Income Tax Accounting under IFRS: A look ahead*

Initial recognition

*connectedthinking

PricewaterhouseCoopers

About this series

The IASB has proposed significantly changing the current IFRS standard on accounting for income tax. This is the third 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

Temporary differences can arise when a company initially recognizes an asset or liability. Such differences have a tendency to arise in a business combination when the assets and liabilities are recorded at their fair values but the tax bases do not change. Temporary differences can also arise when an asset is acquired outside a business combination, if the amount attributed to the asset for tax purposes is different from the financial statement carrying amount.

The proposed changes

The IASB's proposal would provide guidance on the accounting for temporary differences that arise upon a company's initial recognition of an asset or liability. (The table below summarizes the IASB's proposed guidance.) One of the changes the IASB is proposing is that in measuring the value of an asset or liability, the company must use the same assumptions about the tax basis that other market participants would use. This would address situations in which the amount an entity is willing to pay for an asset is influenced by the associated tax attributes that are specific to the entity. The company would recognize a deferred tax asset (DTA) or deferred tax liability (DTL) for any resulting temporary difference. The financial statement effect of recognizing the deferred tax would depend on the circumstances in which the transaction takes place.

Initial recognition of an asset or liability acquired in a business combination	A temporary difference that arises when an asset or liability is acquired in a business combination results in recognizing a DTA or DTL, with the offsetting effects either being recorded in goodwill or impacting the ultimate amount of the bargain purchase gain.
Initial recognition of an asset or liability acquired in a transaction that is outside a business combination and affects comprehensive income, equity, or taxable profit	In some situations, a temporary difference arises when an asset or liability is initially recognized outside a business combination and the transaction affects comprehensive income, equity, or taxable profit. In those instances, the resulting tax charge or benefit should be classified in a manner consistent with the pre-tax accounting. For example, a company may receive cash in exchange for providing goods or services in the future. Assume that, for tax purposes, the company includes the payment in taxable income upon receiving the cash. For financial reporting purposes, the company records the cash with an offset to deferred revenue. There is a deductible temporary difference for the deferred revenue, for which the company records a DTA. The transaction affects taxable profit. Therefore, the company records the deferred tax charge in the income statement.
Initial recognition of an asset or liability acquired outside a business combination, with *no* effect on comprehensive income, equity, or taxable profit	In some situations, a temporary difference arises when an asset or liability is acquired outside a business combination and the transaction does not affect comprehensive income, equity, or taxable profit. Assume that a company pays C1,000 for the shares of an entity. The entity is a shell company that holds a single asset and is not considered a business. The acquisition therefore is not accounted for as a business combination. The asset has a carryover tax basis of zero. There is a taxable temporary difference of C1,000 related to the asset. In this case, the company would record the deferred tax. It would also recognize, as an allowance (discount) against or premium on the deferred tax balance, the difference between the consideration paid and the total recognized amount of the asset or liability (including deferred taxes). The company would classify the discount or premium with deferred tax. However, the company would not consider the discount or premium to be a source of future taxable profit when determining whether a valuation allowance is necessary. The discount or premium would be reduced on a pro rata basis with changes in the related deferred tax asset or liability. The company would recognize the resulting tax expense or income as part of income tax expense (benefit) in the financial statements.

Comparison to IAS 12

The proposal is generally consistent with IAS 12, *Income Taxes*, regarding the accounting for temporary differences arising upon the initial recognition of assets and liabilities:

- in a business combination, and
- in a transaction that (1) is outside a business combination and (2) affects comprehensive income, equity, or taxable profit.

The proposal differs from IAS 12 on the accounting for temporary differences that arise upon the initial recognition of assets and liabilities acquired in a transaction that (1) is outside a business combination and (2) does not affect comprehensive income, equity, or taxable profit. IAS 12 does not permit a company to recognize deferred taxes in that situation.

There are situations in which the amount 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. In other situations, the purchase price for an asset might be increased because the remaining tax basis assumed in the transaction exceeds the amount that would have been deductible had the asset been acquired separately.

In deliberating the issue, the IASB discussed whether (1) measuring the asset or liability to reflect the tax advantage or disadvantage and then (2) recognizing deferred tax to reflect the difference between the carrying amount and the tax basis is a more faithful representation of the transaction's underlying economics. The IASB acknowledged that in these transactions, the consideration paid might not equal the sum of the carrying amount and the deferred tax balance. In the IASB's view, this difference results largely from the time value of money and the premium or discount on future tax cash flows that a willing buyer and seller would agree to. And, because deferred taxes are recorded on an undiscounted basis, there will naturally be a "disconnect" when these transactions are initially recorded.

The IASB therefore concluded that it is most appropriate to (1) classify the discount or premium along with the related deferred tax balance and (2) reduce the discount or premium pro rata with changes in the related deferred tax asset or liability.

Comparison to US GAAP

The proposal is generally consistent with US GAAP regarding the accounting for temporary differences arising upon the initial recognition of assets and liabilities:

- in a business combination, and
- in a transaction that is (1) outside a business combination and (2) affects comprehensive income, equity, or taxable profit.

The proposal differs from US GAAP on the accounting for temporary differences arising upon the initial recognition of assets and liabilities acquired in a transaction that is outside a business combination and does not affect comprehensive income, equity, or taxable profit. Currently, companies account for such temporary differences by following the guidance in EITF 98-11.[1] Under that guidance, a company determines the assigned value of an asset acquired and the related DTA or DTL by running simultaneous equations. The practical effect of this model is to gross up the asset and the related deferred tax.

[1] Emerging Issues Task Force (EITF) Issue No. 98-11, *Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations*

Practical example

Assume that a company acquires the shares of an entity that has a single asset. The purchase is not a business combination. The transaction does not affect comprehensive income, equity, or taxable profit.

The consideration paid was C100. The tax basis of the asset is the same as the previous owner's tax basis, which is nil. The company could have purchased the asset outright for C120, instead of purchasing the shares of the entity. In that case, the tax basis would have equaled the consideration paid. The tax rate is 40 percent.

The following observations can be made about the three accounting approaches:

- the US GAAP guidance would result in the highest depreciation charge; the IASB proposal would result in the next highest amount; and the IAS 12 guidance would result in the lowest amount.
- the US GAAP guidance normalizes the impact on the effective tax rate, whereas the guidance under both the proposal and IAS 12 result in a disproportionate impact on the effective tax rate.

Proposed guidance

The company would not record the asset at the amount of consideration paid; rather, the company would measure the asset so that it reflects the value of the asset that has the higher tax basis available to market participants (C120).

The proposal requires the company to record a DTL of C48 (C120-nil) * 40%), with an offsetting discount of C28.

Asset	120
Discount	28
Cash	(100)
Deferred tax liability	(48)

As the asset depreciates, the DTL would reverse proportionately and the discount would be reduced on a pro rata basis. The unwinding of the discount would affect the company's effective tax rate.

IAS 12

The company would record the asset at the amount of consideration paid (C100). Deferred taxes would not be recorded in this situation.

Asset	100
Cash	(100)

Because the asset would depreciate with no corresponding tax benefit, the company's effective tax rate would be impacted.

US GAAP

The company would record the asset at an amount determined by using a simultaneous equation. The company would initially record a DTL of C40 (C100 * 40%) and increase the cost of the asset by C40. This increase would, in turn, increase the temporary difference, requiring a new calculation of the DTL and so on. This situation is typically resolved by use of the "simultaneous equations" method. The final result is a DTL of C67 and an asset of C167 (C100 + C67).

Asset	167
Cash	(100)
Deferred tax liability	(67)

As the asset is depreciated, the company would adjust the deferred tax liability, and the effective tax rate would not be impacted.

Questions to consider

The IASB's proposal raises many important questions about the practical application of the initial recognition model:

Would the accounting and financial reporting effect under the proposal differ materially from that under IAS 12?

In the practical example above, the DTL was recorded at C48, and the discount was recorded at C28. The proposal specifies that the premium or discount would be reduced pro rata with changes in the related deferred tax asset or liability. The IASB does not specify what it means by "pro rata." We presume it means that as the DTL reverses, the discount would be reduced by an equal amount. If the amortization of the discount or premium is generally consistent with the reversal of the related DTA or DTL, the net effect on the income statement in any given period is nil.

The proposal specifies that a company should measure assets or liabilities by using the same assumptions about the tax basis that other market participants would use. How should this guidance be applied?

The proposal appears to require that when measuring the value of an asset, a company that *could have* acquired the asset in a manner that would have resulted in a higher tax basis should assume that the asset will be fully tax deductible (even though, in reality, there is no—or only a partial tax—basis to deduct).

Take, for example, a company that acquires an asset with a carryover tax basis (e.g., in a share purchase) but could have acquired the asset in a manner that would have resulted in a higher tax basis (e.g., in an asset purchase). In measuring the value of the asset, the company should assume full deductibility. So if, for example, the value of the asset was being determined through use of a discounted cash flow model, it would be appropriate to assume full deductibility of the asset for tax purposes, notwithstanding the fact that actual future deductions are limited to the asset's remaining tax basis.

In contrast, assume that a company enters into an agreement with the taxing authority before acquiring an asset. The purpose of entering into the agreement is to receive a favorable tax basis—one that is not available to other market participants. Does this mean that the company should ignore that agreement when subsequently measuring the value of the acquired asset? The proposal does not provide a clear answer to this question.

The proposal specifies that a company should reduce the premium or discount pro rata with changes in the related deferred tax asset or liability. How should this model be applied when considering the need for a valuation allowance?

The proposal specifies that the discount or premium would be classified as deferred tax on the balance sheet. However, in measuring or determining the need for a valuation allowance on DTAs, the company would not consider the discount or premium a source of future taxable profit or a future deductible amount that needs to be recovered. If, in a subsequent period, a company records a valuation allowance on the DTA, the proposal is unclear about whether the company should cease amortizing the related discount and, if not, on what basis the company should continue amortizing the discount.

A number of other questions arise when one considers the interaction of the discount or premium with a company's deferred tax analysis:

1. Assume the initial DTA that emerges upon recording one of these transactions requires a valuation allowance. Would the company calculate the discount or premium before assessing the need for a valuation allowance? In turn, would making the calculation mean the transaction could possibly result in an immediate income statement charge if the DTA requires a valuation allowance at inception?

2. Assume that the valuation allowance referenced in 1 above is no longer needed in a subsequent period? Depending on the accounting treatment in 1, is the discount also reinstated, or would any potential premium/discount be ignored when the valuation allowance is reversed?

3. Assume that a DTL arising in one of these transactions reduces the need for a valuation allowance on the company's pre-existing DTAs? Should the tax benefit that results from releasing the valuation allowance be recorded in the income statement in a manner similar to that prescribed by the new business combinations guidance? If so, should the benefit be recorded before or after the company accounts for the premium or discount?

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.

The FASB plans to issue an Invitation to Comment on the IASB's proposal to solicit input from US constituents as it considers its own convergence efforts. Upon completing its review, the FASB will decide whether and how to proceed with eliminating remaining differences between FAS 109 and IAS 12. We encourage companies to consider the questions that the FASB will pose in its Invitation to Comment and to provide comments to the FASB.

pwc.com/usifrs/tax

Contacts

Clients of PricewaterhouseCoopers are encouraged to open a dialogue about IFRS with their PwC engagement partner or with the authors of and contributors to this series.

This series of articles was authored by the following individuals:

Tami Van Tassell
Phone: +1 973 236 5049
Email: tami.van.tassell@us.pwc.com

David Beaver
Phone: +1 973 236 4350
Email: david.a.beaver@us.pwc.com

Bill Maloney
Phone: +44 20 7804 9491
Email: william.d.maloney@us.pwc.com

Other contributors to the series include the following individuals:

Jennifer Spang
Phone: +1 973 236 4757
Email: jennifer.a.spang@us.pwc.com

Brett Cohen
Phone: +1 973 236 7201
Email: brett.cohen@us.pwc.com

Tony de Bell
Phone: +44 20 7213 5336
Email: tony.m.debell@uk.pwc.com

PricewaterhouseCoopers is committed to helping companies navigate the conversion from US GAAP to IFRS. With that in mind, please visit www.pwc.com/usifrs/tax or pwc.com/usifrs to view our comprehensive library of our IFRS thought leadership, webcasts and tools addressing the business and technical issues that companies should be considering in anticipation of the move from US GAAP to IFRS.