

TAS Talk

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In the inaugural edition of *TAS Talk*, we examined the potential high level business impacts flowing from the International Accounting Standards Board (IASB) exposure draft standard ED/2009/2 on accounting for income tax. In a series of further articles, we explore specific technical issues in depth. In this fifth article in the series, we look at initial recognition.

Initial recognition under the proposed new accounting standard for Income Tax

In March this year, the International Accounting Standards Board (IASB) released an exposure draft (the ED) of a proposed new accounting standard for income tax. In this article we look at proposed changes to the deferred tax outcomes on initial recognition of an asset or liability.

Temporary differences can arise when a company initially recognises an asset or liability. Such differences have a tendency to arise in a business combination when the assets and liabilities are recorded at their fair values but the tax bases do not change, or in any event change to some amount other than fair value. Temporary differences can also arise when an asset is acquired outside a business combination, if the amount attributed to the asset for tax purposes is different from the financial statement carrying amount.

The proposed changes

The ED provides guidance on the accounting for temporary differences that arise upon a company's initial recognition of an asset or liability. This is summarised in the table below.

One of the changes the IASB is proposing is that in measuring the value of an asset or liability, the company must use the same assumptions about the tax basis that other market participants would use.



This would address situations in which the amount an entity is willing to pay for an asset is influenced by the associated tax attributes that are specific to the entity. The company would recognise a deferred tax asset (DTA) or deferred tax liability (DTL) for any resulting temporary difference. The financial statement effect of recognising the deferred tax would depend on the circumstances in which the transaction takes place.

<p>Initial recognition of an asset or liability acquired in a business combination</p>	<p>A temporary difference that arises when an asset or liability is acquired in a business combination results in recognising a DTA or DTL, with the offsetting effects either being recorded in goodwill or impacting the ultimate amount of the bargain purchase gain.</p>
<p>Initial recognition of an asset or liability acquired in a transaction that is outside a business combination and affects comprehensive income, equity, or taxable profit</p>	<p>In some situations, a temporary difference arises when an asset or liability is initially recognised outside a business combination and the transaction affects comprehensive income, equity, or taxable profit. In those instances, the resulting tax charge or benefit should be classified in a manner consistent with the pre-tax accounting.</p> <p>For example, a company may receive cash in exchange for providing goods or services in the future. Assume that, for tax purposes, the company includes the payment in taxable income upon receiving the cash. For financial reporting purposes, the company records the cash with an offset to deferred revenue. There is a deductible temporary difference for the deferred revenue, for which the company records a DTA.</p> <p>The transaction affects taxable profit. Therefore, the company records the deferred tax credit in the income statement.</p>
<p>Initial recognition of an asset or liability acquired outside a business combination, with no effect on comprehensive income, equity, or taxable profit</p>	<p>In some situations, a temporary difference arises when an asset or liability is acquired outside a business combination and the transaction does not affect comprehensive income, equity, or taxable profit.</p> <p>Assume that a company pays \$1,000 for the shares of an entity. The entity is a shell company that holds a single asset and is not considered a business. The acquisition therefore is not accounted for as a business combination.</p> <p>The acquiring company has not previously chosen to form a tax consolidated group. The asset therefore retains its pre-existing tax basis, which we will assume to be zero. There is a taxable temporary difference of \$1,000 related to the asset.</p> <p>In this case, the ED requires the company to record the deferred tax. It would also recognise, as an allowance (discount) against or premium on the deferred tax balance, the difference between the consideration paid and the total recognised amount of the asset or liability (including deferred taxes).</p> <p>The company would classify the discount or premium with deferred tax. However, the company would not consider the discount or premium to be a source of future taxable profit when determining whether a valuation allowance is necessary.</p> <p>The discount or premium would be reduced on a pro rata basis with changes in the related deferred tax asset or liability. The company would recognise the resulting tax expense or credit as part of income tax expense (benefit) in the financial statements.</p>

Comparison to AASB 112

The ED is generally consistent with AASB 112, *Income Taxes*, regarding the accounting for temporary differences arising upon the initial recognition of assets and liabilities:

- In a business combination, and
- in a transaction that is outside a business combination, which affects comprehensive income, equity, or taxable profit.

The ED differs from IAS 12 on the accounting for temporary differences that arise upon the initial recognition of assets and liabilities acquired in a transaction that is outside a business combination and does not affect comprehensive income, equity, or taxable profit. AASB 112 does not permit a company to recognise deferred taxes in such a situation.

There are situations where the amount a company is willing to pay for an asset is influenced by the associated tax attributes. For example, a company may negotiate a lower purchase price for an asset with a low tax basis if that asset could have been obtained in a transaction that provided the buyer with a higher tax basis. In other situations, the purchase price for an asset might be increased because the remaining tax basis assumed in the transaction exceeds the amount that would have been deductible had the asset been acquired separately.

In deliberating the issue, the IASB discussed whether (1) measuring the asset or liability to reflect the tax advantage or disadvantage and then (2) recognising deferred tax to reflect the difference between the carrying amount and the tax basis, is a more faithful representation of the transaction's underlying economics. The IASB acknowledged that in these transactions, the consideration paid might not equal the sum of the carrying amount and the deferred tax balance. In the IASB's view, this difference results largely from the time value of money and the premium or discount on future tax cash flows that a willing buyer and seller would agree to. And, because deferred taxes are recorded on an undiscounted basis, there will naturally be a 'disconnect' when these transactions are initially recorded.

The IASB therefore concluded that it is most appropriate to (1) classify the discount or premium along with the related deferred tax balance and (2) reduce the discount or premium pro rata with changes in the related deferred tax asset or liability.

A further point to bear in mind when comparing outcomes under the ED with those under AASB 112 is that, in circumstances where deferred tax calculations are required to be performed, the ED requires tax basis to be determined by reference to an

assumed sale of the asset at the end of the reporting period. This is likely to reduce the circumstances in which deferred tax arises on initial recognition compared to the AASB 112 approach of determining tax basis by reference to the intended manner of recovery of the asset's carrying value. It is more likely to be the case that the tax cost base available on sale, compared to the tax deductions available through use, will correspond with the asset's initial carrying value. For example, an initial recognition issue should no longer arise on the acquisition of a building for which the balance of undeducted capital allowances is less than the cost base for capital gains tax purposes.

Comparison to US GAAP

The ED is generally consistent with US GAAP regarding the accounting for temporary differences arising upon the initial recognition of assets and liabilities:

- In a business combination, and
- in a transaction that is outside a business combination, which affects comprehensive income, equity, or taxable profit.

The ED differs from United States Generally Accepted Accounting Principles (US GAAP) on the accounting for temporary differences arising upon the initial recognition of assets and liabilities acquired in a

transaction that is outside a business combination and does not affect comprehensive income, equity, or taxable profit. Currently, companies account for such temporary differences by following the guidance in Emerging Issues Task Force (EITF) Issue 98-11.1. Under that guidance, a company determines the assigned value of an asset acquired and the related DTA or DTL by running simultaneous equations. The practical effect of this model is to gross up the asset and the related deferred tax.

Practical example

Assume that a company, which is not consolidated for income tax purposes, acquires the shares of an entity that has a single asset. The purchase is not a business combination. The transaction does not affect comprehensive income, equity, or taxable profit.

The consideration paid was \$100. The tax basis of the asset is the same as the previous owner's tax basis, which is nil. The company could have purchased the asset outright for \$120, instead of purchasing the shares of the entity. In that case, the tax basis would have equaled the consideration paid. The tax rate is 30 per cent.

The following observations can be made about the three accounting approaches:



- US GAAP would result in the highest depreciation charge; the ED would result in the next highest amount; and AASB 112 would result in the lowest amount.
- US GAAP normalises the impact on the effective tax rate, whereas both the ED and AASB 112 results in a disproportionate impact on the effective tax rate.

The ED

The company would not record the asset at the amount of consideration paid; rather, the company would measure the asset so that it reflects the value of the asset that has the higher tax basis available to market participants (\$120).

The proposal requires the company to record a DTL of \$36 ($(\$120 - \text{nil}) * 30$ per cent), with an offsetting discount of \$16.

Asset	120
Discount	16
Cash	(100)
Deferred tax liability	(36)

As the asset depreciates, the DTL would reverse proportionately and the discount would be reduced on a pro rata basis. The unwinding of the discount would affect the company's effective tax rate.

AASB 112

The company would record the asset at the amount of consideration paid (\$100). Deferred taxes would not be recorded in this situation.

Asset	100
Cash	(100)

Because the asset would depreciate with no corresponding tax benefit, the company's effective tax rate would be impacted.

US GAAP

The company would record the asset at an amount determined by using a simultaneous equation. The company would initially record a DTL of \$30



($\$100 * 30$ per cent) and increase the cost of the asset by \$30. This increase would, in turn, increase the temporary difference, requiring a new calculation of the DTL and so on. This situation is typically resolved by use of the 'simultaneous equations' method. The final result is a DTL of \$43 and an asset of \$143 ($\$100 + \43).

Asset	143
Cash	(100)
Deferred tax liability	(43)

As the asset is depreciated, the company would adjust the DTL, and the effective tax rate would not be impacted.

Questions to consider

The ED raises many important questions about the practical application of the initial recognition model:

Would the accounting and financial reporting effect under the ED differ materially from that under AASB 112?

In the practical example above, the DTL was recorded at \$36, and the discount was recorded at \$16. The ED specifies that the premium or discount would be reduced pro rata with changes in the related deferred tax asset or liability. The IASB does not specify what it means by 'pro rata.' We assume it means that as the DTL reverses, the discount would be reduced by a proportionate amount. If the amortisation of the discount or premium is generally consistent with the reversal of the related DTA or DTL, the net effect on the income statement in any given period is nil. Within the income statement, however, there will be a change to both the profit before tax and the income tax expense where the initial carrying value of the asset is adjusted to reflect a different tax basis available for other market participants.

The ED specifies that a company should measure assets or liabilities by using the same assumptions about the tax basis that other market participants would use. How should this guidance be applied?

The ED appears to require that when measuring the value of an asset, a company that *could have* acquired the asset in a manner that would have resulted in a full tax basis should assume that the asset will be fully tax deductible (even though, in reality, there is no, or only a partial tax basis to deduct).

For example, a company that acquires an asset with a carryover tax basis (e.g. acquired from another member of the same tax consolidated group) but could have acquired the asset in a manner that would have resulted in a higher tax basis (e.g. acquired from a third party). In measuring the value of the asset, the company should assume full deductibility. So if, for example, the value of the asset was being determined through use of a discounted cash flow model, it would be appropriate to assume full deductibility of the asset for tax purposes, notwithstanding the fact that actual future deductions are limited to the asset's inherited tax basis.

The ED specifies that a company should reduce the premium or discount pro rata with changes in the related deferred tax asset or liability. How should this model be applied when considering the need for a valuation allowance?

The ED specifies that the discount or premium would be classified as deferred tax on the balance sheet. However, in measuring or determining the need for a valuation allowance on DTAs, the company would not consider the discount or premium a source of future taxable profit or a future deductible amount that needs to be recovered. If, in a subsequent period, the company records a valuation allowance on the DTA, the ED is unclear on whether the company should cease amortising the related discount or, if not, on what basis the company should continue amortising it.



A number of other questions also arise in considering the interaction of the discount or premium with a company's deferred tax analysis and valuation allowance. For example, is the premium or discount calculated before assessing the need for a valuation allowance? Clearly, there are complexities in the detailed application of the initial recognition methodology put forward in the ED.

Comment Letters

The comment period in respect of the ED closed on 31 July 2009.

A particular concern evident across a number of comment letters is that the ED's proposed manner of dealing with the initial recognition issue is overly complicated.

It may be that the IASB will decide to give some further consideration to the manner in which the issue should be dealt with.

PwC TAS team



Adelaide
Alistair Hutson, Partner
Phone: +61 8 8218 7467
Fax: +61 8 8218 7862
alistair.hutson@au.pwc.com



Brisbane
Tom Seymour, Partner
Phone: +61 7 3257 8623
Fax: +61 7 3031 9312
tom.seymour@au.pwc.com



Peter Dunn, Partner
Phone: +61 7 3257 5670
Fax: +61 7 3031 9177
peter.dunn@au.pwc.com



Melbourne
Ronen Vexler,
Partner / National TAS Leader
Phone: +61 3 8603 3337
Fax: +61 3 8613 2887
ronen.vexler@au.pwc.com



David Romans, Partner
Phone: +61 3 8603 6862
Fax: +61 3 8613 2934
david.romans@au.pwc.com



Belinda Harrison, Director
Phone: +61 3 8603 9226
Fax: +61 3 8613 2125
belinda.j.harrison@au.pwc.com



Perth
Warren Dick, Partner
Phone: +61 8 9238 3589
Fax: +61 8 9488 9004
warren.dick@au.pwc.com



Sydney
Martin Scully, Partner
Phone: +61 2 8266 5545
Fax: +61 2 8286 5545
martin.scully@au.pwc.com

Editor

Catherine Pasula
PricewaterhouseCoopers Tax
Phone: +61 3 8603 4987
catherine.pasula@au.pwc.com

Technical Editor

Geoff Dunn, Director
Tax Technical Knowledge Centre
PricewaterhouseCoopers Tax
Phone: +61 2 8266 5220
geoff.dunn@au.pwc.com

Media enquiries

Nina Anderson
Phone: +61 3 8603 3573
Mobile: 0400 033 937
nina.anderson@au.pwc.com