

Income Tax Accounting under IFRS: A look ahead*

Allocating income taxes



About this series

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

Allocating income tax expense (or benefit) to the various components of comprehensive income and equity is arguably one of the most challenging aspects of accounting for income taxes.

Both IAS 12, *Income Taxes*, and FAS 109, *Accounting for Income Taxes*, include allocation methodologies; however, those methodologies significantly differ. One of the more significant differences is the allocation of an income tax expense (or benefit) that is recorded in one year and relates to an event that occurred in a prior year.

IAS 12 generally requires companies to allocate income tax expense (or benefit) to the area where the pre-tax item was initially charged or credited (sometimes referred to as “backwards tracing”). FAS 109 generally requires companies to record income tax expense (or benefit) in continuing operations, because FAS 109 usually prohibits backwards tracing. There are, however, situations where FAS 109 requires backwards tracing, such as for certain tax effects related to stock based compensation.

<p>The IAS 12 approach to allocating income tax expense (or benefit) is quite simple to articulate and the conceptual basis is easy to understand. In essence, the income tax expense or benefit follows the pre-tax item, regardless of the period in which each is recorded.</p>	<p>For example, a company reporting under IAS 12 records an unrealized loss on available-for-sale securities in OCI in the first year.</p> <p>The unrealized loss is a deductible temporary difference, for which the company does not record a deferred tax asset (DTA) because realization of the benefit isn’t “more likely than not”.¹ As a result, the unrealized loss is recorded in OCI, with no corresponding tax benefit.</p> <p>In the second year, there is no change in the unrealized loss. However, the company determines that the DTA is now realizable. The company records the corresponding deferred tax benefit in OCI, to follow the pre-tax item to which it relates.</p>
<p>While the IAS 12 approach is relatively easy to understand, it can be quite difficult to apply.</p>	<p>For example, a company has several DTAs for which the company has recognized zero benefit (i.e., realization of the benefit is not “more likely than not”). If in a subsequent period the company determines it can realize a portion of the DTAs, the company will need to determine which portion relates to items recognized outside the income statement. This determination can be quite difficult, especially when the DTA includes loss carryforwards. When allocating the tax benefit to the loss carryforward, the company will need to determine which portion of the loss carryforward arose from items recognized outside of the income statement.</p> <p>The IAS 12 backwards-tracing approach can also be challenging when a rate change is enacted. That is because it can be difficult to determine which portion of the effect of the rate change relates to items recognized outside the income statement.</p>

¹ The net DTA under IAS 12 is similar to the net DTA under FAS 109. However, IAS 12 does not use a “valuation allowance;” a DTA is recognized only if it is more likely than not that the benefit will be realized. Under FAS 109, a company records the full DTA and then reduces it by a valuation allowance if it is more likely than not that the benefit, in whole or part, won’t be realized. The IASB has proposed adopting the FAS 109 approach.

The FAS 109 approach is more difficult to articulate and can be complicated to apply. Under that approach, a company first computes the total tax expense (or benefit), and then computes the tax expense (or benefit) attributable to continuing operations. After that, the company allocates among the other financial statement components the difference between the total tax expense (or benefit) and the amount allocated to continuing operations.

This approach is further complicated by exceptions to the general process. For example, certain tax effects are specifically allocated to continuing operations. And, companies must consider income from other components (e.g., discontinued operations) when determining the amount of tax benefit to allocate to a loss from continuing operations.

The FAS 109 approach is easier to apply when there is a change in the value of DTAs and deferred tax liabilities (DTLs) that were generated from activity in a prior year.

Using the facts in the previous example for IAS 12 purposes, the reversal of the valuation allowance would not be backwards-traced to OCI. In determining where in the financial statements to record the tax benefit derived from releasing the valuation allowance, the company must look to the reason behind the release.

If the company determines that the DTA was realizable because of projections about income in *future* years, the benefit will be recorded in continuing operations. However, if the company realized the DTA by using income in the current period, the company would record the benefit in the same location as the pre-tax income that allowed for realization.

The FAS 109 approach also requires that companies record certain other tax effects (e.g., changes in tax laws or rates) in continuing operations, which helps reduce complexity to a degree by eliminating the need to determine where the original tax effect was recorded.

The proposed changes

The question of where to record income tax expense (or benefit) is a difficult one. The IASB has noted that backwards tracing might not be appropriate in all situations and even considered developing a new method of allocating income tax expense. Given the complexities and the unavoidable arbitrariness that would exist in any method, the IASB decided it will adopt the approach used in FAS 109. However, the IASB also included an IAS 12-based model in its proposal and is asking constituents to comment on each. The IASB believed it would be beneficial to solicit feedback on both models in an effort to avoid having to re-expose the proposal before issuing a final standard.

Questions to consider

Companies should consider the financial reporting results of each model—the IAS 12 backwards-tracing model and the FAS 109 non-backwards-tracing model—for different scenarios, such as the valuation allowance reversal illustrated above. Companies should consider which model provides the most meaningful information to financial statement users.

Given (1) the complexities associated with both models and (2) financial-reporting results that, at times, may appear counterintuitive, should the IASB consider a third alternative—reporting income taxes in a single-line item?

Reporting income taxes in a single line item would eliminate the arbitrary allocation and reduce complexity. In some ways, this alternative model might provide more meaningful information to financial statement users, since it would report the total income tax effect of all company transactions for the period.

On the other hand, it would increase volatility in a company's effective tax rate. Would the decreased complexity that results from reporting all income tax in a single line item sufficiently compensate for an increase in the volatility of the effective tax rate? Would it be sufficient for companies to explain such

volatility in their disclosure of the reconciliation of the effective tax rate? Such a disclosure is likely to be required in any event because of increased volatility in the rate attributable to other standards. For example, the relatively new standard on accounting for business combinations contains provisions that will increase volatility in the effective tax rate. Under IFRS, the current (and proposed) income tax accounting for share-based compensation increases volatility in the effective tax rate beyond the volatility experienced under current US GAAP.

The IASB noted that it simplified the requirements of the FAS 109 model without changing the basic approach. Companies should consider whether the language used by the IASB would produce different results than the FAS 109 model. Companies should also consider whether a FAS 109 model with fewer exceptions would be beneficial. The requirement to backwards trace certain items combined with other exceptions in the FAS 109 model would increase the overall complexity and arbitrariness of the allocation process.

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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