

Income Tax Accounting under IFRS: A look ahead*

Intercompany transactions



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

Overview

Although the IASB's proposal will not change the accounting for income tax consequences resulting from intercompany transactions under IFRS, it will add new disclosure requirements. To provide context in understanding the proposed disclosure requirements, and because determining the appropriate accounting for those tax consequences can be tricky, this article reviews the current accounting guidance, highlighting the differences between US GAAP and IFRS.

Background

Some companies within a consolidated group (parent company, sister company, and/or subsidiary) have frequent transactions with other companies in the group. For example, a subsidiary may sell inventory to a sister company, or a parent may transfer intellectual property to its subsidiary. This article refers to such transactions as intercompany transactions.

Oftentimes there is an income tax consequence if an intercompany transaction is between companies that are not included in the same consolidated income tax return.

In general, the profit the seller realizes on the sale is taxed currently by the seller's local taxing authorities. For the buyer, the tax basis of the asset is typically the amount the buyer paid. In the consolidated financial statements, the profit on the intercompany sale is eliminated and the asset is carried at the value it originally had, before the intercompany sale. In this situation, a deductible temporary difference is created because the tax basis of the asset in the buyer's jurisdiction is higher than the carrying amount in the consolidated financial statements.

For the most part, US GAAP and IFRS have the same basic approach to accounting for income tax: Record current tax charges (benefits) in the period incurred, and record deferred tax charges (benefits) in the period that the temporary difference arises. The two sets of guidance diverge, however, when it comes to intercompany transactions. US GAAP specifies an exception to the basic approach: The group would not immediately recognize a current tax charge for income taxes paid on intercompany profits from the sale of an asset that will remain in the consolidated group; nor would it recognize a deferred tax asset for the increase in tax basis arising from the transaction [FAS 109, par. 9(e)]. IFRS contains no such exception.

Example

The following example illustrates the impact of the difference between US GAAP and IFRS in accounting for the income tax consequences of intercompany transactions. For the sake of simplicity, the effect of currency translation is ignored in the example.

CoA and CoB are fully owned subsidiaries of the same parent. CoA sells inventory to CoB for C150, with a profit margin of C50. Before selling the inventory to CoB, CoA had no temporary difference related to the inventory.

The seller's tax rate is 40 percent. The buyer's tax rate is 30 percent. The profit of C50 on the intercompany sale of inventory is eliminated in the consolidated financial statements. The taxing authority in CoA's jurisdiction will tax the profit on the sale in the period of sale to CoB. CoB's tax basis in the inventory is C150, the amount paid by CoB.

The following income tax accounting entries are recorded in the consolidated financial statements when the inventory is sold from CoA to CoB:

US GAAP	debit/(credit)
Deferred charge (balance sheet)	C20
Income tax payable	(C20)
<i>To defer the current tax charge due in the seller's jurisdiction. The deferred charge is a balance sheet account.</i>	

IFRS	debit/(credit)
Current tax expense	C20
Income tax payable	(C20)
<i>To record the current tax due in the seller's jurisdiction.</i>	
Deferred tax asset	C15
Deferred tax expense	(C15)
<i>To record the deferred tax asset in the buyer's jurisdiction</i>	

The group has a current tax payable of C20 (C50 margin x 40% rate) in CoA's jurisdiction as a result of the transaction.

The group also now has tax basis in the inventory of C150 in CoB's jurisdiction, which exceeds the consolidated book basis of C100 by C50. This in turn results in a potential deferred tax asset of C15 (C50 basis difference x 30% rate).

When the inventory is sold outside the consolidated group, the income tax consequences are recognized in the financial statements under US GAAP. Assume that the inventory is sold to a third party for C170. The group has a current tax payable of C6 (C20 margin x 30% rate) in CoB's jurisdiction as a result of selling the inventory to a third party.

The following income tax accounting entries are recorded in the consolidated financial statements when the inventory is sold outside the consolidated group:

US GAAP	debit/(credit)
Income tax expense	C20
Deferred charge (balance sheet)	(C20)
<i>To recognize the deferred charge in the seller's jurisdiction.</i>	
Current tax expense	C6
Income tax payable	(C6)
<i>To record the current tax expense in the buyer's jurisdiction.</i>	

IFRS	debit/(credit)
Deferred tax expense	C15
Deferred tax asset	(C15)
<i>To reverse the deferred tax asset in the buyer's jurisdiction.</i>	
Current tax expense	C6
Income tax payable	(C6)
<i>To record the current tax expense in the buyer's jurisdiction.</i>	

Summary of the impact

Ultimately, once the inventory has been sold outside the consolidated group, the consolidated financial statements under both IFRS and US GAAP will reflect the following items, as they relate to the intercompany profit:

- A charge at the seller's tax rate (because the seller was taxed on the profit in its jurisdiction)
- A charge at the buyer's tax rate for any additional profit that occurs when the inventory is sold outside the group

If the statutory rates in the seller's and buyer's jurisdictions are the same, there is typically no net impact on reported results. If the tax rates are not the same, the difference between US GAAP and IFRS is in the timing of the recognition of the intercompany sale's income tax consequences.

Under US GAAP, the parent company (1) defers the income tax consequences of the intercompany sale until the item is sold outside the group and (2) matches the income tax consequences to the profit from the third-party sale. In the case of an amortizable asset, such as intellectual property, a parent company that reports under US GAAP matches the income tax consequences of the intercompany sale to the property's "recovery through use," as the property is amortized. Therefore, the impact on the effective tax rate (i.e., the tax rate "arbitrage") occurs either at the time of the third-party sale or over time as the property is amortized.

Under IFRS, the income tax consequences of the intercompany transaction are reflected when the intercompany sale occurs. Although the profit from recovering the asset from a third party has not yet been recognized at the time of sale, the entity has nonetheless incurred/received an economic tax charge/benefit. Therefore, the effective tax rate is affected immediately, at the time of the intercompany sale.

Some financial statement users have expressed concerns about the income tax consequence of an intercompany transaction being recorded in a period when the pre-tax accounting is eliminated in preparing consolidated financial statements. The Board acknowledged this concern and added disclosure requirements to the proposed standard to address it. For example, companies must disclose: (1) deferred tax assets and liabilities, and (2) the net tax expense resulting from transfers of assets and liabilities within a consolidated group between taxing jurisdictions with different tax rates either for all transactions or for those whose terms are not customary.

Other considerations

Companies that transition to IFRS will adjust their first IFRS balance sheet so that amounts they had recognized under US GAAP reflect the recognition and measurement guidance under IFRS. For a company reporting under US GAAP, there might be income tax consequences from intercompany transactions that have been deferred. The company would write off that amount when it adjusts the opening IFRS balance sheet on the transition date. Additionally, the company would record deferred tax assets (or liabilities) not previously recorded under US GAAP, to reflect temporary differences created by intercompany transactions. The offset for both entries would be recorded against retained earnings.

Companies should also consider the impact that accounting and disclosure requirements for intercompany transactions will have on systems and processes. In particular, companies will benefit from having a process in place to track the temporary differences that arise in the buyer's jurisdiction as a result of intercompany transactions and to determine when such temporary differences have reversed.

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.

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