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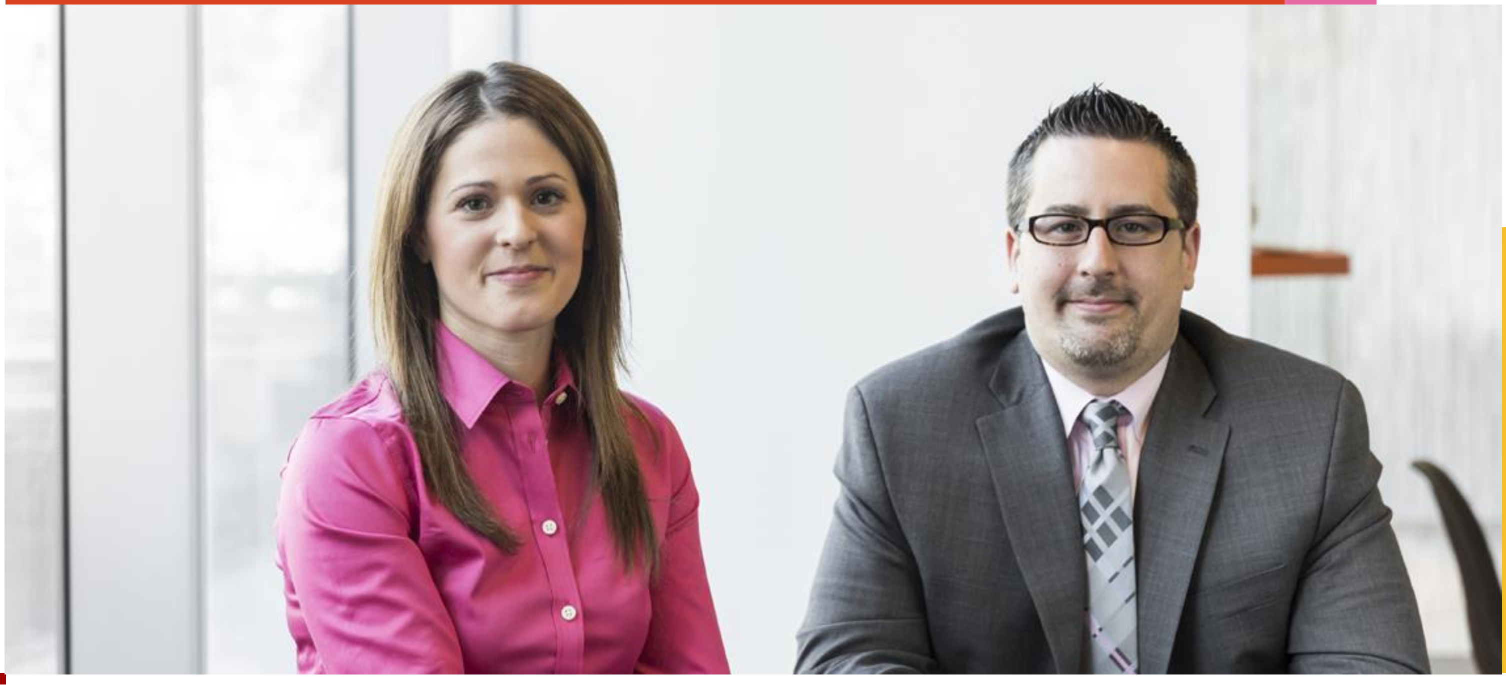
# Global tax accounting services newsletter



*Focusing on tax accounting issues affecting businesses today*

*January-March 2018*

# 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 2,649 primary buyers of tax accounting services globally, conducted by research agency Jigsaw Research (Q1–Q4 2016).*

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 some of the recent activity of the FASB and ESMA, particularly in relation to US tax reform, set out reminders of the key new accounting standards that are now in effect, and discuss the IFRIC's recent tax related activity.

In addition, we draw your attention to certain significant tax law and tax rate changes that occurred around the globe during the quarter ended March 2018. We continue to see a number of territories proposing or introducing legislation in response to the OECD's BEPS initiative and the European Union's Anti-Tax Avoidance Directives. There are also attempts to address the taxation of the digital economy.

Finally, we look at some of the issues connected with tax accounting in GAAP conversions, which many businesses need to consider as they go through M&A processes.

This newsletter, tax accounting guides, and other tax accounting publications are also 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.

# In this issue

# Accounting and reporting updates

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

## The FASB update

### The FASB weighs in on the stranded tax effects generated by US tax reform

On 18 February 2018, the FASB issued final guidance on stranded tax effects in accumulated other comprehensive income (AOCI) caused by the recent US tax reform legislation. The guidance (in the form of a new Accounting Standards Update, ASU 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*) gives companies the option to reclassify the stranded tax effects caused by the 2017 tax reform reconciliation act (the Act), also known as the 'Tax Cuts and Jobs Act' (TCJA) from AOCI to retained earnings.

Adoption of the ASU is required for all entities reporting under US GAAP. However, making the reclassification adjustment is optional.

On adoption, entities should choose whether or not to elect to reclassify the stranded effects associated with the Act. Should they choose to make the reclassification, they must apply this policy to all items within AOCI.

All entities, whether or not they elect to reclassify, are required by the ASU to disclose a description of their accounting policy for releasing stranded income tax effects from AOCI. In the period of adoption, they must also disclose whether or not they have elected to reclassify the stranded tax effects in AOCI related to the TCJA to retained earnings in the statement of stockholders' equity.

If an entity elects to make the reclassification, they must further disclose what the reclassification encompasses. This should address whether the reclassification relates to income tax effects other than the effect of the change in the US federal corporate income tax. In addition, entities electing to reclassify stranded tax effects must make additional disclosures in the first interim and annual period of adoption about the reason for the change in

Continued

# Accounting and reporting updates

accounting policy and the effect of the change on their financial statements.

The guidance is effective for all companies for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. However, early adoption of the ASU is permitted. Two transition methods are available for adoption of the new guidance: (1) retrospective to each period (or periods) in which the income tax effects of the 2017 Act related to items remaining in AOCI are recognized, or (2) at the beginning of the period of adoption.

Entities should note that calculation of the relevant amount for reclassification may not be straightforward. They should carefully review the events that have led to stranded tax effects and consider the effect of valuation allowances and business combinations, among other items, in prior periods.

## Other new standards

US tax reform has, rightly, received a lot of attention over the past few months. However, it is important to maintain awareness of other accounting issues that may impact tax.

For most calendar-year public business entities, the new revenue standard (ASC 606, *Revenue From Contracts With Customers*) has been adopted with effect from 1 January 2018.

The implications of ASC 606 have been discussed in previous newsletters and other publications, but as tax departments go through the Q1 reporting process it is important that this is properly considered. In particular, entities should make sure that the effect on valuation allowances as well as knock-on effects of the new standard, such as transfer pricing or state and local tax effects, are properly accounted for.

ASU 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, will also take effect from 1 January 2018 for many entities. While its effects may be more limited than the new revenue standard, it could also have significant impacts on tax reporting for some entities.

The ASU will change the accounting for equity instruments as well as financial liabilities where entities have elected the fair value option. It may result in more earnings volatility for some entities, as they may be required to measure more items at fair value than was previously the case, and exemptions which previously permitted certain movements in fair value related to available for sale equity securities to be taken to AOCI will cease to apply.

The requirement to measure items at fair value is likely in many cases to give rise to deferred tax assets or liabilities, as book bases change while tax bases do not.

ASU 2016-06, *Accounting for Income Taxes: Intra-Entity Asset Transfers of Assets Other than Inventory* dealing with the income tax effects of intra-entity asset transfers other than inventory, is also effective for public business entities for periods commencing after 15 December 2017. Prior to the introduction of ASU 2016-06, the tax effects of intra-entity asset transfers were deferred until sale of the asset outside the group or recovery of the asset through use. This was an exception to the general principle of ASC 740 that requires comprehensive recognition of current and deferred income taxes.

This exception has now been eliminated for most such transfers, though it continues to exist for transfers of inventory

Continued

# Accounting and reporting updates

Entities must use the modified retrospective approach when adopting the new guidance, recording the cumulative effect of the change in retained earnings at the start of the period of adoption.

There are also a number of accounting standards that may be early adopted in 2018, including the very significant changes to lease accounting in ASC 842, which will have a number of tax accounting effects, and the new goodwill impairment guidance in ASU 2017-04.

## The IASB update

A number of new accounting standards are in effect in 2018. We have referred above to the new revenue standard; it is a converged standard so the US GAAP (ASC 606) and IFRS (IFRS 15) standards are similar.

IFRS 9 also takes effect for periods commencing on or after 1 January 2018. Its key provisions include the adoption of an expected credit losses approach to the recognition of impairment losses on financial instruments, which is expected to lead to day 1 losses being recorded on the initial recognition of many financial assets. This is likely to have tax consequences (either a cash tax effect if the tax treatment follows the book treatment, or a deferred tax impact where book basis changes but tax basis does not).

## The IFRIC update

The IFRS Interpretations Committee (IFRIC) met on 13 March 2018. Among the items on the Committee's agenda was the accounting for deferred tax when a lessee recognises an asset and liability at the commencement of a lease (i.e. when a finance lease is entered into). This issue will become more widely applicable once IFRS 16 is effective, as the new standard will mean that many leases that are currently accounted for as operating leases will change so that they are accounted for as finance leases. The Committee noted that a similar issue arises when considering deferred tax on decommissioning assets and liabilities.

There is diversity in practice in how deferred tax is accounted for. The staff paper discussed by the IFRIC noted that three alternative approaches appear to be used in practice:

- Approach 1 – the initial recognition exception applies. An entity applies the initial recognition exception separately to the temporary differences arising on the initial recognition of the lease asset and the lease liability.
- Approach 2 – the initial recognition exception does not apply; the lease asset and the lease liability are 'integrally linked'. An entity assesses the lease asset and lease liability together on a net basis. Thus, assuming an entity has not made lease payments before lease commencement, temporary differences do not arise on initial recognition.
- Approach 3 – the initial recognition exception does not apply to the gross temporary differences. The initial recognition exception is assumed to apply only when an entity recognises an asset or liability. Thus, the initial recognition exception does not apply on initial recognition of the lease asset and lease liability because an entity recognises an asset and liability at the same time.

One factor that may contribute to the diversity in practice is that the tax treatment of leases differs between territories. Some tax regimes follow the accounting; others allow deductions as lease

Continued

# Accounting and reporting updates

payments are made; and some take more complex approaches.

The staff paper noted that in most jurisdictions entities apply either Approach 1 or Approach 2, but Approach 3 predominates in a smaller number of territories.

The Committee concluded that current IFRS Standards and Interpretations do not provide enough information for a company to determine the appropriate accounting. The Committee accordingly decided to research developing an Interpretation aimed at addressing the accounting for the deferred tax implications of leases. The process of developing an Interpretation is likely to take some time and is not likely to be completed before 2019 at the earliest.

## The ESMA update

On 26 January 2018, the European Securities and Markets Authority (ESMA) issued a statement on the accounting for income tax consequences of the TCJA.

The statement noted the complexity of the new law and the limited time available to prepare accounting estimates of its effects. It reminded preparers of financial statements that IAS 12 requires current and deferred income taxes to be measured based on enacted law and admits no exceptions to this principle.

Accordingly, ESMA noted in its statement that it expects that EU issuers will make a reasonable estimate of the impact of the TCJA.

However, the statement acknowledged that the nature and timing of the new law meant that a higher than normal amount of estimation uncertainty may exist, and that measurement adjustments may need to be made in future periods as this uncertainty is resolved.

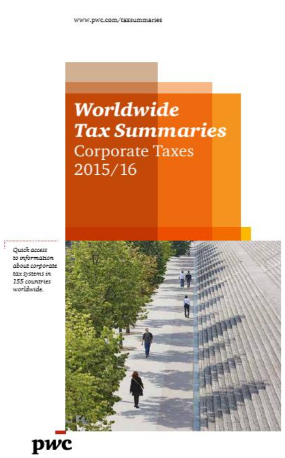
Importantly, ESMA noted that it expected that such adjustments would normally be treated as changes in estimates rather than corrections of errors.

The statement also reminded issuers of the need to provide users of the financial statements with clear information about the significant uncertainties and judgments included in the financial statements.

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

We have commented briefly on some of the tax accounting implications of the law changes set out below, particularly where these go beyond the requirement to adjust the current tax provision calculation or adjust deferred tax balances for rate changes. However, companies should not treat the tax accounting analysis in these summaries as exhaustive and should consider the implications for their particular circumstances.

## Canada

The Canadian government issued its budget on 27 February 2018. The budget contained a number of technical anti-avoidance measures. The Canadian government indicated at the time of the budget that it would be carrying out a detailed analysis of the US TCJA to assess its impact on Canada, suggesting that we may see some sort of reaction to the US tax reform in the near future.

## Denmark

The Danish government published a draft law on 23 February 2018 that would make a number of changes to the Danish tax system. This would include changes to the Danish thin capitalization system in response to a recent decision by the Court of Justice of the European Union (CJEU), which ruled that Denmark's system of giving compensating adjustments when an interest restriction is applied to a related party in another territory is too restrictive. The new law would extend the treatment available in cases of loans between two Danish related parties to cases where one of the parties is not a Danish resident.

This will allow Danish companies to reduce their taxable income where their related counterparties have had their taxable income increased as a consequence of a tin capitalization disallowance.

The government has also made proposals to increase the tax deduction available for R&D expenses from the current 100% to 110%. The deduction would gradually increase towards that level over the years to 2026.

## Finland

New interest deduction limitation rules are proposed in the draft government proposal published 19 January 2018. The proposal is based on the EU Directive 2016/1164 (Anti-tax avoidance directive I, or ATAD I). The proposed rules would set additional restrictions on the interest deductibility as compared to the current rules in force. They would be applicable to all expenses

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# Recent and upcoming major tax law changes

related to obtaining financing (the current rules apply only to interest expenses on related party loans) and to all Finnish tax resident corporate entities (including real estate companies). The current exemption related to the equity ratio test would be abolished. A *de minimis* amount of EUR 3 million would always be deductible if owed to third parties.

## Greece

The Greek government enacted L.4512/18 on 17 January 2018. The most important tax provisions of new law include:

- An income tax exemption for companies' profits which are derived from the use of internationally recognized production patents. Such profits are exempt from taxation for three consecutive years provided that they have been credited to a special tax reserve. The exemption also applies to service companies that use internationally recognized patents.
- Favourable tax rates for the capitalization of specific tax free reserves. In particular capitalization of such reserves is subject to a reduced tax rate (5% for listed companies and 10% for unlisted companies). Following the capitalization, said reserves shall not be distributed for a period of 10 years. Entities taking advantage of this will need to consider the implications for their tax basis in the reserves.
- A reduction in the amount of penalties and surcharges payable as a result of a tax audit (up to 40%) if the taxable entity pays the relevant fines and surcharges in full within one month from their imposition.

## India

The Indian budget was presented to the Parliament on 1 February. It makes a number of proposals for changes to the tax system.

- Tax Rates: Reduction in the corporate tax rate for tax year 2018-19 to 25% for companies which had reported turnover (sales) of up to INR 2.5 billion (approximately USD 40 million) for fiscal year 2016-17. The existing Education Cess and Secondary Higher Education Cess (additional levies, calculated as a percentage of the of corporate income tax charge) of 3% are proposed to be replaced by a Health and Education Cess of 4%.
- Tax on deemed dividends: Amendments to the Dividend Distribution Tax (DDT) provisions are proposed so that certain loans and advances will be taxed by statute as deemed dividends to improve overall compliance and clarify issues that have been subject to legislation. A rate of 30% (without grossing up) has been proposed, higher than that on actual dividends. The liability to discharge DDT is on the company paying the 'deemed dividend'. Companies will need to determine the extent to which any tax on these loans and advances should be accounted for within the income tax framework.
- Alignment of the scope of 'business connection' with a modified Permanent Establishment (PE) Rule: The definition of a 'business connection' has been widened in order to bring it in line with the provisions relating to Dependent Agent Permanent Establishment (DAPE)provided in India's tax treaties, as amended by the Multilateral Convention to

Continued

# Recent and upcoming major tax law changes

Implement Tax Treaty Related Measures (MLI). It will now include business activities carried out through persons who, acting on behalf of the non-resident, habitually play the principal role leading to conclusion of contracts by the non-resident. This is likely to mean more non-resident companies will have PEs in India; however, significant uncertainty as to exactly what activities meet the test can be expected initially.

- ‘Business connection’ to include ‘Significant Economic presence’: This is a second change to the PE model. With the evolution of new business models operating remotely through digital media, many countries are concerned that source countries are unable to tax profits that are generated from their territories. To address this India’s government has proposed that a ‘significant economic presence' in India shall also constitute a 'business connection'. A ‘significant economic presence’ would be determined based on certain prescribed parameters such as the quantum of transactions including download of data or software and solicitation of business in India through digital means. There will be consultation with stakeholders before the minimum thresholds are finalized.
- Capital Gains
  - Withdrawal of exemption on listed securities: The long term capital gains tax exemption will be withdrawn in respect of gains arising from transfer of equity shares, units of an equity oriented fund or units of a business trust, where such transfer is made on or after 1 April 2018, subject to certain stipulations.
  - Long term capital gains exceeding INR 100,000 from listed equity shares/ equity oriented funds to be taxed at a rate of 10% without indexation benefit. Gains arising up to January 31, 2018 to be grandfathered.

  Entities will need to consider the impact of this change on the tax bases of their investments in Indian securities.

## *Netherlands*

On 22 February 2018, the CJEU issued its judgment in Joined Cases C-398/16 and C-399/16 X BV and X NV v Staatssecretaris van Financiën. These cases, which were referred to the CJEU by the Dutch Supreme Court in July 2016, relate to the consequences of the ‘per element’ approach (as established by the CJEU in C-386/14 Groupe Steria) for the Dutch group taxation regime particularly concerning interest deductibility and currency losses. The CJEU followed the reasoning set out by the Advocate General (AG) on 25 October 2017.

It concluded that two comparable situations concerning the financial costs borne by the parent company related to its holding in a subsidiary, were treated differently based on whether or not a fiscal unity exists, which amounted to a restriction on the fundamental freedoms. The Court did not accept the Netherlands’ justifications regarding the need to maintain the coherence of the fiscal unity regime and the need to prevent tax evasion.

Continued

# Recent and upcoming major tax law changes

The Dutch government had previously announced several  in the event that the CJEU came to this conclusion. These measures amount to applying certain provisions of the Dutch tax regime within a fiscal unity as if such a fiscal unity does not exist. As a result, the existing favourable treatment for domestic situations is intended to be eliminated. These measures are expected to take effect from 25 October 2017. Legislation to enact the changes is expected to be introduced in the second quarter of 2018 with enactment expected shortly afterwards.

The Dutch government also issued a Policy Brief, setting out its agenda with respect to taxes. The proposals reflect the OECD BEPS initiatives and further EU initiatives, and broadly align with earlier announcements.

Two specific issues are addressed: (a) the implementation of the EU Anti-Tax Avoidance Directives (ATAD) I and II, and (b) increased scrutiny on conduit structures.

Details of the implementation of ATAD suggest it will go beyond the minimum required by the Directive. There will not be a group exception introduced into the proposed interest restriction rules, and the *de minimis* amount will be EUR 1 million, lower than the required EUR 3 million. A minimum capital rule will be applied to banks and insurers.

The proposed controlled foreign company (CFC) rules will focus on income in specific passive income categories, and on countries either with a low statutory tax rate or included on the EU's list of non-cooperative countries.

The government is expected to open a consultation on the anti-hybrid rules in 2018 and will invite comments from stakeholders, followed by legislation in 2019.

The scrutiny applied to conduit structures will result in a conditional withholding at source if a dividend, royalty or interest payment by a Dutch taxpayer is directly or indirectly paid to a group company in a blacklisted country or a country with a very low statutory tax rate. It is expected that the withholding tax will only effect 'wholly artificial arrangements', meaning that in case there are substantive business reasons (non-tax avoidance reasons) the withholding tax will not be due. In addition, the generally applicable dividend withholding tax will be abolished.

Another result of the increased scrutiny will be increased substance requirements in the Netherlands, without which spontaneous exchange of information with treaty partners will apply. Currently these rules already exist for companies receiving interest or royalty from and/or paying interest or royalty to group companies. These rules will be extended to companies receiving dividends from group companies. Furthermore the substance requirements that need to be met to avoid information exchange will be expanded to include a minimum wage sum and office space requirements.

This represents an extensive series of changes to the tax law of the Netherlands, which is a popular location for holding companies.

## South Africa

The 2018 Budget for South Africa contains some provisions that are likely to impact multinational enterprises with operations in the country.

As well as raising the prospect of changes to CFC rules and R&D incentives, the Budget also proposes changes to the tax treatment of interest, the better to balance certainty and simplicity with protection of the tax base.

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# Recent and upcoming major tax law changes

## Sweden

Proposals have been made by the Swedish government for significant changes to the country's tax system.

The proposals include a reduction in the corporate income tax rate, from 22% to 21.4% (for two years) and then to 20.6%.

Interest restriction rules will also change in line with the requirements of ATAD I. This will mean interest will only be deductible up to 30% of EBITDA, with a *de minimis* amount of SEK 5 million (approximately USD 600,000). Interest on intra-group loans to low tax jurisdictions will not be deductible. Tax deductions will also be denied for interest on borrowings with a sole or main purpose of achieving a tax benefit.

New anti-hybrid provisions will be introduced as well.

Changes to the countries tax allocation reserve system are also proposed. The tax allocation reserve allows entities to set aside 25% of their taxable earnings into a reserve which is not taxed until the reserve is ended (a period of up to six years). Interest at a favourable rate is charged on the income reserved in this way.

The proposed changes will mean that amounts that are allocated to the tax allocation reserve will reverse at 103%, 104% or 106% depending on the timing of the allocation and reversal.

CFC rules have been addressed by the Swedish Ministry of Finance. They are intended to be changed to align them better with ATAD I. Items subject to change will include the definition of related parties, and the manner of determining if the jurisdiction in which a CFC is situated is a low-tax territory.

Other CFC changes will address the potential double taxation that can exist when a capital gain arises on the sale of a CFC which has been subject to CFC taxation.

## Taiwan

Taiwan's government on 18 January 2018 enacted a number of changes to the territory's tax system, including the corporate income tax and the surtax on undistributed earnings.

For 2018, approximately 50% of the 10% surtax already paid on undistributed earnings is creditable against dividend withholding tax. Therefore, the effective surtax rate should be 5%.

For 2019, the 10% surtax is still levied on undistributed 2017 earnings, i.e. if 2017 earnings are not distributed to shareholders in 2018, 10% surtax will be levied in 2019. Tax credits are no longer available against dividend withholding tax. Therefore, the effective surtax rate will be 10%.

For 2020, 5% surtax is levied on undistributed 2018 earnings, and tax credits are no longer available against dividend withholding tax. Therefore, the effective surtax rate will be 5%.

Companies may therefore wish to consider whether they should distribute all prior year earnings before the end of FY2018 to utilize the grace period for crediting surtax on undistributed earnings against dividend withholding tax. They should consider the impact of the change on the rate at which they measure deferred tax on outside basis differences.

The government also increased the corporate income tax rate from 17% to 20%, with effect from 1 January 2018, and the standard dividend withholding tax rate from 20% to 21%. Companies will need to consider the remeasurement of deferred tax assets and liabilities at the new rate.

Continued

# Recent and upcoming major tax law changes

## United Kingdom

Finance Act 2018 was enacted on 15 March 2018. There are two significant provisions: the first is the change to the rate of the Research and Development Expenditure Credit, which increases to 12% for expenditure incurred on or after 1 January 2018 from the previous rate of 11%.

The second is a change to the UK's capital gains system for corporation tax. Up until December 2017, the tax base of assets has been indexed to inflation. From December 2017, no further indexation allowance will accrue. This may present a challenge for systems and processes in the near term. The tax accounting impact of the indexation allowance has often been (in the absence of revaluation of book basis) to create a tax basis in excess of book, which requires assessment for realizability of the resulting deferred tax asset. As a result of the change, for newly acquired assets this complication should cease to exist.

## USA

Following the enactment of the TCJA in December 2017, the Internal Revenue Service (IRS) and Treasury have issued further guidance on the operation of the tax on mandatory deemed repatriation of post-1986 undistributed foreign earnings and profits (transition tax otherwise known as the toll charge) in the form of Notice 2018-07, Notice 2018-13, and Revenue Procedure 2018-17.

The Notices provide further guidance on how to determine aggregate foreign cash positions and earnings and profits for the purpose of the transition tax. The Revenue Procedure makes some modifications to existing procedures for changing the annual accounting period (tax year) of certain foreign corporations whose US shareholders are subject to the transition tax.

Further guidance on the transition tax and other provisions of the new law is expected over the course of the year.

## European Union

The European Commission (EC) published proposals for the taxation of the digital economy on 21 March 2018. This included two draft Directives, one intended to represent a long term solution and one being more of a short term expedient.

The long term solution proposed by the EC is set out in a Directive which provides rules for the establishing a taxable nexus where a digital business has no physical presence but does have a non-physical commercial presence (what the EC calls a 'significant digital presence').

A significant digital presence is defined in the proposal, according to revenues attributable to users in a territory, number of users in a territory, or number of contracts concluded by users in a territory.

The Directive suggests a method for the attribution of profit to the taxable nexus created under this definition. This would consider the economically significant activities undertaken, including the collection and processing of data and content, the sale of advertising, making third party content available on a digital marketplace, and the supply of any other digital service.

The short term solution is set out in a second Directive, which would introduce a Digital Services Tax (DST) levied at 3% of gross revenues derived in the EU from placing advertising on a digital interface, making available a multi-sided digital interface, and transmitting data collected about or generated from users. There would be a *de minimis* worldwide revenue limit of EUR 750 million and an EU revenue threshold of EUR 50 million. The DST

Continued

# Recent and upcoming major tax law changes

would not appear at first sight to fall within income tax accounting, although there are suggestions that it could be creditable against the corporate income tax in EU Member States.

The Directives would need to be unanimously approved by the Council of the European Union. At this stage it seems unlikely that this will happen, as a number of Member States have indicated that they have concerns about the proposals. The proposals have also attracted criticism from outside the EU, as it appears that the taxes levied by the Directives would be paid disproportionately by groups based outside the EU.

Nevertheless, the proposals represent an attempt at unified approach to the taxation of the digital economy, and tax departments will need to monitor developments. It is possible that some Member States may take unilateral measures inspired by the EC's proposals; taxpayers are advised to monitor developments.

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# Tax accounting refresher

In this section we summarise some of the key tax accounting issues to think about when converting from one GAAP to another.

## Tax accounting and reporting considerations in relation to GAAP conversions

### Overview

Companies may be required to convert their financial statements from one accounting framework to another in a number of circumstances. Often the motivation is a cross border acquisition, for example a US headquartered company, reporting under US GAAP, acquiring a Dutch headquartered company, which reports under IFRS.

The requirement to convert could also come about because of regulatory requirements. In many instances, a company may have to file financial information with local regulators using one accounting standard and report its finances to its parent company using another. For example, a French subsidiary with a listed UK parent company may have to file local reports using French GAAP and report its operations to its parent company using IFRS. In other instances conversions may be required when regulators change required accounting frameworks – for instance the UK's recent change from 'old' UK GAAP to 'new' UK GAAP (FRS 101 and 102) or looking further back the adoption of IFRS by listed companies within the EU.

The process of converting financial statements from one framework to another is not always straightforward; it is not something that most finance teams go through very often, so there may be little internal experience to draw on.

While this discussion focuses on converting historical financial information, much of this will also be applicable in circumstances where conversion between different accounting standards is regularly required on an ongoing basis. We have assumed that the conversion does not affect the historic local financial statements, if any, from which tax returns themselves must be prepared. We have focused the specifics of this discussion primarily on IFRS/US GAAP conversions. A summary of the differences between the two frameworks can be found in our publication, *IFRS and US GAAP: similarities and differences*.

The tax accounting for GAAP conversion can be broken down into a number of pieces. The first is to assess the tax consequences of pre-tax adjustments.

Next, companies should assess whether the tax accounting frameworks themselves differ (e.g.

Continued

# Tax accounting refresher

when moving from US GAAP to IFRS, companies should consider the differences between ASC 740 and IAS 12), including the different disclosure requirements. They should assess the impact of any relevant differences on their tax reporting.

Companies should reassess the recoverability of any deferred tax assets after making all of these adjustments.

Finally, companies should consider any disclosures that they need to make as a result of the process, for example, the requirements in IFRS 1. This point applies to both tax and non-tax items and readers should consult the similarities and differences publication referred to above, where it is addressed in more detail in.

## Tax accounting effects of pre-tax GAAP adjustments

When converting from one GAAP to another, there will be a number of areas where the treatment required by the two frameworks is different. The converting company should go through a process of identifying the GAAP differences that will have an impact and develop a strategy as to how to implement the conversion. It should then evaluate the line items within its financial statements that are affected by the GAAP differences and begin the process of working out the impact. PwC's publication on similarities and differences between IFRS and US GAAP is likely to be helpful in this process.

Once the impact of changing GAAP on a particular financial statement line item has been calculated, journal entries will be prepared to give effect to the required change. It is useful for tax accounting teams to be involved at this stage so that they can identify the tax impact of the adjustment, if any, and post the tax journal at the same time.

Most GAAP differences are likely to have an effect on tax accounting in some shape or form, with the exception, in most cases, of balance sheet reclassifications which may not result in any changes to the tax numbers or notes.

Other changes will typically affect either the calculation of deferred tax, or the reconciliation to total tax that is required in the tax note.

In order to assess this, preparers of GAAP conversions must determine whether the GAAP adjustment is a permanent of a temporary difference.

Temporary differences will have an impact on the deferred tax calculation. These could arise, for example, when two GAAPs take a different approach to accounting for defined benefit pension schemes. Let's consider an example.

Under GAAP A, at the opening balance sheet there is a pension deficit of 1,000. During the period there are deductible payments of 100, non-deductible expenses taken to the P&L of 90, and non-deductible actuarial losses taken to OCI of 40. The applicable tax rate is 20%.

Under GAAP B, the opening balance sheet shows a pension deficit of 1,200. There are payments of 100, non-deductible expenses of in the P&L of 95, and non-deductible actuarial losses of 45. This example simplifies pension accounting in the interests of providing a readable example.

This gives rise under GAAP A to an opening deferred tax asset (DTA) of 200 and a closing DTA of 206.  GAAP B would record an opening DTA of 240, with a closing DTA of 248.

Continued

# Tax accounting refresher

| | 1/1/17 Asset/ (liability) | Payments | Expenses | Actuarial gains/ (losses) | 31/12/17 Asset/ (liability) |
|---|---|---|---|---|---|
| **GAAP A** | (1,000) | 100 | (90) | (40) | (1,030) |
| **GAAP A deferred tax** | 200 | | | | 206 |
| **GAAP B** | (1,200) | 100 | (95) | (45) | (1,240) |
| **GAAP B deferred tax** | 240 | | | | 248 |

The accounting adjustments to go from A to B would be as follows:

To increase the opening pension deficit (note that further analysis may be required to determine whether the debit to retained earnings may need to be allocated in whole or part to other reserves):

**Cr pension 200**

**Dr retained earnings 200**

To increase the current period expense:

**Cr pension 5**

**Dr pension expense 5**

To increase the actuarial loss for the period:

**Cr pension 5**

**Dr actuarial gains and losses (OCI) 5**

The tax accounting entries for this can be calculated at 20% of the adjustment:

To reflect the increase in the opening pension deficit:

**Cr retained earnings 40**

**Dr deferred tax asset 40**

To account for tax on the current period expense:

**Cr tax expense 1**

**Dr deferred tax asset 1**

To account for tax on the increased actuarial loss:

**Cr tax (OCI) 1**

**Dr deferred tax asset 1**

This accounting allows us to record the appropriate closing deferred tax position taking into account the pre-tax adjustments, and to identify the appropriate debits and credits to get to that position.

If there were no other GAAP adjustments to record, the effect of going from GAAP A to GAAP B would be to reduce profit before tax by 5, and reduce tax expense by 1. This would not result in any requirement to change the tax reconciliation in the notes.

Let's now consider an adjustment that might give rise to a permanent difference. During the period the company acquires an asset for 1,000, being a license to use IP for a 5 year period. Under local tax law, amortisation of the asset is not deductible and no tax basis can be recognized on a sale.

Continued

# Tax accounting refresher

Under US GAAP, this would typically give rise to a temporary difference on acquisition. The simultaneous equation method would apply, and the deferred tax liability would be 250, with a book asset value of 1,250.

IFRS would apply the initial recognition exception so that no deferred tax asset or liability would exist.

Now consider a scenario where we have an asset which is accounted for in the business under consideration under one framework, but not the other (for example, a US company could have assets attributed to it under US GAAP because of push down accounting that would have been accounted for solely on consolidation under IFRS).

Where the asset has been impaired, depreciated or amortised under US GAAP, that entry will need to be reversed on conversion to IFRS. Let's consider the implications of this for tax accounting purposes. Assume that under US GAAP in 2017 there was amortisation of 200.

The accounting entries required to go from US GAAP to IFRS in 2017 would be as follows:

| | | |
|---|---|---|
| **Dr retained earnings** | **200** | |
| **Cr amortisation expense** | | **200** |

This would have no impact on the tax in the IFRS income statement or balance sheet – there is no movement in the deferred tax balance, and the current tax expense is not impacted by the adjustment.

The impact of the adjustment would instead be seen in the tax reconciliation. Assume US GAAP profits excluding the amortisation of 800. Assume the amortisation is non-deductible and that there are no other adjusting items for tax purposes, and the tax rate is 20%.

Under US GAAP, the company would have book profits of 800, taxable profits of 1,000 and a current tax charge of 200 offset by a deferred tax credit of 40.

| | |
|---|---|
| Current tax | 200 |
| Deferred tax | (40) |
| **Total tax charge** | 160 |

Under IFRS, the company would show book profits of 1,000, taxable profits of 1,000, and a current and total tax charge of 200.

| | |
|---|---|
| Current tax | 200 |
| Deferred tax | - |
| **Total tax charge** | 200 |

An important point to consider when converting historical financial information is that the current tax calculated for a year is unlikely to change (except to the extent that uncertain tax positions impact the current tax charge in the year). This is because the current tax charge has already been calculated to reflect the position expected to be taken on the return (it should not generally be trued up to reflect the actual return as part of the conversion process; that adjustment should continue to be reflected in the period in which the return was filed).

In order to do this a schedule is often prepared which walks from the new GAAP profit before tax to the old GAAP profit before tax, and then from that figure to the taxable income for the period. The latter section is based on the original tax provision calculation; the former section requires each of the GAAP differences to be identified as permanent or temporary. Each temporary adjustment should have an impact in the deferred tax calculation; each permanent adjustment should solely affect the tax reconciliation.

Continued

# Tax accounting refresher

### Accounting for the effect of the different tax accounting frameworks

In addition to the need to assess the tax implications of the pre-tax GAAP adjustments, there is also a need to consider the effects of differences between the tax accounting standards (e.g. between IAS 12 and ASC 740).

If we restrict our consideration to US GAAP and IFRS, the two most widely used accounting frameworks, there are a range of differences that need to be considered. Not all of these will affect every conversion project, but each one should be considered.

We have discussed the differences in a previous newsletter (January-March 2014) so will not go into detail here. However, one point to be aware of is that the general rule that current tax charges and credits do not change as a result of a GAAP conversion is subject to an important exception. This is that the approach taken by the standards to uncertain tax positions (UTPs) is different and will very often lead to a different amount being recorded in respect of UTPs.

Other areas with significant differences include (but are not limited to):

- the accounting for deferred tax on share based payments;
- dealing with valuation allowances or the recognition of deferred tax assets (although the two approaches will often result in the same net balance sheet position);
- IAS 12's concept of the initial recognition exception;
- intra-period allocation, including IFRS's backwards tracing approach; and
- disclosures.

Most of these issues can be looked at on a discrete basis; the application of the initial recognition exception can be more complicated to apply retrospectively in practice.

### Reassessing recoverability of deferred taxes

Once the various GAAP adjustments (both pre-tax and tax) have been dealt with, it is possible that as a result of the resulting changes to deferred tax assets and liabilities a company may need to reassess the recoverability of its deferred tax assets, particularly if these have increased as a result of the conversion.

This will need to be done according to the principals of the new GAAP. Companies may have different inputs to feed into their assessments of recoverability as a result of other changes to the pre-tax accounting, for instance if profits changed as a result of the change in GAAP.

### Conclusion

Carrying out a GAAP conversion is a complex exercise which is often conducted in circumstances where time is limited. It is important to plan the involvement of the tax function so that tax involvement happens at the right time. As the process continues and GAAP adjustments are made, tax teams should be involved so that they can determine the tax impact of changes as they happen.

Tax teams should also bear in mind the need to deal with differences between the tax standards and develop an approach that allows them to assess this.

Continued

# Tax accounting refresher

Over the years we have covered a number of technical topics in the tax accounting refresher section of this newsletter. Here we present a summary of the most recent topics and links to the relevant newsletters. We would love your input on what topics you would like us to cover in future newsletters. If you have any feedback, please feel free to reach out to any of the primary authors listed below.

## Tax accounting refresher topics

| Topic | Newsletter |
|---|---|
| Tax provisions for carve-out financial statements | Q1 2016 |
| Foreign currency tax accounting | Q2 2016 |
| Outside basis difference | Q3 2016 |
| Key tax accounting areas for preparation of 2016 year-end financial statements | Q4 2016 |
| Interim reporting | Q1 2017 |
| Tax accounting and BEPS | Q2 2017 |
| Technology and the tax function | Q3 2017 |
| Key tax accounting areas for preparation of 2017 year-end financial statements | Q4 2017 |

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For more information on the topics discussed in this newsletter or for other tax accounting questions, contact your local PwC engagement team or your Tax Accounting Services network member listed here.

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