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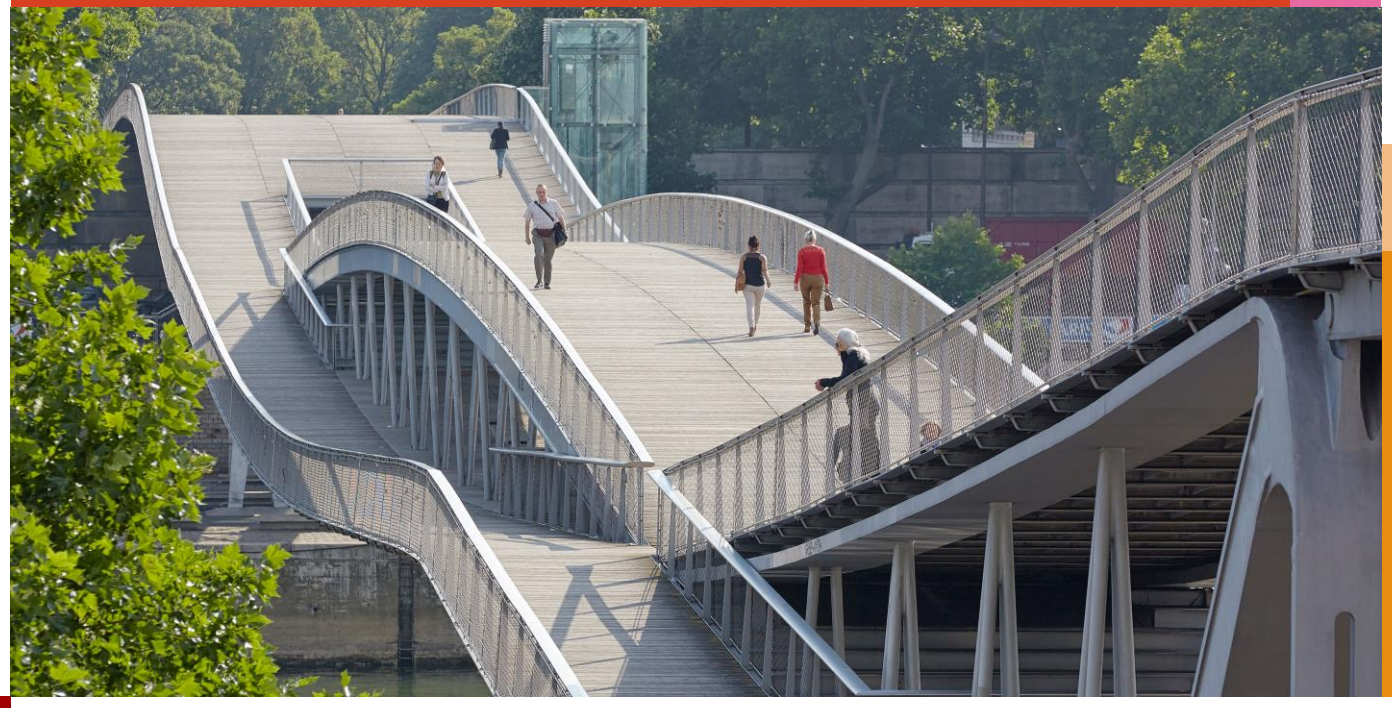
Global tax accounting services newsletter



Focusing on tax accounting issues affecting businesses today

April–June 2016

pwc

Introduction

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Senior tax buyers name PwC as their first choice provider for tax accounting services globally*

**These results are based on an independent survey of 2,536 primary buyers of tax accounting services globally, conducted by research agency Jigsaw Research (Q1–Q4 2015).*

The *Global tax accounting services newsletter* is a quarterly publication from PwC's Global Tax Accounting Services (TAS) group. In the newsletter, we highlight issues that may be of interest to tax executives, finance directors, and financial controllers.

In this issue, we provide an update on regulatory activity of the Financial Accounting Standards Board (FASB) and the International Financial Reporting Standards (IFRS) Interpretations Committee, as well as an update on enforcement activity of the European Securities and Markets Authority (ESMA). We also discuss recent changes to the new revenue standards and restrictions on non-audit services in the European Union (EU).

In addition, we draw your attention to some significant tax law and tax rate changes that occurred around the globe during the quarter ended June 2016.

Finally, we discuss some key aspects of income tax accounting under IFRS and US GAAP for foreign currency movements and transactions—one of the more complex areas of accounting for income tax.

This newsletter, tax accounting guides, and other tax accounting publications are available **online**. You can also **register and access** quarterly TAS webcasts for periodic updates on the latest developments.

If you would like to discuss any of the items in this newsletter, tax accounting issues affecting businesses today, or general tax accounting matters, please contact your local PwC team or the relevant Tax Accounting Services network member listed at the end of this document.

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

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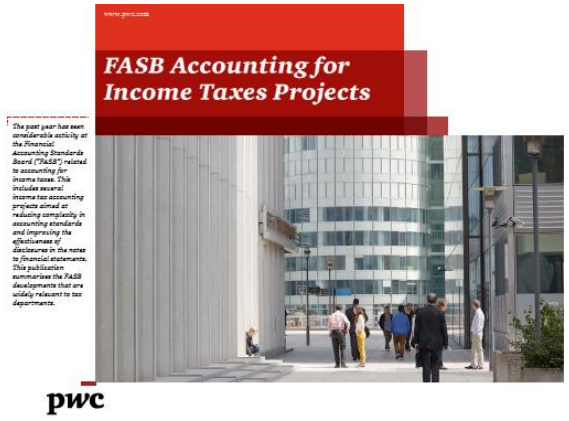
Accounting and reporting updates

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



FASB Accounting for Income Taxes Projects placemat

The FASB activity update

Overview

During the second quarter of 2016, the FASB continued its deliberations regarding the following proposals in the area of accounting for income taxes:

- proposal to eliminate the exception to recognising tax effects of intra-entity asset transfers (see the Q4 2015 newsletter for more details)
- proposal to require detailed disclosures of government assistance (see the Q4 2015 newsletter for more details)
- proposal to redesign tax disclosures in financial statements

We summarise outcomes of the above deliberations below.

In detail

Intra-entity assets transfers

During the first quarter of 2015, the FASB issued an exposure draft proposing to eliminate the current exception under ASC 740 which defers the income tax consequences of intra-entity asset transfers when the profits from such transfers are eliminated in consolidation. Following feedback received on the exposure draft and additional research performed by the FASB staff, the FASB tentatively decided the following:

1. The exception for all intra-entity transfers other than intra-entity transfers of inventory, will be eliminated.
2. The exception for intra-entity transfers of inventory will be retained.

The FASB indicated that the final standard would have an effective date for annual periods beginning after 15 December 2017 for public companies and 15 December 2018 for private companies. Early adoption would be permitted.

Adoption of the new standard will be effected through a 'modified retrospective transition approach' (i.e., cumulative catch-up adjustment to opening retained earnings in the period of adoption). Prior periods would not be (and would not be permitted to be) restated to reflect the change in accounting.

We expect the final Accounting Standard Update (ASU) to be issued later in 2016.

Continued

Disclosure of government assistance

During the fourth quarter of 2015, the FASB issued an exposure draft requiring detailed disclosures of government assistance. Depending on the specific facts in a particular jurisdiction, elements of government assistance that were subject to the recognition and measurement guidance for accounting for income taxes (ASC 740), could have been subject to the disclosure requirements of the proposed guidance.

Following feedback on the exposure draft, during the second quarter of 2016 the FASB tentatively decided to exclude from the scope of the project government assistance that is subject to ASC 740. The FASB has instead tentatively considered additional disclosures as part of the disclosure framework project as noted below.

The FASB will continue its deliberations on this project at a future meeting.

Tax disclosures

Over the past two years, the FASB and its staff have been deliberating its disclosure framework project that included tax disclosures.

During the second quarter of 2016, the FASB tentatively decided that all entities (both public and private) would be required to disclose the following:

Foreign operations

- income (loss) before income tax expense (benefit) disaggregated between domestic and foreign
- income tax expense (benefit) disaggregated between domestic and foreign
- income taxes paid disaggregated between domestic and foreign. Foreign income taxes paid would be further disaggregated for any country that is significant relative to total income taxes paid
- the amount of, and explanation for, a change in assertion about the temporary difference for the cumulative amount of investments associated with undistributed earnings that are/or are not asserted to be essentially permanent in duration
- aggregate of cash, cash equivalents, and marketable securities held by foreign subsidiaries

Other

- terms of any rights or privileges granted by a governmental entity directly to the reporting entity that have reduced, or may reduce, the entity's income tax burden in a particular jurisdiction
- that a change in tax law that is probable to have an effect on the entity in a future period has been enacted

The FASB also tentatively decided that public entities would be required to disclose the following:

Uncertain tax positions

The tabular reconciliation of unrecognised tax benefits at the beginning and end of the period would be enhanced to include:

- settlements using existing tax assets separate from those that are settled in cash
- a breakdown of the ending balance of the liability for unrecognised tax benefits by the line items in the balance sheet in which the various components of the liability are recognised

In addition, the FASB tentatively decided to eliminate the current requirement to disclose positions for which it is reasonably possible that the unrecognised tax benefit will significantly change within 12 months of the reporting date for all entities.

Valuation Allowance

- an explanation of the nature and amounts of the valuation allowance recorded and/or released during the reporting period

Continued

Rate Reconciliation

- separate disclosure of any individual reconciling item that is more than 5% of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate
- a qualitative description of those items that have caused a significant movement in the rate year over year

Carryforwards

- the gross amounts (i.e., not tax effected) of federal, state, and foreign carryforwards by time period of expiration for each of the first five years after the reporting date and a total of the amounts for the remaining years
- the deferred tax asset for carryforwards (tax effected), before valuation allowance, disaggregated by federal, state, and foreign. Those amounts should be further disaggregated by time period of expiration for each of the first five years after the reporting date and a total of the amounts for the remaining years
- the total amount of unrecognised tax benefits that reduce the tax-effected amounts of carryforwards

The FASB tentatively decided that non-public entities would be required to disclose the gross amounts (i.e., not tax effected) of federal, state, and foreign carryforwards.

The FASB tentatively decided to require prospective transition for all income tax disclosures.

The FASB is expected to release an exposure draft later in 2016.

Takeaway

The above developments will likely in some way affect virtually all tax-paying entities that apply US GAAP. Organisations should be proactively evaluating the implications of the changes being proposed in these tax accounting areas.

Continued

Accounting and reporting updates

The IFRS Interpretations Committee activity update

Overview

During the second quarter of 2016, the IFRS Interpretations Committee considered the following tax-related issues:

- The presentation of income tax related to payments on financial instruments classified as equity
- The expected manner of recovery of an indefinite-life intangible asset for the purposes of measuring deferred tax

We outline below the Interpretations Committee's conclusions on these issues.

Presentation of income tax related to payments on financial instruments classified as equity

The IFRS Interpretations Committee noted that the circumstances in which the requirements in paragraph 52B of IAS 12, *Income Taxes* apply are unclear. Paragraph 52B deals with the presentation of the income tax consequences of dividends in circumstances where different tax rates may apply to distributed and undistributed profits.

The IFRS Interpretations Committee decided to propose an amendment to IAS 12 to clarify that the presentation requirements in paragraph 52B of IAS 12 apply to all payments on financial instruments classified as equity that are distributions of profits.

The International Accounting Standards Board (IASB) is expected to consider the amendment proposed by the Interpretations Committee at a future meeting.

Expected manner of recovery of an indefinite-life intangible asset for the purposes of measuring deferred tax

The Interpretations Committee received a request to clarify the determination of the expected manner of recovery of an indefinite-life intangible asset for the purposes of measuring deferred tax.

The Interpretations Committee noted that when measuring deferred tax on indefinite-life intangible assets, an entity should apply existing guidance in paragraphs 51 and 51A of IAS 12 and reflect the tax consequences that would follow from the expected manner of recovery of the carrying amount of those assets. The Interpretations Committee will discuss at a future meeting if it needs to clarify how to determine the expected manner of recovery for amortised assets.

Continued

Accounting and reporting updates

Changes to the new revenue standards

Overview

During the second quarter of 2016, both the FASB and the IASB issued amendments to their respective new revenue standards—ASC 606 (US GAAP) and IFRS 15 (IFRS). The amendments include guidance on identifying performance obligations, accounting for licences of intellectual property (IP) and a number of other changes.

As a reminder, the new revenue standards may have impact on the cash tax profile of many companies or affect computation of book-to-tax differences and the related deferred taxes. This is because tax law often prescribes special rules for recognition of revenue for tax purposes.

We strongly recommend that companies consider the tax implications in advance of the effective dates of the new standards mentioned below, and address issues before the standards' implementation.

Key changes

Identifying performance obligations

The amendments clarify the guidance for determining when promises in a contract are 'distinct' goods or services that should be accounted for separately. An entity should determine whether its promise is to transfer individual goods or services to the customer, or a combined item (or items) to which the individual goods and services are inputs. This guidance is consistent under US GAAP and IFRS.

Licences of IP

The IASB's amendments to the licensing guidance clarify when revenue from a licence of IP should be recognised 'over time' versus when it should be recognised at a 'point in time.'

The FASB decided to develop a different model, which categorises licences as either 'functional' or 'symbolic' in determining the accounting treatment. The FASB also provided guidance on the impact of restrictions in licence agreements, accounting for renewals of licences and the pattern of revenue recognition for performance obligations that include a licence.

These differences between the IASB's and the FASB's guidance could result in different outcomes in revenue reported by IFRS reporters and their competitors reporting under US GAAP, particularly in the media, biotech and software industries.

The IASB and the FASB also clarified when to apply the guidance on recognising revenue for licences of IP with fees in the form of a sales- or usage-based royalty. These clarifications are consistent under US GAAP and IFRS.

Other changes

In addition to the above amendments, the FASB included the guidance on collectibility, non-cash consideration, presentation of sales tax, and transition. The FASB also proposed several technical corrections to the new revenue standard that primarily impact scoping determinations and provide additional relief from certain disclosure requirements.

The IASB's amendments also included clarification of the guidance on the principle versus agent assessment (gross versus net revenue presentation) and additional practical expedients related to transition to the new revenue standard.

Continued

Why is this important?

The amendments do not change the core principles of the revenue standards but are intended to clarify application of some of the more complex aspects of the standard. The amendments could be relevant to a broad range of entities and should be considered as entities determine the impact of the guidance.

Many of the amendments to the standards made by the IASB and the FASB are not the same. Entities with reporting requirements under US GAAP and IFRS will need to consider in their transition process whether their conclusions could be acceptable under both frameworks. IFRS reporters with significant competitors reporting under US GAAP might need to explain significant differences in application to investors.

Effective dates

The FASB amendments have the same effective date and transition requirements as the new revenue standard, which is effective for calendar year-end public companies in 2018 with early adoption permitted in 2017. Non-public companies have an additional year to adopt the new standard.

The IASB's amendments are effective for annual reporting periods beginning on or after 1 January 2018, with early application permitted.

Continued

Accounting and reporting updates

ESMA activity update

Overview

ESMA is an independent European Union Authority, whose predominant role is to serve as the European Union's securities market regulator (similar to the Securities and Exchange Commission (SEC) in the US). One of ESMA's areas of responsibility is to promote the effective and consistent application of the European Securities and Markets legislation with respect to financial reporting.

On 29 March 2016, ESMA issued its public Report on Enforcement and Regulatory Activities of Accounting Enforcers in 2015. The report presented findings of the European accounting enforcers with respect to ESMA's enforcement priorities for 2014. These were the topics that ESMA, together with European accounting enforcers, set as key focus areas of their examinations of listed companies' financial statements in 2014.

The review covered 1,200 issuers, which is close to 20% of all IFRS issuers in Europe with securities listed on regulated markets. As a result of the reviews, the enforcers took action against 25% of the issuers.

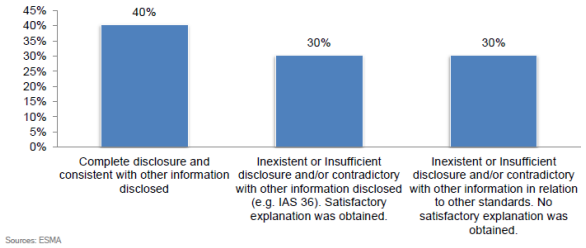
In detail

ESMA's enforcement priorities for 2014 included recognition and measurement of deferred tax assets and uncertain tax positions. Key findings in these areas are summarised below.

Deferred tax assets

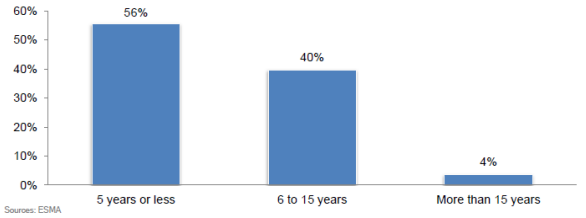
European enforcers found disclosures related to deferred tax assets arising from unused tax losses were not adequate in a large number of cases. The chart below illustrates findings from the reviews with respect to the disclosure of the support for deferred tax asset recognition.

Chart 1: *Disclosure of specific considerations supporting the deferred tax asset recognition*



In addition, only 27% of the issuers recognising material deferred tax assets in excess of deferred tax liabilities provided adequate disclosures of the period(s) over which deferred tax assets were expected to be recovered. The chart below illustrates the findings from the reviews with respect to the disclosure of the number of years expected for recovery of the deferred tax assets.

Chart 2: *Disclosure of number of years expected for recovery of the deferred tax assets*



Furthermore, only half of the issuers reviewed that had recognised deferred tax assets provided information on the significant judgements used when assessing the period expected for recoverability of the deferred tax assets. In this matter, most issuers justified the different periods used by the existence of different time limits and/or different countries where these tax losses had originated.

Continued

Uncertain tax positions

European enforcers found that 25% of the issuers reviewed had material uncertain tax positions. However, only half of such issuers disclosed their accounting policy used for assessing uncertain tax positions. In addition, only 25% of issuers that had material uncertain tax positions disclosed their measurement basis.

The takeaway

ESMA and the European enforcers have acknowledged the high standard of application of IFRS in 2014. However, they also noted room for improvement, in particular in the application of IAS 12 requirements related to recognition, measurement, and disclosures of deferred tax assets arising from tax losses. These areas will continue to be one of ESMA's areas of focus in 2016.

For uncertain tax positions, the lack of specific guidance under IFRS seems to have led to diversity in practice. It is expected that this will be rectified once the IFRS Interpretations Committee finalises its draft Interpretation clarifying the guidance on uncertain tax positions.

Continued

Accounting and reporting updates

Restrictions on non-audit services in the EU

Overview

At the end of 2013 the European Commission, Parliament and Council reached agreement on new legislation to reform the audit market within the EU. The new legislation includes restrictions on non-audit services, which apply from the first fiscal years starting on or after 17 June 2016. No transitional arrangements or grandfathering is available. The restrictions take the form of a cap on the amount of non-audit fees that can be billed and a 'blacklist' of prohibited services that the auditor cannot provide.

In addition, the legislation includes rules on mandatory rotation of audit firms for all public interest entities in the EU (see the Q1 2014 newsletter for more details).

In detail

The new legislation restricts the non-audit services that can be provided by the auditor of a public interest entity.

A public interest entity is defined as any EU-domiciled entity with instruments listed on a regulated EU exchange, any bank or insurance undertaking. The public interest entity definition applies even where a company is part of a group listed outside Europe. European subsidiaries of US groups, for example, will be subject to the restrictions if they have EU-listed securities, an EU banking licence, or undertake insurance activities.

The non-audit services restrictions include the following:

- Fees received for non-audit services in any one year cannot exceed 70% of the average of the audit fees billed over the previous three years.
- There is a list of non-audit services that cannot be provided by the auditor of a public interest entity (or by its network firms) to that entity, or to its parent or subsidiaries within the EU.
- Other non-audit services may be provided, as long as the audit committee of the public interest entity approves the provision of these services after assessing the potential threats to independence that could arise, and the safeguards that have been applied.

EU member states have flexibility to implement less onerous or more stringent restrictions related to non-audit services in their local law. In addition, the member states have the option to add other non-audit services to the prohibited list if it is believed that the service presents a particular threat to independence.

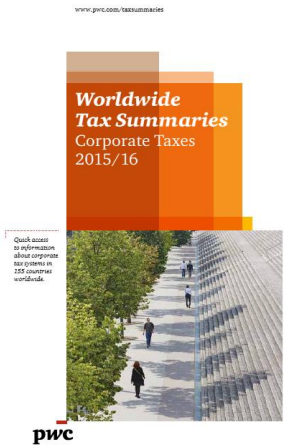
Takeaway

Public interest entities that use their auditor for the provision of tax advice and tax compliance services should be mindful of the new restrictions for non-audit services. This is particularly important as the restrictions apply from the first fiscal years starting on or after 17 June 2016, and there are no transitional arrangements or grandfathering. Public interest entities should also be mindful of any variations in the restrictions between EU member states they operate in.

Continued

Recent and upcoming major tax law changes

This section focuses on major changes in the tax law that may be of interest to multinational companies and can be helpful in accounting for income taxes. It is intended to increase readers' awareness of the main global tax law changes during the quarter, but does not offer a comprehensive list of tax law changes that should be considered for financial statements.



Worldwide tax summaries

Australia

During the second quarter of 2016, the Australian Treasurer delivered the 2016-17 Federal Budget, that included the following key proposals:

- The corporate tax rate would be reduced to 25% over ten years. The rate reduction would apply to all companies (both resident and non-resident) and to other entities taxed like companies/corporations (e.g., limited partnerships).
- Tax consolidation rules would be modified. In particular, adjustments relating to deferred tax liabilities would be removed from entry and exit calculations for entities joining or leaving tax consolidated groups.
- A 40% 'diverted profits tax' (DPT) would be introduced for certain large companies with global revenues of AU$1 billion or more. The DPT is intended to be based on the insufficient economic substance aspect of the United Kingdom (UK) DPT and would apply in addition to Australian Multinational Anti-Avoidance Legislation (MAAL) which was largely modelled on the 'avoided permanent establishment' aspect of the UK DPT legislation.
- Anti-hybrid rules would be introduced and transfer-pricing rules would be strengthened in line with the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project.
- Large businesses would be encouraged to adopt a tax transparency code. The code represents a set of principles and 'minimum' standards for voluntary disclosure of tax information by businesses.
- Penalties for failure to disclose information to the Australian Taxation Office (ATO) that could apply to companies with global incomes of AU$1 billion or more would be increased up to AU$450,000.
- The Taxation of Financial Arrangement (TOFA) rules would be simplified. This includes a closer link to accounting, and simplified accruals and realisation rules, a new tax hedging regime and simplified rules for foreign exchange gains and losses.

Continued

In addition, the ATO finalised the design of the Local File requirements under the Australian country-by-country (CbC) reporting laws that apply to years beginning on or after 1 January 2016. Taxpayers will need to carefully manage the process, especially since there is some divergence from the template recommended by the OECD both in form and content. Failure to comply with the Local File reporting requirements carries the possibility of significant penalties up to AU$450,000.

Canada

During the second quarter of 2016, Canada implemented two measures aligned with the OECD's BEPS project. Effective 1 April 2016, the Canada Revenue Agency (CRA) began sharing selected Canadian tax rulings (e.g., cross-border rulings related to transfer pricing and preferential regimes) with certain countries. On 12 May 2016, Canada also joined the Multilateral Competent Authority Agreement (MCAA) on the exchange of country-by-country reports. The MCAA has already been signed by over 35 countries.

Ecuador

During the second quarter of 2016, the Ecuadorian Congress enacted Solidarity Act to fund the rebuilding of areas affected by the recent magnitude 7.8 earthquake. The Solidarity Act includes a one-time 3% income tax surcharge that is payable based on taxable income for the 2015 tax year. The Act also includes a five-year income tax exemption for new productive investments made in the affected zone.

EU

During the second quarter of 2016, the European Commission (EC) presented a proposal for a directive which would require public CbC reporting of tax and other financial data by large companies (i.e., companies with consolidated turnover over EUR 750 million) operating in the EU. The proposed directive would amend the existing EU Accounting Directive and would require reporting of the following data:

- a brief description of the nature of the activities
- the number of employees
- the amount of the net turnover, in aggregate, including the turnover with related parties
- the amount of profit or loss before tax
- the current year current income tax accrued (excluding deferred tax and uncertain tax positions)
- the amount of income tax paid in the year
- the amount of accumulated earnings

The same multinational groups that would have to comply with the above requirements would also, in principle, have to file a country-by-country report under OECD BEPS Action 13.

In addition, the EU finance ministers have reached an agreement on the proposed Anti-Tax Avoidance Directive. The proposed directive includes provisions dealing with interest deductions, controlled foreign companies, exit taxation, hybrid mismatches, and a general anti-abuse rule (see the Q1 2016 newsletter for more details). A switchover clause, which was first proposed to ensure a minimum effective tax on profits arising in low or no tax countries, was not included in the agreement.

Continued

India

During the second quarter of 2016, the governments of India and Mauritius signed a protocol amending the countries' tax treaty. Under the protocol, India will have the right to tax capital gains arising to a resident of Mauritius on the transfer of shares in Indian companies acquired on or after 1 April 2017. In addition, interest income of a bank resident in Mauritius will be taxed in India (with certain exceptions). Lastly, fees for technical services arising in India and paid to a resident of Mauritius may be taxed in India.

Residents of India and Singapore would also need to consider the impact of the signed protocol on the tax treaty between their countries. This is because the treaty provisions allocating rights to tax capital gains to the country of residence were linked to the continuation of the corresponding provisions in the India-Mauritius tax treaty that have now been amended.

In addition, the Indian Central Board of Direct Taxes (CBDT), the highest administrative body for income tax in India, issued draft rules that address the calculation of income attributable to assets in India that are taxed under the indirect asset transfer rules, and include related reporting and document maintenance requirements. Under the indirect asset transfer rules, income arising from transfer of a share or interest in a company or entity incorporated or registered outside India is taxable in India if the share or interest derives substantial value from the assets located in India.

Israel

During the second quarter of 2016, the Israel Tax Authority (ITA) published Circular 4/2016, which provides guidance on permanent establishment treatment and income attribution rules for foreign companies selling products or providing services online to customers in Israel (also known as the 'e-commerce'). In particular, the Circular provides guidance when such activities create a 'fixed place of business,' or have 'physical' or 'economic presence' in Israel.

Mauritius

See comments under India.

Singapore

See comments under India.

South Africa

During the second quarter of 2016, the South African Revenue Services (SARS) and Ministry of Finance published draft regulations that would require country-by-country reporting by multinational groups in line with the OECD's requirements.

The regulations would be effective for tax years beginning on or after 1 January 2016.

Switzerland

During the second quarter of 2016, the Swiss parliament passed the final corporate tax reform package (CTR III). The key elements of CTR III include the following:

- Introduction of an interest deduction calculated based on equity exceeding a certain threshold (i.e., surplus equity), known as the notional interest deduction (NID).
- Introduction of a cantonal patent box for patents and similar rights that takes into account the nexus approach recently developed by the OECD. Under this provision, the cantons may grant a maximum relief on patent box profit of 90%.
- Introduction of an optional deduction of 150% of R&D expenditures incurred in Switzerland.
- Elimination of the special cantonal tax regimes for holding, mixed, and auxiliary companies. A five-year transition period would apply.

Continued

In addition, Switzerland released a draft legislation to require Swiss-parented multinationals with annual consolidated group revenue of CHF900 million or more to report country-by-country information for fiscal years beginning on or after 1 January 2018. However, Swiss multinationals could voluntarily file the country-by-country report for fiscal years beginning on or after 1 January 2016, in order to avoid penalties in countries where country-by-country reporting requirements already have been introduced.

United Kingdom

During the second quarter of 2016, the UK government issued a consultation document on the design and implementation of new rules to cap interest deductions at 30% of taxable earnings before interest, depreciation, and amortisation (EBITDA) for UK entities, or based on the net interest to EBITDA ratio for multinational groups. The consultation document is open for comment until 4 August 2016.

United States

During the second quarter of 2016, the Internal Revenue Service (IRS) and US Treasury issued the following regulations:

- The proposed regulations under Section 385. These regulations would recharacterise related-party loans issued on or after 4 April 2016 as equity investments, if those loans are issued within a 72-month period from the date that the issuer of the loan
  1. distributes a dividend
  2. acquires equity in a related entity, or
  3. distributes boot (i.e., cash or other property) in an asset reorganisation

  The regulations would also provide onerous new contemporaneous documentation requirements that apply to intercompany debt when at least one member in the 'expanded group' (defined by the regulations) is publicly traded, has more than US$100 million of total assets reported on financial statements, or has more than US$50 million in revenue. If the documentation requirements are not met, the debt would be automatically characterised as equity.

  Although the proposed regulations appear to be intended to target inversions (redomiciliations), the proposed rules would dramatically impact typical international treasury management practices, such as cash pooling and related-party financing. Taxpayers should immediately analyse the potential impact these rules would have on their routine business transactions and current treasury management functions.

- Proposed and temporary regulations that limit inversions and certain post-inversion transactions. Under these regulations, if a foreign corporation that acquires a US target has made other acquisitions of one or more US companies in the 36-month period preceding the acquisition, such transaction would likely be treated as an inversion.

- Proposed regulations that would create tax reporting requirements for certain US disregarded entities. These regulations would generally require US entities that are owned 100% by a foreign person, and are disregarded as entities separate from those foreign owners for US federal income tax purposes, to file an annual Form 5472, *Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*. This requirement would apply even if a US disregarded entity subject to these proposed reporting rules had no transactions or income that would otherwise be reportable for US federal income tax purposes.

Continued

Tax accounting refresher

In this section we discuss some key aspects of income tax accounting under IFRS and US GAAP for foreign currency movements and transactions.

Tax Function of the Future—Driving value through tax reporting

Foreign currency tax accounting

Foreign exchange is one of the more complex areas of accounting for income tax and requires consideration of a number of aspects. These include the tax impact of transactional exchange gains and losses, the deferred tax impact of translating assets and liabilities into a reporting currency, and the appropriate translation of tax expense and current and deferred tax balances.

As significant complexity can arise when an entity holds assets or liabilities in a currency other than its reporting currency or where entities in a consolidated group maintain their books and records or operate in a currency other than the group reporting currency, we will provide an overview of these situations under both IFRS and US GAAP.

IFRS

Under IFRS, when an entity holds monetary assets and liabilities in a different currency than its reporting currency, they are translated ('remeasured' in US GAAP terminology) using the exchange rate applicable at the end of the reporting period. In some cases, depending on the jurisdictional tax rules, the resulting gains and losses relating to the entity's own assets and liabilities may only be taxable or deductible in the period in which they are realised. When this is the case, the book carrying value will have changed as a result of the change in exchange rate but the tax base has not been altered, resulting in a taxable or deductible difference on which deferred tax may need to be recognised or provided.

For example, assume a company reporting in Euro with a balance sheet date of 30 June sold an asset for US$100 on 31 May when the exchange rate was 0.8. On 30 June the receivable was still outstanding and the exchange rate had moved to 0.9. The company is taxed on revenue on an accrual basis but on foreign exchange movements only when they are realised. The book carrying value of the receivable asset has increased from Euro 80 ($100 x 0.8) to Euro 90 ($100 x 0.9). At the time when the receivable is settled, only the exchange gain of Euro 10 (Euro 90-Euro 80) will be taxed as the Euro 80 was already taxed when accrued. As such, there is a taxable temporary difference of Euro 10 and a deferred tax liability should be recognised. The deferred tax liability would typically be recognised in the income statement. However, where the foreign

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exchange gain/loss is recognised outside profit or loss (for example, foreign currency borrowings hedging a net investment in the consolidated financial statements or qualifying as a hedging instrument in a cash flow hedge), the deferred tax is also recognised outside profit or loss.

Where an entity holds a non-monetary asset (such as a building, land, or plant and equipment) in a foreign currency under IFRS, absent any impairment, the asset is translated and then held at the exchange rate in effect at the date of purchase. If realisation of the asset, either through use or sale, gives rise to tax consequences in the foreign country, the tax base will be based on those consequences and will be retranslated at the exchange rate in effect at the end of each period. As the tax base of the asset changes in line with the exchange rate while the book carrying value remains the same, a temporary difference arises on which deferred tax may need to be recognised or provided.

Similarly, if a branch of the reporting entity operates in a currency other than the reporting currency of the entity itself, the translation of its non-monetary assets and liabilities into the reporting currency may give rise to temporary differences as the book carrying value is translated at the historical rate at the time of purchase whereas the tax base is translated at the rate prevailing at the reporting date (see an example from the IFRS Manual of Accounting to the right.)

Example – Deferred tax and foreign branch

An entity operates a foreign branch that has the same functional currency as the entity. At 1 January 20X5, the foreign branch acquires a property for FC540, 000 (FC = foreign currency) when the exchange rate is C1:FC12. The asset has an expected useful life of five years and zero residual value. For tax purposes, the asset is written off over three years. The exchange rate at 31 December 20X5 is C1:FC9. The tax rates in the entity's country and the foreign country are 30% and 25% respectively.

At 31 December 20X5, a temporary difference arises in respect of the property as follows:

	Foreign branch FC	Exchange rate C1 = FC	Entity C
Net book value of property			
Cost	540,000	12	45,000
Depreciation charge for the year	(108,000)		(9,000)
Net book value	432,000		36,000
Tax base of property			
Cost	540,000		
Tax depreciation claimed	(180,000)		
Tax base	360,000	9	40,000 *
Temporary difference	72,000		(4,000)
Deferred tax @ 25%**	18,000		(1,000)

* The tax base is measured at the year-end rate because this rate gives the best measure of the reporting currency amount that will be deductible in future periods.

** The tax rate is 25% (that is, the rate applicable to the foreign country) because the entity will be taxed on the asset's recovery in that jurisdiction.

Continued

When the financial results and position of a foreign subsidiary, joint venture or an associate are translated into the reporting currency for full or partial consolidation, no deferred tax consequences will arise unless the entity's functional currency is different than its tax reporting currency or the currency in which its books and records are maintained. This is because, when a consolidated subsidiary, joint venture or an associate has the same functional and tax reporting currency and maintains its books and records in that currency, the deferred tax of that entity will be calculated in that currency. The final deferred tax balance will then be translated into the presentational (i.e., reporting) currency at the rate prevailing at the reporting date, after it has been calculated. The book carrying value and tax base of an asset or liability will therefore effectively be translated at the same rate and will not result in an additional temporary difference.

When the functional currency of the overseas entity is different than its tax reporting currency or the currency in which it keeps its books and records, the tax base needs to be translated into the functional currency at the rate prevailing at the reporting date. As the book carrying value will be translated once into the functional currency at the rate prevailing at acquisition and then maintained in the functional currency at the rate prevailing at acquisition and then maintained in the functional currency, this will give rise to a temporary difference on which deferred tax may need to be recognised or provided. Deferred tax also needs to be provided in this situation if the local tax law provides for indexation of the tax base creating an additional temporary difference. This situation as it applies to non-monetary assets can give rise to the main differences between US GAAP and IFRS in the area of tax and foreign currency.

US GAAP

Similar to IFRS, where an entity holds monetary assets and liabilities in a currency other than the reporting currency under US GAAP and the reporting currency is also the functional currency, the monetary assets and liabilities are remeasured into the reporting currency using the exchange rate applicable at the end of the reporting period. Temporary differences may also arise under US GAAP where such transaction gains and losses are only included in the tax return in the period in which they are realised.

Where an entity holds non-monetary assets and liabilities in a currency other than the reporting currency under US GAAP and the reporting currency is the functional currency, the asset is translated into the reporting currency at the exchange rate in effect at the date of purchase for accounting purposes. Likewise, the tax basis is measured at the rate in effect at acquisition. Deferred tax is not provided for tax basis differences arising from exchange rate movements. Instead, such movements result in permanent differences in the year in which they impact the current provision. This is one of the main foreign currency-related differences between IFRS and US GAAP due to an exception in US GAAP which applies when the functional currency of the overseas entity differs from its local currency.

In summary, deferred tax in this situation should be computed in the foreign currency by comparing the historical book and tax bases after the respective depreciation, but before any indexation for book or tax purposes. In particular, no deferred tax should be recognised on any temporary differences arising from remeasuring the tax basis at historic rates (or from indexing the tax base if this is provided by local tax law). Once the deferred tax balance has been computed, it is translated into the reporting currency at the rate applicable at the balance sheet date along with all other monetary assets and liabilities.

When the functional currency of a foreign subsidiary is different from the reporting currency under US GAAP, the accounts of the subsidiary need to be translated into the reporting currency. Whether or not deferred tax is recognised on the temporary difference arising from this currency translation adjustment (which becomes part of the subsidiary's outside basis difference) will depend on the accounting policy of the parent company.

Continued

If the view is taken that indefinite reinvestment can be and is asserted in respect of the subsidiary, no deferred tax is provided when no remittance of the earnings of the subsidiary is foreseen.
If the view is taken, however, that indefinite reinvestment cannot be asserted, deferred tax is provided. Where deferred tax is not provided due to the availability of foreign tax credits, consideration should be given to whether there are sufficient credits to also cover the temporary difference on translation adjustments.

There is no deferred tax on inside basis differences resulting from currency movements when the 'local' currency is the same as the functional currency (ignoring any assets held, or transactions undertaken, in a third currency).
As is the case under IFRS, the deferred tax balance is calculated in the functional currency (with the tax base and the book base being denominated in that currency) and then, if the functional currency is different from the reporting currency, accounts are translated into the reporting currency and any translation adjustments create a portion of the outside basis temporary difference related to the parent's investment in the subsidiary.

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