Global Tax Accounting Services

Tax Management and Accounting Services

Focusing on tax accounting issues affecting businesses today

Global Tax Accounting Services newsletter

April – June 2013

pwc

Dear readers

The Global Tax Accounting Services newsletter is a quarterly publication from PwC's Global Tax Accounting Services Group and highlights issues that may be of interest to tax executives, finance directors and financial controllers.

In this release we discuss a variety of accounting and reporting developments and the related tax accounting considerations. We also draw your attention to some significant tax law and tax rate changes during the quarter ended 30 June 2013 and some important tax accounting issues to consider.

For questions related to items discussed in this newsletter, for a comprehensive discussion of tax accounting issues affecting businesses today, or for general tax accounting questions, please contact your local PwC team or the relevant Tax Accounting Services network member listed at the end of this document.

Readers should not rely on the information contained within this newsletter without seeking professional advice. For a comprehensive summary of developments, please consult with your local PwC team.

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Accounting- and reporting-related updates

This section offers insight into the most recent developments in accounting standards, financial reporting and related matters along with the tax accounting implications.

Revised exposure draft on leases

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a revised exposure draft on leases (the Exposure Draft). The 16 May Exposure Draft attempts to address criticisms of the 2010 exposure draft, yet still meet the key objective of recognising leased assets and the related liabilities on the balance sheet.

Leasing transactions are flexible arrangements that are used as a tool by many organisations to secure the use of an asset with payments typically made over time, to borrow against the full fair value of a property and, sometimes, to unlock the value of appreciated property while continuing to use it.

The following provides an overview of the proposals outlined in the Exposure Draft from the perspective of both a lessee and a lessor.

Lessee accounting

The Exposure Draft requires lessees to recognise a right-of-use asset and a lease liability for virtually all leases, initially measured at the present value of lease payments, with the exception of short-term leases.

A lease is considered short-term if the lease has a maximum possible term of 12 months or less (including any options to renew or extend). Rent-free periods would also be considered when determining if the lease is short term.

The income statement will reflect a front-loaded expense pattern (similar to today's capital leases) or a straight-line expense pattern (similar to current operating leases). The right-of-use asset represents the lessee's leasehold interest in the underlying asset, and the liability represents the lessee's obligation to pay future rents.

Lessor accounting

Lessors have always been required to record an asset. However, proposals in the Exposure Draft would require de-recognition of some or all of the leased asset and recognition of a lease receivable and its interest in the asset's residual value. A lessor's income statement will reflect straight-line income (similar to current operating leases) or the financing approach (similar to a capital lease today).

In some cases the execution of a lease will permit immediate profit recognition on the portion of the asset 'sold', with profit on the residual deferred until the underlying asset is re-leased or sold. This is a change from current accounting standards.

In addition to any upfront profit, interest income on the receivable and residual asset is recognised over the lease term.

Tax accounting and other implications

While various countries' tax laws may not be directly impacted by the proposals in the Exposure Draft, accounting changes may directly impact an organisation's computation of deferred income tax assets and liabilities and other non-income-based taxes, as well as accounting systems, processes and controls.

Adoption of a standard based on the Exposure Draft will likely create a number of differences between financial accounting and tax accounting (book/tax differences), such that companies may be required to record new, or adjust existing, deferred income tax assets and liabilities.

For lessees subject to US tax, for example, the Exposure Draft would require recognition of the following items on the income statement related to financing leases:

- Interest expense on the liability to make lease payments
- Amortisation of the right-of-use asset
- Changes in liability resulting from reassessments
- Impairment losses

Generally, with regard to operating leases subject to tax in the United States, a deferred income tax asset is recorded for the difference between the cash rent deducted for income tax purposes and the US GAAP or IFRS rent accrued for financial accounting purposes. The Exposure Draft will likely require companies with this fact pattern to:

- reverse the income statement items outlined above;
- take into account the appropriate tax adjustment based on their method of accounting for such leases; and
- adjust existing deferred income tax assets and liabilities accordingly.

Lessees will need to consider if they are required to adjust existing deferred taxes as part of the cumulative balance sheet adjustments recorded at the transition date. The tax laws in every jurisdiction will need to be considered independently to determine the appropriate deferred tax adjustments.

Under the proposed standard, the concept of an operating lease no longer exists. As such, a right-of-use asset and liability will be recorded for all leases other than those considered short term. Leveraged lease accounting is eliminated altogether. Property lessors will likely see little difference in the income statement for leases classified as operating today. However, lessors leasing assets other than property are likely to find their income accelerated relative to operating leases under the current standard. As a result, existing deferred income taxes recorded by a lessor may need to be adjusted to reflect the proposed de-recognition approach.

As the FASB and IASB await comments on the Exposure Draft, companies should consider the following action items in light of the proposed standard:

- Identify the key stakeholders (e.g. financial reporting, tax, treasury, technology) and educate each department on the proposed standard
- Identify and catalogue all existing lease contracts and embedded leases to determine what data gaps exist
- Standardise data for mapping and migration to a long-term digital solution
- Estimate the financial statement impact of the transition, including the effect on deferred income taxes and cash taxes

IFRIC 21 levies

On 20 May 2013, the IASB issued IFRIC 21, *Levies*, an interpretation on the accounting for levies imposed by governments. IFRIC 21 is an interpretation of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 sets out criteria for the recognition of a liability, one of which is the requirement for the entity to have a present obligation as a result of a past event, known as an obligating event. The interpretation clarifies that the obligating event that gives rise to a liability to pay a levy is the activity described in the relevant legislation that triggers the payment of the levy. IFRIC 21 sets out the accounting for an obligation to pay a levy that is not an income tax. Levies are imposed by governments in accordance with legislation and are often measured by reference to an entity's revenues, assets or liabilities (e.g. 1% of revenue).

The interpretation addresses diversity in practice around when the liability to pay a levy is recognised. Practice differs particularly when a levy is measured based on financial data relating to a period before the date on which the obligation to pay the levy arises.

IFRIC 21 addresses the accounting for a liability to pay a levy recognised in accordance with IAS 37, and the liability to pay a levy whose timing and amount is certain. It excludes income taxes within the scope of IAS 12, *Income Taxes*. Its application to liabilities arising from emissions trading schemes is optional.

IFRIC 21 addresses the following issues:

What is the obligating event that gives rise to a liability to pay a levy?

- The obligating event that gives rise to a liability to pay a levy is the event identified by the legislation that triggers the obligation to pay the levy.
- The fact that an entity is economically compelled to continue operating in a future period, or prepares its financial statements under the going-concern principle, does not create an obligation to pay a levy that will arise from operating in the future.

When is a liability to pay a levy recognised?

- A liability to pay a levy is recognised when the obligating event occurs. This might arise at a point in time or progressively over time.

Is the accounting at an interim reporting date the same as at year end?

- The same recognition principles apply in interim and annual financial statements. The obligation should not be anticipated or deferred in the interim financial report if it would not be anticipated or deferred in annual financial statements.
- The interpretation provides examples that illustrate the accounting for the liability to pay a levy.

IFRIC 21 will affect entities that are subject to levies that are not income taxes within the scope of IAS 12. These are common in many countries and in many industries including banking, retail and transportation, to name a few.

IFRIC 21 is effective for annual periods beginning on or after 1 January 2014 and should be applied retrospectively. Earlier adoption is permitted.

Tax transparency and country-by-country reporting

On 27 June 2013, the Capital Requirements Directive 'CRD IV' was published in the EU's Official Journal (2013/36/EU). This publication confirms the timetable for application of its key provisions, including the provision for country-by-country tax reporting for banks. The directive must be incorporated into the national laws of the member states by 31 December 2013 (except for certain provisions).

CRD IV Directive and country-by-country reporting

The CRD IV Directive introduces new EU rules on bankers' remuneration and bonus caps, capital management and enhanced corporate governance and transparency, including country-by-country tax reporting.

Article 89 of the CRD IV Directive stipulates that member states shall require institutions to disclose by member state and by third country where they have an establishment, on a consolidated basis for the financial year:

a) Name(s), nature of activities and geographical location

b) Turnover

c) Number of employees on a full-time equivalent basis

d) Profit or loss before tax

e) Tax on profit or loss

f) Public subsidies received

Institutions must make public disclosure of the information referred to under paragraphs (a), (b) and (c) for the first time on 1 July 2014. By 1 July 2014, all global systemically important institutions authorised within the EU will submit to the European Commission (the Commission) the information referred to in paragraphs (d), (e) and (f) on a confidential basis.

The Commission, after consulting with the European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority, will conduct a general assessment of potential negative economic consequences of the public disclosure of such information, including the impact on competitiveness, investment and credit availability and the stability of the financial system. The Commission will report to the European Parliament and Council on this by 31 December 2014. The Commission has the power to propose amendments or deferral in the event it identifies significant negative effects. Subject to this report, all institutions will be required to make public disclosure of all six elements from 1 January 2015.

The information referred to above under Article 89 will be audited in accordance with the EU's Accounting Directives and will be published, where possible, as an annex to the annual financial statements or, where applicable, to the consolidated financial statements of the institution concerned.

Under Article 90 of the CRD IV Directive on the public disclosure of return on assets, institutions will disclose in their annual report (among the key indicators) their return on assets, calculated as their net profit divided by their total balance sheet.

EU Accounting and Transparency Directives and country-by-country reporting

On 29 June 2013 the new EU Accounting Directive (the Accounting Directive) was also published in the EU's Official Journal (2013/34/EU). This Directive regulates the information provided in the financial statements of all limited liability companies registered in the European Economic Area (EEA). It also includes a (non-financial) country-by-country reporting provision. Listed and large unlisted extractive (oil, gas and minerals) and logging companies will need to disclose information on a country-by-country and project-by-project basis. The following types of (material) payments will be reported:

a) Production entitlements

b) Taxes levied on the income, production or profits of companies

c) Royalties

d) Dividends

e) Signature, discovery and production bonuses

f) Licence fees, rental fees, entry fees and other considerations for licences and / or concessions

g) Payments for infrastructure improvements

The information disclosed on payments to governments will be publicly available through the stock market information repository or the business registry in the country of incorporation (in the same way as financial statements are made available).

Member states will have two years to incorporate the Accounting Directive into their national legislation. The system will be reviewed within three years, and the review could result in extending the obligation to other industry sectors.

The European Parliament's Rapporteur on this dossier, Raffaele Baldassarre (EPP / Chr. Democrats, Italy), is due to present his draft report to the European Parliament on the directive later this month.

To ensure a level playing field within the EU, the draft revised directive on transparency requirements for issuers of securities on regulated markets (Directive 2004/109/EC), known as the 'Transparency Directive', introduces the same disclosure requirement as the Accounting Directive. This includes all companies listed on EU regulated markets, even if they are not registered in the EEA and incorporated in a non-EU country.

FASB ratifies consensus on netting unrecognised tax benefits against loss or other tax carryforward assets

The Financial Accounting Standards Board (FASB) ratified the accounting guidance proposed by the Emerging Issues Task Force (EITF) for Issue 13-C, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*.

This new standard requires the netting of unrecognised tax benefits (UTBs) against a deferred tax asset for a loss or other carryforward that would apply in settlement of the uncertain tax positions. Under the new standard, UTBs will be netted against all available same-jurisdiction loss or other tax carryforwards that would be utilised, rather than against only carryforwards that are created by the UTBs. This is a departure from the original guidance provided by the FASB staff.

The new standard requires prospective adoption but allows optional retrospective adoption (for all periods presented). For public entities, the standard must be adopted in annual reporting periods beginning after 15 December 2013 and interim periods therein. Private companies must adopt the standard in annual periods beginning after 15 December 2014 and interim periods therein. Early adoption is permitted. The standard does not require any new or additional recurring disclosures.

Recent and upcoming major tax law changes and the tax accounting implications

This section focuses on major changes with tax accounting implications that may be of interest and related discussion about how they should be accounted for. It is intended to increase readers' awareness of the main global tax law changes during the quarter, but does not offer a comprehensive list for all countries.

Some tax rate changes

Country	Prior Rate	New Rate
Cyprus (CIT)	10%	12.5%[1]
Egypt (CIT)	20%	25%[2]
Denmark (CIT)	25%	24.5%[3]
Puerto Rico	30%	39%[4]

Other important considerations in tax law changes

Australia

The following proposals were introduced during the second quarter of 2013:

- Tighter thin capitalisation rules:
  - Changed the safe harbour limits for general entities by a reduction in the general limit from 3:1 to 1.5:1 on a debt-to-equity basis (or 75% to 60% on a debt-to-total-asset basis).
  - For outbound investors, a reduction in the worldwide gearing ratio from 120% to 100% and extend it to inbound investors
  - An increase to the de minimis threshold from AUD 250,000 to AUD 2 million of debt deductions.
- Remove the immediate deduction for costs of mining rights and information acquired from non-government third parties, and instead provide a tax deduction over the shorter of 15 years or the effective life of the asset.
- Removal of deductions for interest costs that fund investments of offshore companies generating non-assessable income to Australian investors.
- Dividends paid from 'debt interests' (i.e. certain redeemable preference shares) held in offshore subsidiaries will no longer be exempt from Australian tax.
- Refine the tax consolidation rules to prevent deductions to joined group from 'deductible liabilities' (i.e. leave provisions) held by a joining entity and ensure that non-residents cannot transfer subsidiaries to existing consolidated groups to secure a tax-cost uplift.

Belgium

The following proposals were introduced during the second quarter of 2013:

- Currently, a.o. shares qualifying as financial fixed assets according to Belgian GAAP should be deducted from the basis for calculating the notional interest deduction (NID). The government has proposed during the budget negotiations in 2013 to also exclude shares, which qualify as cash investments according to Belgian GAAP, from the NID calculation basis, provided that the shares can benefit from the Belgian dividends received deduction regime.

Croatia

With the date of accession to the European Union, the Republic of Croatia is committed to harmonising VAT Law with the EU acquits communautaire. From 1 July 2013, movement of goods and services between Croatia and the EU will no longer be considered as an import/export. There will be no borders, custom clearings and custom compliance (i.e. custom declarations).

The goods shipped and transported to a business in another EU country will be considered intra-community goods (those that have been released for free circulation in one of the EU countries, including Croatia) without the necessity for customs formalities.

Canada

On 26 June 2013, Bill C-60 was enacted which extended, for two years, the temporary accelerated capital cost allowance for new investments in machinery and equipment by Canadian manufacturers.

On 26 June 2013, Bill C-48 received Royal Assent, and included the following provisions:

- Implemented a variety of outstanding technical tax amendments, including legislative proposals released on 18 December 2009, and 19 August 2011, relating to the taxation of Canadian multinational corporations with foreign affiliates
- Tax technical changes relating to real estate investment trusts
- Technical changes relating to the deductibility of contingent amounts, withholding tax that applies to certain interest payments made to non-residents, and certain life insurance corporation reserves
- Implemented income tax measures proposed in the 2010 federal budget and released for comment on

[1] This change was enacted on 29 April 2013 and is effective from 1 January 2013.

[2] This change was enacted on 18 May 2013 and is effective from 1 June 2013.

[3] This change was enacted on 27 June 2013 and is effective from 1 January 2014. The rate reduces to 23.5% as of 1 January 2015 and 22% on 1 January 2016.

[4] This change was enacted 30 June 2013 and is effective retroactive to 1 January 2013.

7 May 2010, and 27 August 2010, relating to:

- The taxation of non-resident trusts and interests in offshore investment fund property
- Specified leasing property
- Conversions of specified investment flow-through trusts and partnerships into corporations
- Foreign tax credit generators
- Tax avoidance transactions information reporting regime

Denmark

The following proposals were enacted on 27 June 2013:

- A reduction in the corporate tax rate from 25% to 22% over a three-year period.

  2014: 24.5%
  2015: 23.5%
  2016 and beyond 22%

- Danish entities are entitled to a 'refund' of the value of tax losses, not exceeding DKK 25 million, from research and development in the 2015 assessment year. The current limit in effect is DKK 5 million.

Egypt

A corporate tax rate change from 20% to 25% was enacted on 18 May 2013. The previous rate was 20%, but was 25% on companies whose tax pool exceeds EGP 10 million. Amendments to the annual salary tax brackets and amendments to the personal exemptions applicable for the payroll salary tax also were enacted in May.

France

No changes in tax law have occurred since the first quarter of 2013; however, an update to the CICE (competitiveness & employment) tax credit section was made. Under US GAAP and IFRS, this tax credit is recognised and measured as a component of pre-tax income. Under French GAAP, there is a choice to account for the tax credit as a component of pre-tax income or as a component of income tax expense. This option has been confirmed with the 23 May 2013 information note from the French National Association of Statutory Auditors (Compagnie Nationale des Commissaires aux Comptes - CNCC), which provides information on accounting for and disclosure of this new tax credit in statutory accounts.

Germany

Tax Bill 2013 was enacted on 26 June 2013, which included the following provisions:

- No tax exemption for dividend income if the payment is treated as a business expense at the level of the foreign subsidiary (may affect hybrid financing structures), effective for dividends received in fiscal years beginning after 31 December 2013.
- Retroactive mergers – positive income of the merged entity which arose in the retroactive period cannot be offset by NOLs / current losses of the receiving entity. Effective for mergers where registration with commercial register is filed after 6 June 2013.
- Ensuring taxation right of Germany for certain income of shareholders in partnerships (applicable for all open tax years).
- Adoption of authorised OECD approach (AOA) basic principles into German tax law (effective for fiscal years beginning after 31 December 2012).
- Amendment of real estate transfer tax (RETT) rules (applicable for transactions after 6 June 2013).

Gibraltar

A 10% tax on interest receivables over GBP 100,000 associated with intercompany loans was enacted on 1 July 2013.

Greece

Ministerial Circular POL 1134/2013 was issued on 6 June 2013 and included the following clarifications:

- The two-year minimum holding period, set as condition for application of the Parent - Subsidiary Directive (i.e. exemption on dividend withholding tax) is now reviewed retrospectively.
- Contrary to practice so far, dividends may be distributed to a parent company qualifying for exemption even before such parent company has held the minimum 10% in the distributing company for a period of two years. In cases where the percentage drops before the two-year period has elapsed, the withholding tax plus penalties will be imposed.
- The same exemption applies to dividends received by a Greek parent from a foreign EU subsidiary.
- It is clarified that both above exemptions apply also to companies established in Switzerland.

Israel

Proposed corporate tax rate increase from 25% to 26.5%.

The Israeli government has also issued a temporary provision providing discounted corporate tax rates on accumulated profits distributions for a limited time period.

In addition, the income tax authorities have issued guidelines regarding deemed dividends.

Italy

Law Decree 76/2013 was enacted on 28 June 2013, which increases the advance payments from 100% to 101% (101% of the tax due for the previous tax period). This change applies on the second advance payments, and tax payers should consider when their payments are due in order to comply with the new percentage.

Malta

The Maltese participation exemption has been extended to cover branch profits. This exemption applies to income as well as to gains derived by a company registered in Malta which are attributable to a permanent establishment (including a branch) situated outside Malta and to gains derived from the transfer of such a permanent establishment.

New Zealand

In some situations, IFRS require special treatment for interest-free and reduced-interest loans. This can involve the recognition of a one-off adjustment to the value of the loan and notional payments (or receipt) of interest. It is proposed that these IFRS adjustments do not have a tax effect. The amendment confirms that positive adjustments are not taxable and negative adjustments are not deductible.

Norway

The following proposals were introduced during the second quarter of 2013:

- The proposed corporate tax rate would be reduced from 28% to 27% with effect from 1 January 2014.
- Announcements are expected to further reduce the corporate tax rate as well.
- The petroleum special tax rate has been proposed at 51% (previously this rate was 50%).
- A proposal to limit the deduction for interest on intercompany debt to not exceed 25% of taxable income in the relevant year (subject to certain adjustments). Unused deductions for interest can be carried forwarded for five years. The new 25% limitation would apply to the interest cost allocated to onshore deductions. Only interest cost allocated offshore will be deductible as of 1 January 2014.
- Limitation on the deduction for uplift in the petroleum special tax from 7.5% annually for four years to 5.5% annually for four years. These changes are proposed to take effect on investments made on or after 5 May 2013.

The proposed decrease in the corporate tax rate along with a proposed increase in the petroleum special tax has been established to close the increasing gap between onshore and offshore companies.

Portugal

A proposal was introduced for the Extraordinary Tax Credit for Portuguese investment performed in 2013 (CFEI):

- The CFEI corresponds to a deduction of corporate income tax equal to 20% of the eligible investment made (with a limit of 70% of the tax due), as long as the following conditions are met:
  - Maximum investment of EUR 5 million.
  - Investments must be made between 1 June 2013 and 31 December 2013.
  - The investment needs to be operating until the end of the tax period starting on or after 1 January 2014.
  - There is a carryforward possibility in the following five tax periods where excess credits exist.
  - Investments eligible for the CFEI must consist of tangible fixed assets and depreciable intangible assets, acquired first-hand, with some exceptions (i.e. land and light passenger cars).

Puerto Rico

On 30 June 2013, Puerto Rico enacted Act 40 which included the following provisions:

- The surtax deduction available to corporations to compute the additional surtax will be decreased from USD 750,000 to USD 25,000. The normal tax rate will remain at 20%. However, the surtax rates will revert to the rates established by the 1994 Code, which range from 5% to 19%, making the top corporate income tax rate 39%.
- The alternative minimum tax (AMT) has changed significantly and will now include additional components in order to calculate the tentative minimum tax.
- The NOL carryover period will be increased from 10 years to 12 years for losses incurred in taxable years that commenced after 31 December 2004 and ended before 1 January 2013. The carryover period for NOLs incurred during taxable years commencing after 31 December 2012 will be 10 years. The carryover period for losses incurred before 31 December 2004 remains at seven years. In the case of taxpayers taxed as corporations, the NOL deduction for regular income tax purposes will be limited to 90% of the net taxable income.
- Establishes a moratorium on various tax credits, effective for taxable years commencing after 31 December 2012 and before 1 January 2016. This moratorium does not apply to tax credits granted or purchased before 30 June 2013; however, the credit claimed will be limited to 50% of the income tax liability. Finally, in order to be able to claim such tax credits after the moratorium period ends, any person holding tax credits has to file an information return on or before 31 July 2013.

Quatar

Certain developments are expected with respect to the taxation of profits and gains arising from shares and securities listed on the Qatar Exchange.

Slovenia

On 1 June 2013, amendments to the Corporate Income Tax Code were enacted:

- Allowance for investments in equipment and intangible assets increased from 30% to 40%, with the cap being abolished.
- General tax allowance for research and development increased from 40% to 100%.
- The use of retained tax losses is limited to a maximum of 50% of the actual tax base as of 1 January 2013.

Spain

The following proposals were introduced during the second quarter of 2013:

- An investment incentives benefits proposal was made which would allow companies with a turnover of less than EUR 10 million to deduct up to 10% of the profits generated during the tax period. The deduction would be allowed in the tax year in which the profits are reinvested in the economic activity of the company.
- A tax incentive was made which would allow for a new R&D incentive related to business innovation. It is not necessary to be in a taxpaying position to benefit from the incentive. The maximum amount of the incentive is capped at EUR 3 million per year.
- A proposal with regard to the tax incentives for the transfer of intangible assets ('Patent Box') was made regarding the tax treatment of income from certain intangible assets. The incentives will be based on the net income derived from the transfer of the intangible asset and not on the income generated from the intangible asset, which is a substantial reduction of this incentive. In addition, an expansion of the tax regime which applies to intangible assets acquired (under certain limitations) and in cases of transmission of intangible assets.
- Amendment to the Income Tax Act for the purpose of disallowing, for all companies, the deductibility of impairment losses on securities representing the equity of entities, listed and unlisted. Further, losses earned abroad through a permanent establishment are considered non-deductible except in the case of the transfer of the loss or the suppression of activities. Transitional rules will apply for tax years beginning prior to January 2013.
- Amendment of the Income Tax Act to extend for 2014 and 2015 the temporary measures established in 2012, which expire December 2013. Those measures, among others, include the minimum instalment payment of 12% for companies with a turnover in excess of EUR 20 million, the limitation to offset tax losses, and to limit the deductibility of goodwill.
- Amendment of the Income Tax Act to extend for 2014 and 2015 the requirement to include in the calculation for instalment payment purposes income ordinarily exempt under the exemption regime related to dividends and income on the transfer of shares.

Vietnam

Effective 1 January 2014, the standard corporate income tax rate is reduced to 22%, which will be further reduced to 20%, effective 1 January 2016.

Tax accounting refresher

Constantly changing tax laws present a barrier to efficient tax management on a global scale, particularly when the related tax accounting considerations must be addressed in the reporting period of enactment or substantive enactment.

Tax incentives designed to promote research and development investment tax credits

Background

To stimulate innovation and investment, particularly in the current challenging economic climate, many countries have chosen to implement various forms of research and development (R&D) incentives. These can take the form of credits, 'super' deductions, a patent or innovation box or even cash grants. Some jurisdictions also provide relief in the form of reduced tax for income associated with technology-based intellectual property.

The financial reporting consequences of what may be viewed as economically similar tax law changes can vary depending on the particular terms and operation of the legislation.

Although many incentives, in an overall sense, are intended to achieve similar economic goals, the financial reporting impacts can sometimes vary more widely. At the same time, a particular legislative approach can be influenced by a number of other government institutional factors such as budget implications and legal risks or concerns as to whether a particular incentive program may be challenged as unfair.

As the number and scope of such incentives increases, it is becoming ever more important for tax executives to understand the implications of the incentives and how they impact the rest of the business.

The current global picture

R&D credits mechanisms have been implemented in Australia, Austria, Belgium, Canada, France, Ireland, Italy, Japan, Korea, Mexico, the Netherlands, Portugal, Spain, Turkey the United Kingdom and the United States.

Although the Mexican government has disallowed the credit, it has replaced it with certain funds for such activities. The UK scheme, on the other hand, is new and was substantively enacted for IFRS purposes and enacted for US GAAP purposes in July of this year.

Incentives structured as 'super' deductions are currently in place in Brazil, China, Czech Republic, Denmark, Hungary, India, the Netherlands, Poland, Romania, Russia, Singapore, South Africa, Turkey and the United Kingdom.

Patent or innovation box regimes are currently available in Belgium, China, France, Hungary, Luxembourg, the Netherlands, Spain, Switzerland, Turkey and the United Kingdom.

In Turkey, the patent box regime is valid only for the intellectual property (IP) from R&D activities carried out in technology development zones. As with the R&D credit, the UK's patent box regime has only just been implemented.

Research & Development credits

Relief for R&D expenditures typically takes the form of a credit or a 'super' deduction. As far as the accounting is concerned, there are broadly two scenarios. Either the benefit falls within the scope of IAS 12 and ASC 740 and is accounted for in determining income tax expense, or it falls outside of the income tax standards and is accounted for in determining pre-tax income. However, even where the amount forms part of pre-tax income, the accounting may not always be the same.

The first question to ask is therefore whether the credit or benefit is within the scope of IAS 12 and / or ASC 740. The determining factor regarding whether the credit or benefit is within the scope of IAS 12 and / or ASC 740 is how the benefit is received and whether there is any connection to income tax liability. Generally, if the benefit or incentive can be claimed only on the income tax return and can be realised only through the existence of taxable income, the application of income tax accounting is warranted. The US Advanced Energy Manufacturing Credit (AEMC) is an example of this type of accounting.

When a benefit is not dependent on the existence of taxable income or income tax payable, and the credit is fully refundable, ASC 740 and IAS 12 are generally not applicable. Under these, facts the relief should generally be accounted for in pre-tax income.

The refundable feature of the credit is similar to a government grant or assistance as an incentive to encourage certain behaviour or investment. The settlement mechanism for providing the subsidy does not affect the accounting, and the refund does not belong in the tax provision because, unlike a typical tax refund, it is not dependent upon future taxable income or loss or income tax payable.

Several additional questions may be considered when analysing whether the accounting for a credit or incentive is within the scope of income taxes:

- Is there a direct relationship between the benefit received and taxable income or income tax liability otherwise due?
- How is the benefit claimed?
- If there is more than one manner in which the benefit may be obtained, is the election irrevocable?
- Can the benefit be sold?
- Is the benefit refundable? For example, if a benefit claimed on an income tax return exceeded tax otherwise due (including as a result of a subsequent loss carryback), would the benefit nonetheless be refundable?
- Is the benefit taxable? Does taxability depend upon the manner in which the benefit is obtained?

These and other questions help to determine which overall accounting model is most appropriate for recognition of the benefit.

The application of income tax accounting is generally warranted if a particular credit or incentive can be claimed only on the income tax return and can be realised only through the existence of taxable income or income tax otherwise due. If not dependent on income taxes payable or taxable income, and if refundable, the benefit should generally be accounted for under the government grant accounting model. Some credits or incentives may be refundable through the income tax return or in some other manner (e.g. direct cash from the government or offset against other taxes such as excise or VAT) at the option of the taxpayer. In general, regardless of the method a company chooses to monetise the benefit, such an option would cause the accounting to be within the pre-tax accounts. However, there may be some exceptions. For example, if the method of monetising the benefits could result in significantly different taxation or other economic consequences of the benefit, it may be that the accounting model will follow the method of monetising the benefit. In this regard, it is also important to understand whether the choice to monetise (or not) is irrevocable.

Credits such as the French and Irish R&D credits can be or are refundable in nature. Where this is the case, and there is no connection to income taxes payable or taxable income, we believe the benefit should be accounted for as income (i.e. 'above the line'). The relevant requirements to consider for an 'above the line' accounting under IFRS treatment are those set out IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*. IAS 20 would require the credit to be recognised 'above the line' in the period in which the related R&D costs are recognised and recovery is reasonably assured.

US GAAP does not provide specific guidance on grant accounting, but practice has generally looked towards the guidance in IFRS.

In the United Kingdom, the government consulted on new R&D relief regime before it was enacted. As part of the consultation, views from constituents were sought as to whether the proposals could be accounted for 'above the line'. The legislation was ultimately crafted in such a way that the government grant accounting model applied.

Timing

There are certain credits or incentives that require an application and / or approval process which raises the question, for credits reported in the income tax accounts, of when the benefit should be recorded.

We believe that if there is discretion on the part of the taxing authority or any government official to deny the application or alter its terms, the effects of the credit / incentive should not be reflected in the financial statements until the formal acceptance agreement is received. As such, we believe the tax effects should be recorded in the period in which the acceptance agreement is received. If the election is within the company's control, and there are no conditions attached to it, a company should account for credits currently if it can demonstrate its intention to make the election for the period(s) in question.

Grant accounting

Where IAS 20 applies, a grant is recognised at the point in time that there is reasonable assurance that the company will comply with the conditions attaching to the grant. IAS 20 requires government grants to be recognised as income in the periods in which the company recognises, for example, the related costs for which the grants are intended to compensate. Application of IAS 20 may result in various accounting alternatives, the determination of which may depend on the specific facts and circumstances.

After the determination has been made that the benefit should be accounted for outside of income taxes, there are still several other accounting considerations that need to be made.

The first consideration is whether the benefit received is taxable to the entity that claims the tax credit on its return or applies for a direct payment. In certain cases, the benefit received from the government does not attract additional tax because it is either a direct reduction of taxes payable or a cash refund from the government. However, the credits can be taxable in certain situations, depending on how the credits are monetised and the certainty of a company's filing position. In cases where companies have uncertainties related to these credits, they may need to record a liability for an uncertain tax position.

Patent box

The introduction of patent box regimes is a relatively hot topic in Europe, with six European countries having adopted a regime in the last decade. These regimes typically allocate relevant income and expenditure to a pool which is taxed separately at a reduced rate. Such incentive is a 'back-end' incentive which targets income arising from the exploitation of certain intellectual property (IP).

Accounting for patent boxes can be complex given there can be several steps to arrive at the patent box tax rate. For example, the UK regime adopts a formulaic approach to the calculation of the patent box profit or loss. This formula generates a corporation tax deduction whose effect is to reduce corporation tax on the profits attributable to patents to 10%. It is also important to note that the different regimes in the territories mentioned vary considerably, and it is important to consider the details of each regime in deciding on the accounting.

Special deduction vs. reduced tax rate

With respect to patent box regimes and similar back-end incentives that fall within income tax accounting, it may be necessary to determine whether the benefit should be treated as a 'special deduction', using the terminology of ASC 740, or as a reduced tax rate. Special deductions are generally recognised in the year they are included in the tax return (i.e. similar to general business tax credits), whereas a reduced tax rate is applied in measuring deferred taxes. There is no specific guidance in IFRS regarding special deductions, although the underlying principles of the special deduction described in ASC 740 are often looked to as guidance in analogous situations under IFRS.

ASC 740 does not define ‘special deductions,’ but it does provide examples. In general, special deductions have tax law requirements or limitations that are based upon future performance or activities which have not been recognised in the tax or book basis of assets or liabilities. For instance, one special deduction includes a limitation based upon annual wages.

In contrast, some tax benefits which take the form of deductions that are not treated as special deductions may be a consequence of a future event, but are not contingent upon any specific performance or income-generating activity not yet recognised. These benefits are reflected in the tax rate applied to measure deferred taxes. Accordingly, it may be necessary to evaluate whether the particular incentive has a performance requirement or other limitation that would differentiate it from being equivalent to a tax rate reduction.

Generally, tax benefits from special deductions are recognised no earlier than the year in which the special deductions are deductible on a tax return.

When considering a future reduced tax rate, deferred tax assets and liabilities that are expected to reverse into applicable patent box income would be tax-effected at the lower patent box income tax rate. This approach is consistent with the objective of measuring deferred taxes using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realised. Thus, if the incentive in effect provides a reduced tax rate, the patent box regime should be factored into the assessment of the tax rate that is expected to apply to patent box profits. Deferred taxes would be measured at the reduced patent box rate as opposed to the general corporate tax rate. This may require what could be a complicated assessment to determine the temporary differences which will reverse at the applicable patent box rate as compared with those expected to reverse at the otherwise applicable corporate rate.

These regimes will have a significant impact on the effective tax rate of affected companies, and management should consider the impact on the reported tax numbers.

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Contacts

For more information on the topics discussed in this newsletter or for other tax accounting questions, including how to obtain copies of the PwC publications referenced, contact your local PwC engagement team or your Tax Accounting Services network member listed below.

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