

# Income Tax Accounting under IFRS: A look ahead\*

## Investments in subsidiaries



## About this series

The IASB has proposed significantly changing the current IFRS standard on accounting for income tax. This is the seventh 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](http://www.pwc.com/usifrs/tax).

## Background

Temporary differences may arise between (1) the carrying amount of investments in subsidiaries and associates or interests in joint ventures, and (2) the tax basis of those investments or interests.

These differences are typically referred to as *outside basis differences*. They can occur for various reasons, including unremitted earnings, impairment of the investment, and changes in foreign exchange rates. Accounting for these outside basis differences can be complex. The IASB proposes that companies recognize deferred tax liabilities (DTLs) and deferred tax assets (DTAs) for these temporary differences, with one exception.

## The proposed changes

The exception the IASB proposes would apply to investments in foreign subsidiaries and foreign joint ventures when the investment is essentially permanent (what the IASB terms “permanent in duration”) and when it is apparent that the temporary difference will not reverse in the foreseeable future. An investment in a foreign subsidiary or foreign joint venture is essentially permanent if the investor can provide evidence that it has a specific plan to reinvest the undistributed earnings, demonstrating that remittance of the

earnings will be postponed indefinitely. In the case of such entities, a company applying the IASB’s proposal would not recognize a DTL or DTA for an outside basis difference.

The proposal does not extend the exception to investments in associates, even if an investor can control the timing of the reversal of the temporary difference. For example, an investor may have an agreement with an associate that allows the investor to control the timing of the distribution of profits of the associate. The investor, therefore, may be able to assert that the temporary difference will not reverse in the foreseeable future. It appears, however, that the proposal would still require deferred taxes to be recorded in this situation.

If an investor were to lose control of a foreign subsidiary, the proposal’s exception would not apply, meaning that the investor would recognize deferred taxes. If, on the other hand, a foreign investee were to become a subsidiary, the investor would do two things: (1) derecognize the previous deferred taxes related to the investee before it became a subsidiary and (2) apply the proposal’s guidance to determine whether to recognize deferred taxes on the subsidiary (i.e., determine whether the exception to recognizing deferred taxes would apply in that circumstance). Any change in deferred taxes would be recognized in the income statement.

## Comparison to IAS 12

The guidance in the proposal resembles the guidance in IAS 12, *Income Taxes*. With regard to *taxable* temporary differences, both grant an exception to recording a DTL for an outside basis difference. The exception in IAS 12, however, is broader than the proposal's exception. That is because IAS 12 applies to foreign *and* domestic subsidiaries, associates, and joint ventures. Under IAS 12, if two criterion are met an entity would not record DTLs for outside basis differences:

- The investor must be able to control the timing of the reversal of the temporary difference.
- It must be probable (more likely than not) that the temporary difference will not reverse in the foreseeable future.

With regard to *deductible* temporary differences, under IAS 12 a DTA should be recorded on an outside basis difference only if it is probable that the temporary difference will reverse in the foreseeable future. Under the proposal, a DTA is not recorded if the investment is essentially permanent in duration and the temporary difference will not reverse in the foreseeable future.

In its proposal, the IASB acknowledges that the exceptions in IAS 12 have no conceptual basis. However, the IASB goes on to state that calculating deferred taxes for outside basis differences in *foreign* subsidiaries and *foreign* joint ventures can be sufficiently complex that the costs outweigh the benefits. The IASB, therefore, concluded to retain an exception for foreign subsidiaries and joint ventures.

Calculating deferred taxes for outside basis differences in some 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 did not, however, extend the exception in the proposal to domestic subsidiaries. This change may have a significant impact on some companies.

Although the proposal's exception does not include domestic subsidiaries, joint ventures, and associates, a DTL might nonetheless be avoidable for a domestic subsidiary. If, under the proposal, an investor were able (and intended) to recover its investment in a domestic subsidiary without a tax consequence, the basis difference would not qualify as a temporary difference and no deferred taxes would be recorded.

## Comparison to US GAAP

The guidance in the proposal is largely consistent with US GAAP. Under FAS 109, *Accounting for Income Taxes*, a number of factors go into determining whether deferred taxes should be recorded for outside basis differences. Those factors include: the form of ownership of the interest (e.g., subsidiary or corporate joint venture as opposed to equity or cost-method investee); whether the entity is domestic or foreign; and management's intentions.

DTAs for outside basis differences of domestic or foreign subsidiaries and joint ventures are recorded only if it is apparent that the temporary difference will reverse in the foreseeable future; the starting presumption for a DTA is that it might not be recorded.

DTLs are recorded for *domestic* subsidiaries and joint ventures unless the reported amount of the investment can be recovered tax-free without significant cost. In the US, investments in domestic subsidiaries can often be recovered in a tax-free manner.

APB 23, *Accounting for Income Taxes—Special Areas*, provides guidance on recording DTLs on outside basis differences of foreign subsidiaries and foreign joint ventures that are essentially permanent. Under APB 23, there is a presumption that the undistributed earnings of a foreign subsidiary will be transferred to the parent company and be subject to income taxes in the parent company's jurisdiction. Unless the company can overcome that presumption, it should recognize a DTL. A company may overcome the presumption if it can demonstrate its intent and ability to delay indefinitely the reversal of the temporary difference (e.g., by indefinitely reinvesting the undistributed earnings).

The guidance in US GAAP for changes in control differs from the guidance in the proposal. APB 23 specifies that when a foreign equity- or cost-method investee becomes a subsidiary, the investor must "freeze" the existing DTL on the unremitted earnings of that equity- or cost-method investment. The DTL is reversed when and if those earnings are later remitted.

## Questions to consider

The proposal raises important questions about the practical application of the model for recognizing deferred taxes on investments in subsidiaries, associates, and joint ventures.

### **Would applying the proposal result in a DTA-recognition threshold for outside basis differences that differs from the corresponding thresholds under current IAS 12 and FAS 109?**

Under US GAAP (FAS 109 and APB 23) and current IAS 12, the threshold for recognizing a DTA for outside basis differences is higher than the threshold for other deductible temporary differences. If a company has no specific plan for reversing the outside basis difference in the foreseeable future, it would not record a DTA.

In the proposal, it is not clear whether having such a plan is a criterion for recording a DTA. Rather, the proposal's guidance implies that a company should recognize a DTA when (1) the investment is not permanent and (2) the tax basis of the investment is higher than the carrying amount of the investment. Whether this is meant to serve as the new threshold for recognizing a DTA for an outside basis difference, replacing the threshold in IAS 12 (and in US GAAP if the US adopts IFRS), is not clear from the proposal's language.

In addition, what is meant by "permanent" is unclear. Under the proposal an investment is considered permanent if there are specific plans to reinvest the undistributed earnings. How should that criterion be applied to investments that have losses? Also, what would the position be if only a portion of the outside basis was considered permanent? That is, while the company had unremitted earnings, they had followed a practice of bringing back only a portion of their foreign earnings but not all.

### **Does the proposal give conflicting guidance on allocating income tax expense (benefit)?**

The proposal specifies that if a change in circumstances causes a company to either reverse a DTA or DTL on an outside basis difference or record a new DTA or DTL where none had previously existed, the company must recognize income tax expense (benefit) in the income statement.

However, in describing the allocation requirements for income tax expense (benefit), the proposal specifies that the tax effect of items charged to other comprehensive income (OCI) during the year should be recorded in OCI. How do these two bits of guidance interact? Assume that upon a change in circumstances, a company records a DTL on July 1 for an outside basis difference. Assume also that a portion of the outside basis difference results from currency translation adjustments (CTA) made between January 1 and June 30. Should the tax effect of the CTA arising during that period be recorded in OCI or in the income statement? The proposal does not provide a clear answer to this question.

## 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 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.

## Contacts

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