

Income Tax Accounting under IFRS: A look ahead*

Tax basis



About this series

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

The tax basis of an asset or liability is one of the key elements in determining deferred tax assets (DTAs) and deferred tax liabilities (DTLs). A company determines DTAs and DTLs by comparing the book carrying amount of an asset or liability to the tax basis of that asset or liability, and then applying the applicable tax rate to the resulting difference.

Determining the tax basis of an asset or liability may appear straightforward, but it can be one of the more difficult aspects of calculating deferred taxes. The IASB's proposal attempts to clarify and simplify the determination of tax basis.

The proposed changes

The IASB's proposal defines "tax basis" as *the measurement, under applicable substantively enacted tax law, of an asset, liability, or other item.*

Under the proposal, a company would determine an asset's tax basis based on the tax consequences of *selling* the asset for its carrying amount on the reporting date. For example, if the tax law allows a company to take a tax deduction for the original cost of the asset upon selling the asset, the tax basis would be the original cost of the asset. The tax basis of a liability would be determined by the tax consequences of settling the liability at its carrying amount on the reporting date.

The IASB's proposal retains from IAS 12, *Income Taxes*, the notion that some items may have a tax basis but no carrying amount. For example, research and development costs may be charged in the income statement when they are incurred, but be deducted for tax purposes over time. In those cases, the balance sheet does not include an asset or liability for the research and development costs, but a future tax deduction for the costs will be available. The tax basis is the expected future tax deduction.

Part of the difficulty in determining the tax basis of an asset or liability is that the tax deductions and the tax rate available to a company that is actively using an asset may differ from the deduction and rate that would be available to the company if it were to sell the asset. What if the tax basis of the asset is based on the assumption that the company will sell the asset, but in fact the company plans to consume the asset through use (and not recover any of the asset through sale)? Under the IASB's proposal, the company would have to measure the asset, as follows:

- If the same deductions are available for *both the use* (e.g., depreciation) and *sale* (e.g., deduction for basis at time of sale) of the asset, the company would measure the DTA or DTL at the applicable rate, based on the company's expected manner of recovering the asset.
- If the deductions are available only upon the sale of the asset, the company would measure the DTA or DTL by using the rate applicable to the sale.

Assume, for example, that a company has a taxable temporary difference of C50 related to a piece of equipment (i.e., the book basis of the asset exceeds its related tax basis by C50). The cost of the equipment is deductible as it is used. The same deduction is also available when the equipment is sold, less any deductions previously taken. The company is subject to an ordinary tax rate of 40 percent and a capital gains tax rate of 20 percent. If C10 of the taxable temporary difference will reverse because of future book depreciation, and C40 of the taxable temporary difference will reverse because of a future sale, the deferred tax liability should be measured at a rate of 24 percent $[(C10 * 40\%) + (C40 * 20\%)/50]$.

The expected manner of recovery impacts only the measurement of deferred taxes (e.g., the applicable tax rate), not the tax basis.

The proposal also retains the concept that certain differences between the book carrying amount and the tax basis are not temporary differences and therefore do not give rise to a deferred tax. This concept rests on the assumption that a company will recover or settle the carrying amount of an asset or liability without tax consequences. For example, a company may accrue fines or penalties that are not deductible for tax purposes. The carrying value is different than the tax basis of the liability, which is nil. The difference, however, is not a temporary difference, because the settlement of the liability will not have a tax consequence.

Tax basis under IAS 12

Under current IAS 12, the tax basis is the amount attributed to an asset or liability for tax purposes. The tax basis should reflect the tax consequences of the method that, as of the balance sheet date, the company believes it will ultimately use to recover or settle the carrying amount of a particular asset or liability. In other words, understanding what will happen for tax purposes once the asset is eventually recovered (or once the liability is settled) is critical to determining the tax basis.

For example, if management expects to recover the carrying value of a piece of equipment by using the equipment, the tax basis is what management anticipates the tax deduction will be for the depreciation of that asset. If management expects to recover the carrying value by selling the equipment, the tax basis is what management anticipates the tax deduction will be when it sells the asset.

If management expects to recover the carrying value of an asset in a dual manner (i.e., use the asset and then sell it), the tax basis, tax rate, and related deferred taxes for the asset should reflect the dual manner of recovery. In such cases, the tax consequences of, and the temporary differences that result from, recovering a portion of the asset through use should be determined separately from the tax consequences of, and the temporary differences that result from, recovering a portion of the asset through sale. The company would have to apply the appropriate tax basis and rate to each portion of the asset.

If management expects to recover or settle assets or liabilities without tax consequences, the tax basis equals the carrying amount.

How the proposal compares to IAS 12

The accounting results under the proposal could differ significantly from the accounting results that companies currently obtain under IAS 12. The differences may be particularly evident as companies apply the “expected manner of recovery” concept. As noted above, a single asset that is accounted for under IAS 12 might have more than one deferred tax balance associated with it: one for the portion recovered through use, and one for the portion recovered through sale. Under the proposal a single asset would have only one deferred tax balance associated with it.

How the proposal compares to US GAAP

In deliberating the definition of tax basis, the IASB concluded that the definition used in practice under US GAAP is clearer and less open to interpretation than the IASB’s definition of that term in IAS 12. The definition of tax basis in the IASB’s proposal is meant to be consistent with US GAAP. The Board acknowledged that the proposed requirements are more specific than the definition of tax basis used in US GAAP, but concluded the resulting tax basis will be consistent with that used under US GAAP in most cases.

Inherent in FAS 109, *Accounting for Income Taxes*, is the assumption that a company’s assets and liabilities will be recovered or settled at their book carrying amounts. EITF 98-11¹ explains that the tax basis of an asset is the amount used for tax purposes and is not solely limited to the amounts that are deductible through depreciation. Rather, tax basis also includes any amounts under tax law that would be deductible upon sale or liquidation of the asset.

¹ Emerging Issues Task Force (EITF) 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 a property (land and building) in a business combination. The fair value of the building is C100. The property is held for the purpose of generating rental income. The company intends to sell the property after eight years, although the building has a useful life of ten years. The tax law does not allow deductions for depreciation of the building, but it does allow capital deductions of C100 when the building is sold. The residual value of the building is expected to be C20 when it is sold. The company is subject to a 40 percent ordinary tax rate and a 20 percent capital tax rate.

The deferred tax accounting under the proposal, US GAAP, and IAS 12 is compared as follows:

Accounting under the proposal and US GAAP

The accounting treatment under the proposal is consistent with the US GAAP accounting. Even though the depreciation is not deductible for tax purposes, the cost of the asset will be deductible when it is sold. At the time of the acquisition, both the book basis and the tax basis (as determined under the tax law) are C100, and no temporary difference exists. As the building depreciates for financial reporting purposes, the book basis decreases and a deductible temporary difference is created. The deduction under the tax law is available only upon sale of the asset, so the relevant tax rate is the rate applicable to the sale. Therefore, the company should record a DTA (measured by using the 20 percent rate) and assess the DTA's realizability. A valuation allowance may be necessary because of the capital nature of the DTA. Certain tax jurisdictions might not allow companies to offset capital losses with ordinary trading income.

This example is relatively straightforward. In more complicated fact patterns, it might be unclear how a company should apply the proposal.

Accounting under IAS 12

Under IAS 12, the company needs to determine the portion of the asset's carrying value that will be recovered through use and the portion that will be recovered through sale. The company then needs to determine the tax consequences of, and the temporary differences arising from, the portion recovered through use and the portion recovered through sale.

The expected residual value of C20 implies that the company expects to recover C80 of the carrying value through use. The tax basis of the portion of the asset to be recovered through use is nil because no tax deductions are available for depreciating the property. The carrying value of the asset recovered through use will result in tax payments that are higher than those that would arise if there were tax deductions in use. The nil tax basis results in a taxable temporary difference of C80 and a DTL of C32 ($C80 \times 40\%$).

The company expects to recover C20 through the sale of the asset, and a capital deduction of C100 will be available. This expected recovery results in a deductible temporary difference of C80. The resulting DTA of C16 ($C80 \times 20\%$), which represents a potential capital loss upon disposal, should be assessed for recoverability under IAS 12. Recognition of the DTA may be precluded because of the capital nature of the deduction.

As illustrated in the example, the IASB's proposed changes could have a significant impact on the deferred taxes of companies currently applying IAS 12.

Questions to consider

Several important questions come to mind in contemplating the practical application of the IASB's proposed definition of the term tax basis:

Should companies consider uncertain tax positions when determining the tax basis?

At times, a tax position that a company takes in its tax return may be uncertain. The IASB's proposal does not provide guidance on whether management should consider the expected outcome of an uncertainty when determining the tax basis of an asset or liability.

Will illogical accounting answers result from the proposal's requirement to determine an asset's tax basis by reference to an assumed sale?

Consider a tax jurisdiction that provides a tax deduction for the depreciation of an asset but no tax deduction when an asset is sold. We presume based on the definition in the proposal the tax basis in that situation would be nil even if a company were to expect to recover the carrying value by using the asset. The tax basis under both US GAAP and current IAS 12 would be the expected tax deduction for using the asset.

In contrast, consider a tax jurisdiction that provides a tax deduction for the cost of the asset only when it is sold. The proposal is clear that the tax basis would equal the cost of the asset. A DTA would arise, therefore, when the carrying amount of the asset is depreciated. What is not clear from the proposal is whether a company would need a valuation allowance if it has no plans to sell the asset. Would a company need to predict the availability of capital gains to recover the DTA if the DTA is capital in nature? Would it be acceptable to record the DTA as long as the fair value of the asset is greater than or equal to the tax basis? The proposal does not answer these questions.

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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