is not a business combination, and (2) affects neither accounting profit nor taxable profit at the time of the transaction.</p>	<p>In asset purchases that are not business combinations, a deferred tax asset or liability is recorded, with the offset generally recorded against the assigned value of the asset. The “simultaneous equations” method is used to determine the amount of the deferred tax asset or liability.</p>	<p>Adjusted fair value approach. The asset or liability is adjusted to remove entity-specific tax effects. For example, if the asset purchased has a carryover tax basis but the asset could have been purchased in a transaction that would have provided a higher tax basis, the asset’s carrying value is adjusted to remove the impact on the asset’s value of having a lower tax basis. In this case, the asset’s carrying amount would be increased, because the asset would be worth more with a higher tax basis.</p> <p>Deferred taxes are then recorded (as normal).</p> <p>Any difference between purchase price and the recorded amounts (e.g., asset and deferred tax) is recorded as a discount or premium that is amortized to income tax expense as the deferred tax reverses.</p>
<p>Allocation of income tax expense (benefit) to financial statement components</p>	<p>A full “backwards tracing” approach: Income tax expense is recognized in the income statement unless the tax arises from a transaction or event that is recognized outside the income statement (e.g., in equity), regardless of the period in which the tax expense is recognized.</p>	<p>In general, a company allocates income tax to the financial statement category where the pre-tax item was recorded, except for changes in the recognition of income tax expense (benefit) that occur in a period after the pre-tax item is recognized (e.g., release of a valuation allowance or tax rate changes). “Backwards tracing” is generally prohibited.</p>	<p>The IASB intended to adopt the US GAAP approach.</p> <p>However, the IASB did not carry over the exact wording of FAS 109, but rather tried to make the guidance more clear. Consequently, the proposed guidance might not retain the same meaning as in FAS 109.</p> <p>The IASB is also seeking comments on a second approach to allocating income tax expense, which retains the current IAS 12 approach with some revisions to provide guidance in areas where IAS 12 had been silent.</p>

Area	Current IAS 12	US GAAP	IASB's proposal
Enacted vs substantively enacted tax laws	Changes in tax laws/rates are reflected when enacted or substantively enacted.	Changes in tax laws/rates are reflected when enacted.	Changes in tax laws/rates are reflected when substantively enacted, which in some jurisdictions is only achieved on enactment (e.g., the US).
Distributions to shareholders—distributed rate vs undistributed rate	A company would use the undistributed rate until it recognizes the dividend for financial reporting purposes.	Treatment may depend on the facts. In jurisdictions where the distributed rate is lower, guidance requires use of the undistributed rate until the distribution occurs. ³	Uses an expectations-based approach: If the company has the intention and ability to make distributions, it should use the distributed rate.
Recognition of deferred tax assets	Net approach: The company does not recognize assets unless it is probable (greater than 50 percent) that they will be realized.	Gross approach: The company records the full deferred tax asset and reduces it by a valuation allowance if it is not more likely than not to be realized.	Adopts the US GAAP approach. However, the IASB noted the change would have no effect on the net amount recognized. The proposed standard also incorporates language from FAS 109 regarding determining the realizability of deferred tax assets.
Balance sheet classification	Deferred tax assets and liabilities are classified as noncurrent in the balance sheet. Disclosures are required of deferred tax assets and liabilities that are expected to reverse after more than 12 months.	Deferred tax assets and liabilities are classified as current or noncurrent based on the classification of the financial statement asset or liability generating the temporary difference. Deferred tax balances unrelated to financial statement assets and liabilities (e.g., net operating loss carryovers) are classified as current or noncurrent, based on their expected reversal dates.	Adopts the US GAAP approach.
Uncertain tax positions	There is no specific guidance. In practice, if the likelihood of a liability is greater than 50 percent, the company will record the liability measured as either a single best estimate or a weighted-average probability of the possible outcomes.	For uncertain tax positions having technical merits that meet the “more likely than not” recognition threshold, the benefit is measured at the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized.	All tax positions are considered for uncertainty. Tax positions are measured at the weighted-average probability of <i>all</i> possible outcomes.

³ EITF Issue No. 95-10 *Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*

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Uncertain tax position— disclosure	Disclose assumptions about the future and the major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next year.	Detailed disclosures specific to uncertain tax positions is required, including a roll-forward of unrecognized tax benefits.	Disclose information about major sources of estimation uncertainties relating to tax (including unresolved disputes with taxing authorities). The uncertainty must be described, and the disclosure should enable financial statement users to assess the possible financial statement effects of the uncertainties and related timing. A numeric roll-forward is not required.
Other disclosures	Disclosures are required to assist the financial statement users in understanding the impact of current and deferred taxes on the financial statements.	The disclosure requirements are generally similar to those required by IAS 12.	The disclosure requirements are generally similar to those required by IAS 12 and FAS 109. Certain amendments were proposed to: 1) eliminate certain disclosures that were in IAS 12 but not in FAS 109, 2) add disclosures, where relevant, that were in FAS 109 but not in IAS 12, and 3) add new disclosures as a result of other proposed amendments to the standard. Despite the proposed revisions to more closely align the disclosure requirements, differences between the proposed standard and US GAAP still remain.

Next steps

The IASB's proposal was released on March 31, 2009. The comment period ends on July 31, 2009. We encourage companies to consider the impact of the proposed accounting and to provide the IASB with comments.

We also encourage companies to consider the questions that the FASB will pose in its Invitation to Comment and to provide comments to the FASB.

Articles in the series

In this series we will explore accounting guidance related to the following topics:

Article	Release date
Tax Basis	April 14, 2009
Initial Recognition	April 16, 2009
Intercompany Transactions	April 21, 2009
Uncertain Tax Positions	April 23, 2009
Allocating Income Taxes	April 28, 2009
Investments in Subsidiaries	April 30, 2009
Financial Statement Disclosures	May 5, 2009
This and That	May 7, 2009

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