

Tax Accounting Update

Accounting for income taxes — 2009 year-end ten hot topics
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With many companies / groups preparing December year end accounts it is timely to consider what tax balances may be included in those accounts and common issues.

Income tax accounting remains an area of focus by major capital markets, regulators and stakeholders as income taxes affect a large number of companies' financial reporting and are often material to a company's financial statements. As the income tax accounting literature is far-reaching and tax law ever-changing, accounting for income taxes often proves challenging due to the requirement to exercise significant judgment.

There are a number of tax reporting standards, for example US GAAP, IFRS and local GAAP. Companies / groups may report under one or more of the above making the preparation of tax balances even more challenging. As such, companies remain focused on their accounting for income taxes.

In this newsletter, we highlight ten areas that may be important for entities as they prepare their annual financial statements.

1) Uncertain tax positions

Evaluating uncertain tax positions under both US GAAP and IFRS is a challenging area, especially for those non-public entities (including funds) preparing their accounts under US GAAP who are required to apply ASC 740-10-50 (FIN 48) for the first time in annual accounting periods beginning after 15 December 2008. For many of these non-public entities their 31 December 2009 annual accounts will be the first ones in which they need to adopt FIN 48.

The adoption of FIN 48 by funds gives rise to a unique set of issues and special considerations as many of the funds concerned will be preparing their accounts using Investment Company accounting. Under this accounting practice a fund accounts for its investments at fair market value regardless of the percentage size of the holding or the level of control exercised over the investment. In such cases, the fund will need to distinguish between those Uncertain Tax Positions (UTPs) that may result in a tax liability for the fund itself and those that will impact the valuation of the fund's portfolio investments.

Private companies, funds, their special purpose holding vehicles and portfolio companies who are required to prepare US GAAP accounts for the first time should prepare support and documentation of the respective entities' FIN 48 position.

If this is the first year you have to consider FIN 48 the initial step is to discuss the requirements with your auditors and tax advisors to determine the level of work and documentation required.

If you have a 31 December 2009 balance date and have not started reviewing your FIN 48 position you should commence the process now, as it often involves substantial work to prepare the required documentation to provide to the auditors to enable them to sign off on the FIN 48 disclosures in the accounts.

2) Valuation allowance assessments

Evaluating the need for and the amount of a valuation allowance for deferred tax assets (DTAs) under US GAAP often requires significant judgment and consideration of all positive and / or negative evidence. When performing a valuation allowance assessment, companies should take into account all possible sources of past and future taxable income including: (a) future reversals of existing taxable temporary differences; (b) estimated future taxable income above and beyond the reversal of existing temporary differences; and (c) tax-planning strategies.

Valuation allowances and the related assessments continue to attract close attention by the regulatory bodies.

3) Business combinations

Companies need to consider tax accounting considerations when completing business combinations. Key challenges include how to account for goodwill, intangible assets, acquisition-related costs, contingent consideration, tax indemnifications, etc. In addition, companies reporting under US GAAP are required to adopt the new accounting guidance on business combinations. The guidance fundamentally changes the tax accounting considerations in business combinations. It may affect companies regardless of whether or not they completed a business combination during the year. Several key changes in the new guidance have income tax accounting implications, including the treatment of pre-acquisition tax contingencies and the release of valuation allowances set up on acquisition. Companies should give careful consideration to the tax effect of the new guidance.

4) Recent tax law and rate changes

Changes in tax law or rates may significantly affect the recognition and measurement of current and deferred taxes.

Many countries in the region have reduced corporate tax rates for the 2009 year and / or have made changes to their respective local tax laws. You should ensure that you check the respective countries' tax rates and whether any tax law changes will impact your tax balance calculations.

When corporate tax rates change, this will have an impact on deferred tax asset and liability balances. Any adjustments required to deferred tax balances as a result of changes in the corporate tax rate generally have an impact on the respective company's or group's current year tax expense. In some circumstances, other comprehensive income and equity may also be effected.

Companies must recognise the effect of tax law or rate changes in the period in which the change is enacted or substantively enacted. In some instances, changes may be enacted or substantively enacted after year-end but before the issuance of financial statements. In those instances, the change would not be recognised until the period that includes the appropriate enactment date; however, consideration should be given to whether it is necessary to disclose the effect on existing DTAs and deferred tax liabilities (DTL) in the year-end financial statements.

In practice, this can be one of the more complex areas in income tax accounting. In summary, under US GAAP tax rate or law changes are only taken into account when they are enacted, whilst under IFRS it is when they are enacted or substantively enacted. Moreover, under IFRS there is a requirement to "backward trace" the effects of any tax rate or law changes, whilst under US GAAP such changes go directly to income from continuing operations.

5) Goodwill

Tax considerations related to goodwill do not end on the acquisition date. Numerous tax law and tax accounting considerations can impact whether there is an impairment of goodwill as well as the amount of any impairment.

Companies and tax advisers can, and should, play a significant role in assessing the tax considerations which may impact goodwill impairment testing. Given the significance of impairments resulting from challenging market conditions, the testing outcomes may become more sensitive to impacts from tax considerations. It is very important to have an interdisciplinary coordination among the various expert resources involved with impairment testing.

6) Investments in subsidiaries, branches, associates and JVs

Due to the prolonged economic downturn and consequently the tight lending and credit conditions, many companies are considering ways to increase liquidity in order to meet working capital requirements, repay maturing debt, finance capital projects, and meet certain funding obligations. As a result for companies reporting under US GAAP they may conclude that they can no longer sustain an indefinite reinvestment assertion on undistributed earnings of a foreign subsidiary. Similarly, companies using IFRS may conclude that it is probable that the temporary differences in respect of the non-distributed profits in their overseas subsidiaries may reverse. In such cases, the deferred tax impact of the tax effects of the distribution of retained profits must be considered, which may require significant judgment.

Companies should also remember the documentation and disclosure requirements pertaining to these “outside basis” differences.

7) Foreign currency

The deferred tax accounting for foreign currency movements requires a careful understanding of the relevant tax law. For example, certain tax jurisdictions impose a current tax on unrealised foreign currency exchange gains and / or losses while other jurisdictions tax such gains and losses only when realised. The impact of foreign currency movements also must be considered in situations where a company changes its indefinite reinvestment assertion and is required to measure the DTL on its outside basis difference in a foreign subsidiary.

8) Tax does not necessarily mean “income tax”

Certain tax credits, incentives and other common taxes, such as withholding taxes in certain jurisdictions, are not directly linked to taxable income and therefore should not be accounted for as an income tax. Over the past decade, various national governments have pursued policies designed to spur economic growth and provide incentives for companies that develop technology in emerging industries. For many of these new tax credits and incentives, the realisation of the economic benefit does not depend on the existence of taxable income. Therefore, it should not be accounted

for under income tax accounting guidance. The decision to apply a (pre-tax) income recognition model or the guidance under income tax accounting depends on whether there is a direct relationship between the benefit received and taxable income or tax liability otherwise due.

9) Non-amortising / non-depreciating assets

For assets that are amortised or depreciated for financial reporting purposes, the assumption is that the carrying value of the asset will be recovered over time through revenues, which are typically taxed at ordinary tax rates. Accordingly, DTAs and DTLs that result from temporary differences relating to such items are normally recognised at the ordinary income tax rate. However, for assets that are not amortised or depreciated for financial reporting purposes, the assumption is that the carrying value of the asset can only be recovered through a future sale.

In jurisdictions where the ordinary tax rate and capital gains tax rate differ, the applicable tax rate for a temporary difference relating to an asset that is not being depreciated or amortised for financial reporting purposes is the tax rate (i.e. ordinary or capital gains) applicable to the expected recovery of the asset.

10) Financial statement presentation and disclosure reminders

The capital market regulators continue to stress the importance of improved transparency and providing useful disclosures. Given the diverse range of readers of financial statements, companies should always consider their related disclosures especially those in respect of uncertain tax positions, unrecognised deferred tax assets or outside basis differences as may be required.

Conclusion

Preparing year end tax balances is often an onerous and time consuming exercise, however with appropriate systems and forward planning a lot of the pain can be reduced.

Please note the above is for information purposes only and should not be relied on as final advice.

Contacts

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