Attachment: Deferred tax accounting where the expected manner of recovery of an asset through use only gives rise to tax consequences under multiple regimes

Background information

Tax legislation in certain jurisdictions results in income and profits being assessable under multiple tax regimes depending on the nature of the transaction, with no ability to settle the multiple tax obligations by offsetting one against the other. The multiple tax regimes may exist within a single jurisdiction, an example being a jurisdiction with separate income tax and capital gains tax (CGT) mechanisms. Multiple tax regimes may also apply to the same income and profits across multiple jurisdictions, an example being where operations in an offshore location are taxed in both the local and parent entity jurisdictions.

In certain circumstances, a single expected manner of recovery of an asset may give rise to tax consequences under multiple regimes.

Example:

- An entity acquires a license as part of a business combination - measured and recognised at fair value.
- The entity intends to hold the license until expiry at which point it will have a residual value of zero. The entity will fully depreciate the carrying amount of the license for accounting purposes over its period of use, during which it will generate both accounting and taxable income.
- Under tax legislation in the relevant jurisdiction, the license has no deductible/depreciable amount for income tax purposes. However, the entity is entitled to a deduction on sale, relinquishment or expiry for CGT purposes. The CGT deductible amount can only be used to calculate net capital gains or losses (i.e. the deduction is not available to reduce assessable income for income tax purposes).
- As the license has been acquired as part of a business combination, the initial recognition exception within IAS 12 *Income Taxes* paragraphs 15 and 24 does not apply (i.e. any deferred tax must be recognised as part of the business combination accounting).

Issue

An entity expects to recover the entire carrying amount of an asset through use only (i.e. no further recovery on disposal) and this gives rise to tax consequences under multiple tax regimes – i.e. income tax during period of use and CGT at end of use. What is the tax base when the asset has a depreciable amount for CGT purposes but not for income tax?

Views

There is diversity amongst the major accounting firms on this particular issue. We are aware of three views in practice:

- View 1: single tax base
- View 2: multiple tax bases
- View 3: accounting policy choice

Each of these views is considered in turn below.

View 1: single tax base

Under this view, it is assumed that it is only necessary to identify a single tax base where there is a single expected manner of recovery of the accounting carrying amount. In the example under consideration, the asset is considered to have a tax base that is available to the Entity as a result of the recovery of the asset through use, being the CGT tax base.

Paragraph 5 of IAS 12 defines the tax base of an asset or liability as the amount attributed to that asset or liability for tax purposes and defines a temporary difference as the difference between the carrying amount of an asset or liability in the statement of financial position and its tax base. As such, deferred tax should be recognised based on the difference between the asset's carrying amount and its tax base. Assuming the CGT tax base and carrying amount are consistent at the date of the business

combination, there is no temporary difference and therefore no deferred tax to recognise as part of the business combination accounting.

A deductible temporary difference, potentially giving rise to a deferred tax asset (DTA), arises over time as the asset is depreciated for accounting purposes with no equivalent change in the CGT tax base. The potential DTA represents the tax effect of the temporary difference between the carrying amount of the asset and the future CGT tax deduction. The potential DTA would be assessed for recoverability, which determines whether it can be recognised.

This view considers that:

- The expected manner of recovery of the asset is through use. At the end of the useful life of the license (expiry), the entity is entitled to a deductible amount for CGT purposes. This represents the tax base.
- For the purpose of measuring deferred tax, it is not relevant that the Entity is not entitled to a tax deduction *during* the period of use under the income tax regime as an available (CGT) tax base for the asset has been identified.
- It is also not relevant that the CGT deductible amount can only be used to calculate net capital gains, as this impacts only the recognition of any DTA that arises in relation to the CGT deductible amount (i.e. whether there are probable capital gains to utilise the CGT deductible amount now or in the future).
- The CGT tax base is the appropriate single tax base because it is available to the Entity regardless of the manner of, or intention relating to, recovery (i.e. through use only; through use and subsequent sale; and through sale only).
- Refer to Appendix 1 for an illustrative example of View 1.

View 2: multiple tax bases

Under this view, the Entity expects to recover the entire carrying amount through the period of use, with no further recovery on disposal. Deferred taxes are recognised having regard separately to the future tax consequences arising from recovery through use, for which there is no income tax deduction, and the future tax consequences that arise at the end of use/expiry, for which there is a CGT tax base.

At the date of the business combination, the Entity recognises a deferred tax liability (DTL) for the future income tax consequences associated with the expected recovery through use. The DTL is based on the taxable temporary difference between the asset's carrying amount (i.e. acquisition date fair value) and the tax base (i.e. an income tax base of nil).

The Entity will also consider the recognition of a DTA for the future CGT tax consequences associated with the expiry of the license. The DTA is based on the deductible temporary difference between the asset's residual value of nil (being the expected value at the end of use) and the tax base (i.e. the CGT tax base). The recognition of this DTA depends on an assessment of its recoverability.

This view considers that:

- The overall objective of IAS 12 is to account for the current and future tax consequences which reflect the expected recovery of the carrying amount of the asset.
- The objective paragraph of IAS 12 goes on to state "If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions."
- The expected manner of recovery of the asset is through use. This gives rise to two tax consequences:
  - Income tax – assessable income arising from realisation of the carrying amount with nil tax depreciation/deduction during the period of use
  - CGT - deductible amount is available at relinquishment/expiry with nil taxable proceeds
- Income tax: As the Entity recovers the carrying amount of the license through use, it will pay higher income tax due to there being no tax depreciation/deduction (i.e. compared to a situation where there were no tax consequences, such as the income generated from the license being exempt from tax). Recognition of an income tax DTL is consistent with the objective paragraph in IAS 12.

- CGT: At the end of the asset's useful life (license expiry), the Entity will be entitled to a CGT deductible amount that can be applied against future capital gains. While the CGT deductible amount will reduce future capital gains, making tax on future capital gains smaller, it does not impact the payment of future income tax.
- The two tax consequences are separate/distinct. That is, the CGT outcome does not impact the income tax outcome. Therefore, recognition of a DTL for income tax purposes and separate consideration of a DTA for CGT purposes, is appropriate. Accounting for both future tax consequences is consistent with the overall objective of IAS 12.
- To measure the deferred tax associated with the separate income tax and CGT tax consequences, it is appropriate to allocate the carrying amount of the asset based on the expected manner of recovery.
    - The income tax DTL is measured having regard to that portion of the asset's carrying amount that is expected to be recovered during the period of use, i.e. the depreciable amount of the asset. Therefore, the DTL is based on the taxable temporary difference between the asset's depreciable amount (given nil residual value this will be the asset's carrying amount) and the nil income tax base.
    - The CGT-related DTA is measured having regard to that portion of the carrying amount expected to be recovered through sale or at expiry, being the asset's residual value (which in the case of expiry is nil). Therefore, the DTA is based on the deductible temporary difference between the asset's nil residual value and the CGT tax base which is equal to the acquisition date fair value.

  Allocating the carrying amount across the tax regimes in this manner is consistent with paragraph BC6 of the Basis for Conclusions to IAS 12, which notes that 'recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value'.
- Refer to Appendix 1 for an illustrative example of View 2.

View 3: determination of tax base is an accounting policy choice

This view acknowledges that IAS 12 is unclear on how to determine an asset's tax base when the expected manner of recovery through use only gives rise to tax consequences under multiple tax regimes. Accordingly, an Entity is able to make an accounting policy choice between Views 1 and 2 above. The accounting policy must be developed in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and be consistently applied to all similar transactions.

Appendix 1: Illustrative example

- Fact pattern:
  - Business combination purchase consideration: $100
  - Fair value of license: $100 with an estimated life of 3 years
  - Other assets and liabilities of the business were included in the business combination but have been ignored for simplicity
  - Income tax depreciable amount: Nil
  - CGT deductible amount (upon sale or expiry): $100
  - Corporate income tax rate (income tax and CGT): 30%
  - No forecast capital gains to support the recognition of a DTA relating to the future CGT deductible amount

View 1: single tax base

Business combination accounting:

Purchase consideration (PC)	100
Identifiable net assets (INA)	
License	100
Deferred tax (1)	-
Total	100
Goodwill (PC – INA)	-

(1) Temporary Difference = Nil (license carrying amount (CA) of 100 less tax base of 100). Therefore no deferred tax to recognise as part of the business combination.

Subsequent Accounting

	Y0	Y1	Y2	Y3	**Total**
Accounting income		50	60	70	**180**
License depreciation		(30)	(35)	(35)	**(100)**
PBT		20	25	35	**80**
ITE (see calc below)		(15)	(18)	(21)	**(54)**
NPAT		5	7	14	**26**
Effective tax rate (ETR)		***75%***	***72%***	***60%***	**67%**
Income tax expense					
Current tax					
Assessable income		50	60	70	
Deductions		-	-	-	
Taxable income		50	60	70	
Current ITP @ 30% (**A**)		(15)	(18)	(21)	
Deferred tax					
Carrying amount	100	70	35	0	
Tax base	100	100	100	100	
Temporary difference	-	30	65	100	
Potential DTA @ 30%	-	9	19.5	30	
DTAs not recognised	-	(9)	(19.5)	(30)	
Net DTA		-	-	-	
Change in deferred tax (**B**)		-	-	-	
ITE (**A + B**)		(15)	(18)	(21)	

The ETR does not equal to the corporate income tax rate throughout the period of use (assuming that the CGT DTA is not recognised). Refer to Appendix 2 for the impact on the ETR when the Entity is able to recognise the DTA relating to the future CGT deductible amount.

View 2: multiple tax bases

- Fact pattern:
  - All facts are identical to those assumed in View 1
  - Any potential impairment of goodwill is ignored for simplicity

Business combination accounting:

Purchase consideration (PC)	100
Identifiable net assets (INA)	
License	100
Deferred tax (1)	(30)
Total	70
Goodwill (PC – INA)	30

(1) Taxable Temporary Difference (income tax) = 100 (license CA of 100 less tax base of 0). Gives rise to an income tax DTL of 30 (i.e. 100 @ 30%). Deductible Temporary Difference (CGT) = 100 (nil residual value less tax base of 100). Gives rise to a CGT DTA of 30 (i.e. 100 @ 30%). However, DTA is not recognised because future recovery is not considered probable.

Subsequent Accounting:

	Y0	Y1	Y2	Y3	**Total**
Accounting income		50	60	70	**180**
License depreciation		(30)	(35)	(35)	**(100)**
PBT		20	25	35	**80**
ITE (see calc below)		(6)	(7.5)	(10.5)	**(24)**
NPAT		14	17.5	24.5	**56**
Effective tax rate (ETR)		***30%***	***30%***	***30%***	**30%**
Income tax expense					
Current tax					
Assessable income		50	60	70	
Deductions		-	-	-	
Taxable income		50	60	70	
Current ITP @ 30% (**A**)		(15)	(18)	(21)	
Deferred tax					
1. Income tax					
Carrying amount	100	70	35	0	
Tax base	0	0	0	0	
Temporary difference	(100)	(70)	(35)	0	
Deferred tax liability @ 30%	(30)	(21)	(10.5)	0	
Change in deferred tax (**B**)		9	10.5	10.5	
2. CGT					
Carrying amount	-	-	-	-	
Tax base	100	100	100	100	
Temporary difference	100	100	100	100	
Potential DTA @ 30%	30	30	30	30	
DTAs not recognised	(30)	(30)	(30)	(30)	
Net DTA	-	-	-	-	
Change in deferred tax (**C**)		-	-	-	
ITE (**A + B + C**)		(6)	(7.5)	(10.5)	

The ETR is equal to the corporate income tax rate throughout the period of use while the CGT DTA is not recognised. Initial recognition of the CGT DTA and any subsequent remeasurement will impact the ETR. To the extent the CGT DTA was recognised as part of the business combination, this would impact the amount of goodwill recognised. In that scenario, the ETR would continue to equal to the corporate income tax rate except when the CGT DTA is remeasured.

Appendix 2: Probable future capital gains

Same fact pattern as per Appendix 1 above except the Entity forecasts capital gains to recognise the DTA relating to the CGT deductible amount (i.e. the probable recognition threshold is met).

View 1: single tax base

Business combination accounting:

Purchase consideration (PC)	100
Identifiable net assets (INA)	
License	100
Deferred tax (1)	-
Total	100
Goodwill (PC – INA)	-

(1) Temporary Difference = Nil (license CA of 100 less tax base of 100). Therefore no deferred tax balance to recognise as part of the business combination.

Subsequent Accounting

	Y0	Y1	Y2	Y3	**Total**
Accounting income		50	60	70	**180**
License depreciation		(30)	(35)	(35)	**(100)**
PBT		20	25	35	**80**
ITE (see calc below)		(6)	(7.5)	(10.5)	**(24)**
NPAT		14	17.5	24.5	**56**
Effective tax rate (ETR)		***30%***	***30%***	***30%***	**30%**
Income tax expense					
Current tax					
Assessable income		50	60	70	
Deductions		-	-	-	
Taxable income		50	60	70	
Current ITP @ 30% (**A**)		(15)	(18)	(21)	
Deferred tax					
Carrying amount	100	70	35	0	
Tax base	100	100	100	100	
Temporary difference	-	30	65	100	
Potential deferred tax asset @ 30%	-	9	19.5	30	
DTAs not recognised					
Change in deferred tax (**B**)		9	10.5	10.5	
ITE (**A + B**)		(6)	(7.5)	(10.5)	

Recognition of the emerging DTA relating to the CGT deductible amount results in an ETR that equals the corporate income tax rate throughout the period of use.

Appendix 3: Reasons for the IFRS IC to address the issue

a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

   Yes. As there is no specific guidance on the issue under IAS 12, different views exist on how to apply tax effect accounting when the expected manner of recovery through use only gives rise to tax consequences under multiple tax regimes. We are aware that there is diversity amongst the major accounting firms on this particular issue.

b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

   Yes. Consistent application of IFRS Standards on the issue would enhance comparability of financial statements across entities.

c) Can the issue be resolved efficiently within the confines of IFRS Standards and the *Conceptual Framework for Financial Reporting*?

   Yes. It can be resolved efficiently by providing explicit guidance on how to apply tax effect accounting when the expected manner of recovery through use only gives rise to tax consequences under multiple tax regimes.

d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS Standards?

   Yes. We have specified the issue to be the determination of an asset's tax base when the expected manner of recovery through use gives rise to tax consequences under multiple tax regimes.

e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

   Yes. The issue does not relate to any of current or planned IASB projects.