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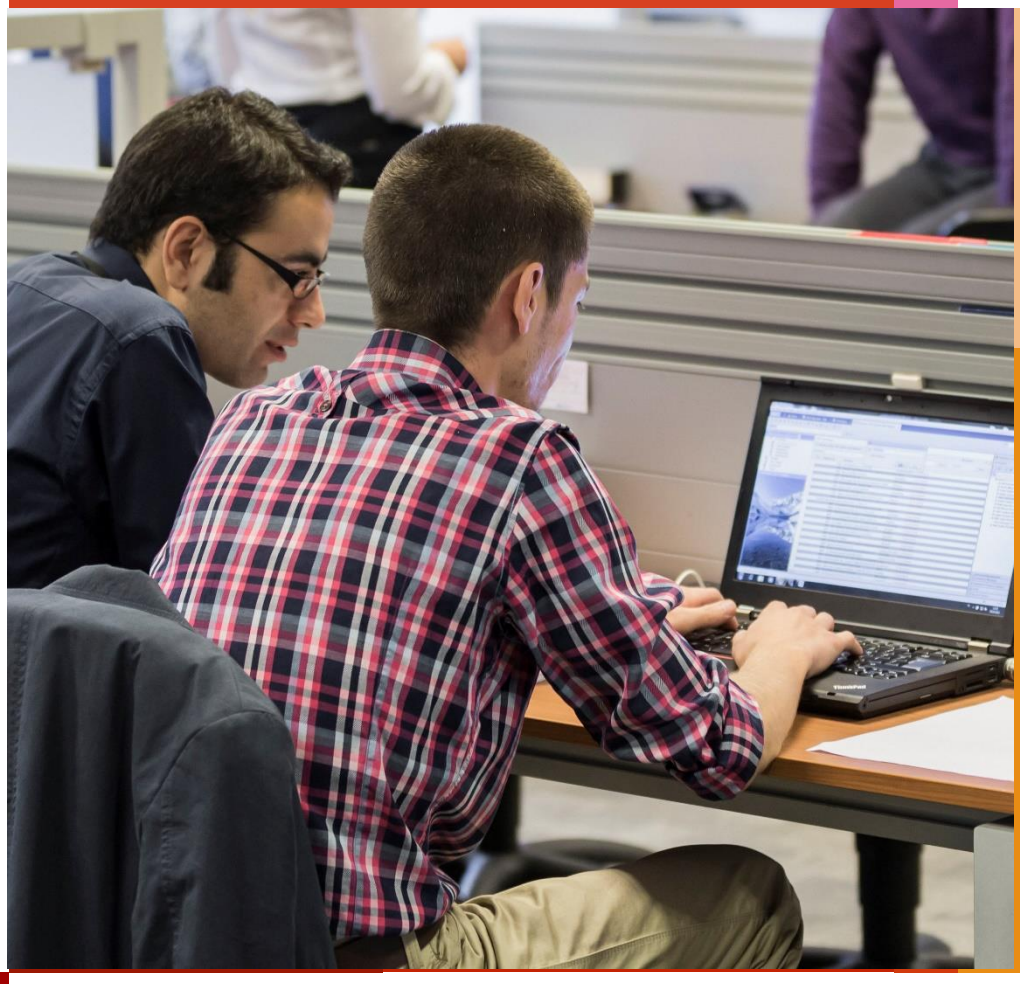
Income tax

Uncertainty over income tax treatments

IFRIC Interpretation

June 2017



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IFRS Interpretations Committee's Interpretation of IAS 12

On 21 October 2015, the International Accounting Standards Board's IFRS Interpretations Committee released a draft Interpretation ('the Interpretation') entitled 'Uncertainty over Income Tax Treatments'. The draft Interpretation provided guidance on how to account for uncertain tax treatments (commonly referred to as "uncertain tax positions"). In short, it is the IFRS equivalent of the US GAAP interpretation, ASC 740 (formerly FIN 48). Since the original draft was released, there has been an extensive consultation process and 61 comment letters were received. Various amendments were made to the draft before it was presented to the IASB for ratification.

The genesis of the Interpretation was a question that was put to the IFRIC asking when the recognition of a current tax asset is appropriate if tax laws require an entity to make an immediate payment in respect of a disputed amount. The Interpretations Committee noted that paragraph 12 of IAS 12 Income Taxes provides guidance on recognition in such a situation, but observed diversity in practice for various issues on the recognition and measurement of a tax liability or asset in circumstances in which there is uncertainty in the application of the tax law. The Committee therefore decided to consider the issue in more detail.

The Interpretation was ratified in the IASB meeting on 16-17 May 2017, and issued on 7 June 2017. It will be effective for annual reporting periods beginning on or after 1 January 2019, with early adoption permitted. We anticipate that many entities will wish to take early action to assess its impact on their financial statements, and some may wish to adopt it early. We summarise the key points below, and expand on certain key areas later in this paper.

Summary

In summary, the Interpretation proposes the following structure for assessing uncertain tax positions.

Scope	It provides guidance on how to determine an entity's taxable profits (or tax losses), tax bases, unused tax losses, unused tax credits and tax rates where there is uncertainty over whether tax positions taken by an entity will be accepted by the tax authority. It is applied to both current and deferred tax where there is uncertainty over an entity's tax position.
Unit of account	An entity needs to decide whether to consider its uncertain tax positions (UTPs) individually or collectively, based on which approach provides better predictions of the resolution of the uncertainties with the tax authority.
Detection risk	An entity must assume the tax authority will examine the position (if entitled to do so) and will have full knowledge of all the relevant information.
Recognition and measurement	There is a two stage test. If it is probable (i.e. a probability of more than 50%) that a tax authority will accept a particular UTP (or group of such UTPs), then the tax position recorded in the entity's accounts should be consistent with what is or will be used in its tax returns, i.e. there should be no additional liability. However, if it is not probable that a tax authority will accept in full a particular (group of) UTP(s) then the entity must adjust its income tax accounting, generally by recognising an additional liability. The adjustment could also be a decrease in an entity's current tax asset, or an adjustment to its deferred tax balances depending on the tax accounting position of the entity. The recognition of a UTP (group of UTPs) is measured using either the most likely amount or the expected value, depending on which is thought to give a better prediction of the resolution of each (group of) UTP(s), to reflect the likelihood of an adjustment being realised on examination.
Changes in recognition and measurement	An entity must reassess a UTP if new information comes to light or if facts or circumstances change (e.g., if a period within which the tax authority may examine the tax treatment expires). The Interpretation states that the absence of agreement or disagreement by a taxation authority in isolation is unlikely to represent a change in circumstances. However, the Interpretation does not completely rule out taking this into account. This is likely to be relevant primarily in circumstances where no statute of limitation exists for the potential exposure; judgment will be required to assess at what point an absence of action represents either a change in facts and circumstances or new information.
Disclosures	The Interpretation does not introduce any new disclosure requirements. However, it reinforces the need to comply with existing disclosure requirements in relation to judgements made, assumptions and estimates used, and tax –related contingencies. This has been an area of interest for regulators in recent years (see for example the UK Financial Reporting Council's recent report on its thematic review, or the 2015 ESMA report on enforcement and regulatory activities).
Transition	An entity has a choice on initial adoption of the Interpretation. It can recognise the cumulative effect in retained earnings or equity, at the start of the first reporting period when it first applies the Interpretation, without adjusting comparative information. Alternatively, it can apply the Interpretation retrospectively to each prior reporting period in accordance with IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors). Retrospective application is only permitted when this is possible without the use of hindsight.

The Interpretation will apply to all IFRS financial statements for public and private entities alike. Adopting the Interpretation could, in many cases, require significant changes or enhancements to an entity's accounting policies, financial statement disclosures, data gathering processes and internal controls, especially for multinational groups. It is also likely to impact existing corporate tax planning and management processes.

We believe that a multidisciplinary approach to implementation is required to get it right the first time. This document provides some thoughts on the road to implementation that outlines nine suggested phases for implementing the Interpretation, including an illustrative estimate of the time required to complete each phase.

In more detail

Today, IAS 12 provides very little guidance on UTPs. The standard sets out at paragraph 46 that:

Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Accounting for UTPs is an area which intrinsically requires considerable judgment. Historically there has been diversity in practice in a number of areas related to accounting for UTPs, which the IFRIC took into account in determining that a new Interpretation should be developed.

Unit of account

The new Interpretation addresses unit of account. Specifically, entities need to determine whether they should consider individual UTPs as a unit of account or whether some or all UTPs should be considered in combination. In making this determination, entities may wish to consider how they prepare their tax filings and/or how they expect the taxation authority to consider the issues in question. The determination should reflect the approach that better predicts how the uncertainty will be resolved, and as a result may change if the expected manner of resolution changes. For example, if it was expected that a particular tax authority would deal with a number of UTPs related to transfer pricing issues together, the entity might determine that the unit of account should be all of those transfer pricing issues.

Recognition and measurement

For many entities the biggest change as a result of adopting the Interpretation will be in the recognition and measurement steps. In the absence of formal pronouncements on the matter many took the position that in general entities should determine as an accounting policy choice whether the expected value (weighted average) method or the most likely outcome method should be used to measure their UTPs and should apply the chosen method to all of their outstanding UTPs. However, this has evolved over the years and different models are applied in practice to determine the unit of account and to recognise and measure the impact of the uncertainty.

Many entities used a most likely outcome method; others adopted variants of this approach such as classifying UTPs into different risk pools and applying a fixed percentage provision to all UTPs in a particular pool. The use of the expected value method has been less common, but by no means unknown.

The Interpretation now provides new and clear guidance as to how entities should recognize and measure UTPs. Having established the unit of account, an entity must go through a two step process to determine what additional liability, if any should be recorded.

The first step is recognition. If an entity determines there is a greater than 50% probability of the tax authority accepting the position (or group of positions) taken by the entity in its filed return with no adjustment, the accounting should reflect the filed return (or anticipated return, or the decision not to file a return) and no additional liability should be recorded. If the probability is less than 50%, the accounting should reflect the impact of the uncertainty, usually by recognising an additional liability.

The entity must then consider for each UTP or group of UTPs whether the most likely outcome or the expected value method will better predict the resolution of the uncertainty. Although in the past this was often treated as an accounting policy choice, as noted above, the Interpretation is clear that entities should apply judgment to each UTP (or group of UTPs) to assess the appropriate measurement method.

Entities should approach assets related to uncertain tax positions (which could be generated for example if an entity makes a payment of the full amount in question to mitigate interest and penalty risk) in the same way as liabilities.

In some circumstances entities may have uncertain positions that offset, for example if there is an uncertain position related to transfer pricing for a transaction between two territories. The entity should then assess the potential asset and liability separately, rather than applying an incremental tax rate (based on the difference in the tax rates of the relevant jurisdictions) to the amount. It should record the corresponding tax liability (or asset) on a gross basis on the balance sheet. Interest calculations for the respective tax liabilities and assets should also be performed on a separate jurisdictional basis.

The Interpretation provides specific guidance on how to determine which of the two methods it offers is likely to be more appropriate. It sets out that the most likely amount method "may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value".

The expected value method "may better predict the resolution of the uncertainty if there is a range of possible outcomes that are not binary and are not concentrated on one value".

It is likely that this will require entities to reassess their analysis of UTPs. We anticipate that given the changes to the tax environment in recent years, the expected value method will be more prominent than has been the case to date. In particular it is likely to be considered more appropriate in transfer pricing cases where there is frequently a broad range of possible outcomes.

The greater clarity offered by the Interpretation can be expected to lead to a more consistent approach to UTPs for IFRS preparers. The same set of facts should more frequently result in the same outcome for a given UTP than was the case in the past, although entities will continue to need to exercise judgment in a number of areas.

In particular, judgment may be required over how many potential outcomes should be considered. There is no specific guidance on this in the standard but entities can draw on the guidance in IFRS 15, which uses a similar expected value vs most likely outcome model. IFRS 15 (at para 54) sets out that entities should "identify a reasonable number of possible consideration amounts." In the basis for conclusions for IFRS 15, the point is discussed further, with the conclusion that "in many cases, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes." This does not give us an explicit answer but should provide reassurance that in a case with a continuous distribution of outcomes, an entity could use a limited number of points from the distribution to form the basis for its calculation.

Having selected the possible discrete outcomes, entities will also need to use their judgment to assign a probability to those outcomes. Factors to consider could include:

1. The perceived weight of the tax law in the taxpayer's favor;
2. The extent of precedent of the tax law being applied to the particular position or transaction;
3. Expectations regarding how aggressively the taxing authority might pursue a particular position or, alternatively, its willingness to reach a negotiated compromise; and
4. The entity's willingness to defend the position through the legal process (as opposed to conceding to a negotiated compromise to avoid the hazards of litigation).

Some entities must prepare accounts under both IFRS and US GAAP or other local GAAPs. This issue will continue to be a GAAP difference with US GAAP (users of other GAAPs will need to consider whether or not the approach in the Interpretation can be accepted under their GAAP). When the FASB considered the question of UTPs in 2006, it also adopted a two-step recognition and measurement approach. The recognition step is similar, but not identical, to that outlined in the Interpretation; a different approach is taken to measurement which is based on cumulative probability and which will often lead to a different outcome.

Example

An entity has a transfer pricing position that it considers to be vulnerable to challenge by a tax authority. It claims a deduction worth 100 of tax in its tax return for the expense. It currently accounts for UTPs using the most likely outcome method. The table below shows the position for the additional amount it expects to pay to the tax authorities over and above the amount presented in its filed tax return under its current method and the expected value method.

	Estimated additional liability	Probability	Estimate of expected value
Outcome 1	0	5%	0
Outcome 2	40	40%	16
Outcome 3	80	30%	24
Outcome 4	100	25%	25
		100%	65

Using the most likely outcome method, the entity would record a provision for 40. Under the Interpretation, the entity might observe that the outcomes are widely dispersed, and as a result conclude that the expected value method is more appropriate. Accordingly it would include a provision for 65, to reflect the effect of the uncertainty.

If the entity were reporting under US GAAP using the cumulative probability method, it would recognize a benefit of 20 or said another way, would record a UTP of 80, as shown in the table below.

	Estimated benefit	Probability	Cumulative probability
Outcome 1	100	5%	5%
Outcome 2	60	40%	45%
Outcome 3	20	30%	75%
Outcome 4	0	25%	100%
		100%	

Changes in recognition and measurement

Entities will need to reassess their UTPs period by period to ensure that they continue to be carried at the appropriate value. However, a change in the recorded liability associated with a UTP should only be expected where the facts and circumstances have changed; in other words a trigger should exist for a re-evaluation of the liability.

As noted earlier, the risk of detection by the tax authorities is not a factor that can be considered in this assessment. In rare circumstances entities may need to use judgment to evaluate whether inaction by the tax authorities can be construed as a change of circumstance constituting implicit acceptance of the position.

Transition

The Interpretation has been ratified and was issued on 7 June 2017. The effective date for the Interpretation is 1 January 2019. Early adoption is permitted.

Entities based in the European Economic Area should also consider the requirement for EU endorsement, which may not take place until as late as mid-2018. EU rules do not prevent early adoption of an interpretation in the absence of EU endorsement. However, entities considering early adoption should review the ability to early adopt in the jurisdictions relevant to them with their advisors and consult with their auditors to ensure that no local regulatory issues should arise if they wish to early adopt.

It is likely that it will take some time to assess the impact of adoption. Groups should therefore start to plan the process by which they will adopt Interpretation, and should build into that process consideration of the effect of early adoption.

Accounting for transition

In the case of the Interpretation, there is transition guidance set out in Appendix B. This allows the Interpretation to be applied, "either:

a. Retrospectively applying IAS 8, if that is possible without the use of hindsight; or

b. Retrospectively with the cumulative effect of initially applying the Interpretation recognized at the date of initial application…"

The second approach provides effective relief from the IAS 8 requirements to restate comparatives and allows the cumulative effective of the initial application of the Interpretation to be booked to retained earnings. The former approach might require a portion of the cumulative adjustment relating to the prior year to be booked through the restated income statement of that year.

Adopting the Interpretation will require entities to review their existing UTPs and apply the new guidance to them. Given the subjective nature of the issues in question, entities will need to be careful to avoid using hindsight when re-assessing their positions. Entities will need to consider what the position would have been at the start of the period of adoption (and possibly for earlier periods if the transitional relief outlined above is not availed of).

Entities will need to be careful to distinguish between changes in the provision that relate to the period before the interpretation is adopted, which will affect retained earnings, and those that relate to changes in circumstances or new information in the current period. This might be challenging for potentially subjective provisions which may have many different potential outcomes and the basis of which may be totally different under the new interpretation, for example transfer pricing exposures and other issues with widely dispersed, non-binary outcomes.

Determining whether a change arises from new facts or information in the current period may be difficult and groups should expect their auditors to want to understand how they have arrived at their positions.

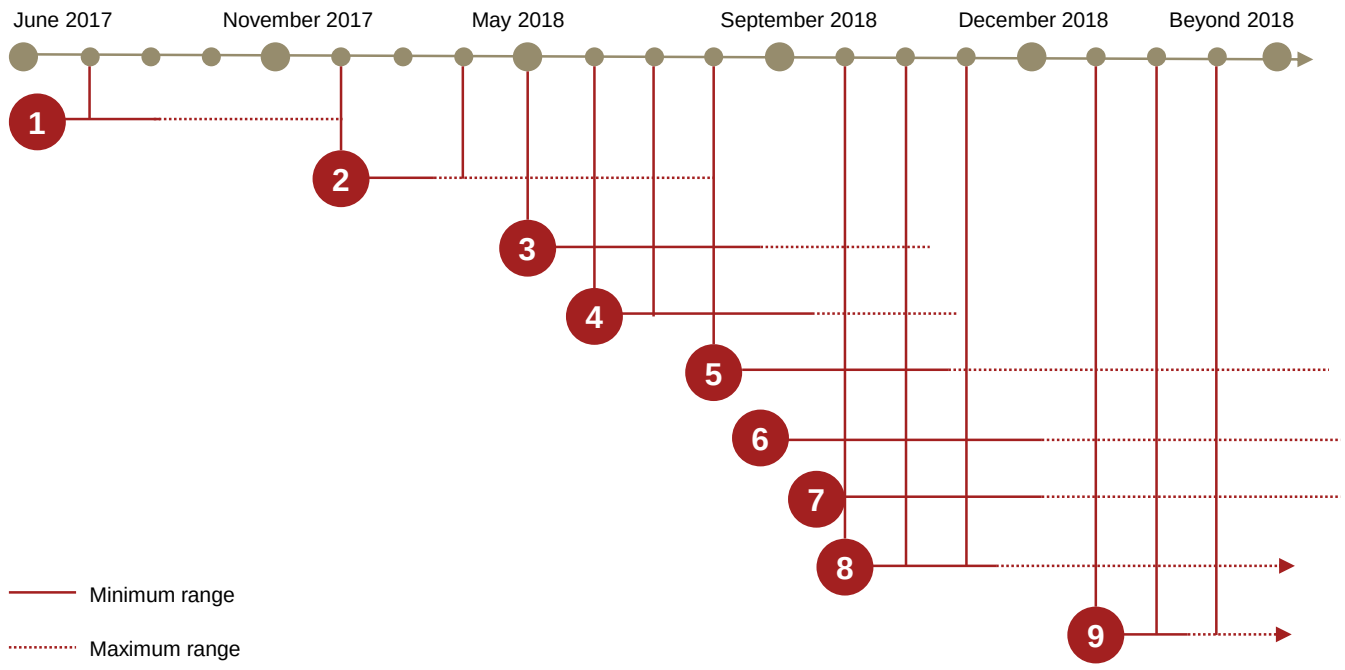
In order to minimize the challenge of hindsight, entities should consider beginning to review the application of the new Interpretation to their existing UTPs at the earliest possible opportunity. This could include calculating their position assuming application of the Interpretation alongside the position under their current accounting policy. This will also allow entities to begin to quantify the impact of the change so that any required disclosures can be considered. Waiting until the preparation of the first set of financial statements after adoption could create difficulties given the amount of information required and the time available.

Interest and penalties

Entities with uncertain tax positions should also consider how to deal with interest and penalties. This subject is not dealt with by the Interpretation but was recently discussed by the IFRIC at its March 2017 meeting, at which time it decided not to add the subject to its agenda. In its tentative conclusions on this, the IFRIC summarised the positions that entities can take on interest and penalties. Entities should either apply IAS 12 to interest and penalties and record them in the tax line, with appropriate disclosures, or apply IAS 37 (Provisions, Contingent Liabilities and Contingent Assets) to the issue, which brings with it a different set of disclosure requirements. Although this is currently often considered to be a matter of accounting policy choice, the IFRIC's discussion suggested that entities ought to consider whether or not the amounts payable or receivable for interest and penalties are income taxes in making the decision as to which standard to apply.

Timeline and action plan

IAS 12 Uncertainty over Income Tax Treatments Interpretation – Client action plan summary and timeline
(Illustrative for a December year end entity)



1 Assess impact of Interpretation and establish internal communication and education.

a. Assess high level potential implications of the Interpretation to the organisation and compare to the existing methodology for assessing tax uncertainties.

b. Educate senior management and/or the audit committee about the broad effects of adopting and complying with the Interpretation. Senior management will also need to be prepared to address potential queries from external stakeholders (shareholders, analysts, non-governmental organisations, etc.).

c. Establish internal lines of communication and responsibility for uncertain tax positions (UTPs). This is likely to involve personnel from various different departments.

2 Develop an implementation plan.

a. An implementation plan should be drawn up to coordinate the efforts to implement the Interpretation. It is recommended that the entity's independent auditors are involved at an early stage.

3 Identification of all significant uncertain tax positions.

a. Prepare or review the existing inventory of all significant UTPs, bearing in mind that many observers expect that there will be increased controversy as a result of transparency initiatives.
b. Consider the effect of any information gathered on tax provisions and disclosures for pre-adoption accounting periods (including interim periods).

4 Modify/develop accounting policies and processes

a. Design or modify existing processes and related controls to determine when a UTP should be recognised (or derecognised).
b. It will also be necessary to determine how a UTP should be analysed for recognition and measurement (e.g. what unit of account should be used, and what level of documentation is needed to support the amount recorded).

5 Assess and develop supporting documentation for uncertain tax positions.

a. After UTPs have been identified, the enterprise should assess each UTP for recognition and measurement.
b. Consideration should be given to the appropriate level of evidence required to support management's conclusions. In some cases, it may be appropriate to obtain an opinion from external tax advisers as additional supporting documentation. Regardless of the information used to support its position, management's documentation must stand on its own and allow one to understand the position taken by the enterprise, the relevant tax law in question, and management's basis for recognition (or conclusion that there should be no recognition).

6 Prepare draft financial statement presentation and disclosures.

a. Management will need to determine whether there are any new disclosure requirements that will need to be addressed through processes, procedures, and controls.
b. Management should also assess whether there are any inconsistencies with disclosures made in previous or comparative periods and discuss with external auditors any further disclosures that may be required.
c. Management need to consider how consistent any presentation of UTPs will be with any other public disclosures as a result of tax transparency initiatives.

7 Change and develop internal controls.

a. In order to comply with the Interpretation, an entity will probably have to design or modify existing processes for gathering income tax information, documenting tax return positions, and monitoring the status of audits on a global basis.
b. Management will probably need to make changes to the entity's internal controls over accounting for UTPs.

8 Tax planning and tax investigation management.

a. We recommend that senior management consider: developing procedures to manage income tax related risks; developing policies and controls to ensure positions taken are consistent with the enterprise's risk management procedures; and developing procedures to monitor any investigations by tax authorities.

9 Identify and determine appropriate resources and systems required for ongoing compliance.

a. Management will need to develop a plan for complying with the ongoing requirements of the Interpretation.
b. In assessing whether the entity possesses adequate resources and systems, management should take into consideration, among other things, the volume and significance of its existing UTPs, the likelihood of future UTPs, and the increasing complexity of the tax laws in the relevant jurisdictions.

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Contacts

For further information, please speak to your usual PwC adviser or one of the TAS contacts below:

Andrew Wiggins
Global and UK Tax Accounting Services Leader
T: +44 (0) 121 232 2065
E: andrew.wiggins@pwc.com

Rick Levin
USA Tax Accounting Services Leader
T: +1 (312) 298 3539
E: richard.c.levin@pwc.com

Tjeerd van den Berg
EMEA Tax Accounting Services Leader
T: +31 (0)88 792 10 19
E: tjeerd.van.den.berg@pwc.com

Mario Alfredo Arteaga
Latin America Tax Accounting Services Leader
T: +52 (999) 948 2957
E: Mario.alfredo.arteaga@mx.pwc.com

Dervis Pajo
Asia Pacific Tax Accounting Services Leader
T: +86 21 2323 1577
E: dervis.pajo@cn.pwc.com

Spence McDonnell
Canada Tax Accounting Services Leader
T: +1 (41 6) 869 2328
E: spence.n.mcdonnell@pwc.com

Contacts

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.

Tax accounting leaders in major countries

Country	Name	Telephone	Email
Australia	Ronen Vexler	+61 (2) 8266 0320	ronen.vexler@pwc.com
Belgium	Koen De Grave	+32 (3) 259 3184	koen.de.grave@pwc.com
Brazil	Manuel Marinho	+55 (11) 3674 3404	manuel.marinho@pwc.com
Canada	Spence McDonnell	+1 (416) 869 2328	spence.n.mcdonnell@pwc.com
China	Dervis Pajo	+86 (21) 2323 1577	dervis.pajo@cn.pwc..com
Finland	Iain McCarthy	+358 (0) 20 787 7975	iain.mccarthy@fi.pwc.com
France	Marine Gril-Gadonneix	+33 (1) 56 57 43 16	marine.gril-gadonneix@pwcavocats.com
Germany	Heiko Schäfer	+49 (69) 9585 6227	heiko.schaefer@pwc.com
Hungary	David Williams	+36 (1) 461 9354	david.williams@hu.pwc.com
India	Pallavi Singhal	+91 (80) 4079 6032	pallavi.singhal@in.pwc.com
Italy	Marco Meulepas	+39 (02) 9160 5501	marco.meulepas@it.pwc.com
Japan	Nobuko Yamashita	+81 (3) 5251 2340	nobuko.yamashita@pwc.com
Mexico	Fausto Cantu Mario Alfredo Arteaga	+52 (81) 8152 2052 +52 (999) 948 2957	fausto.cantu@mx.pwc.com mario.alfredo.arteaga@mx.pwc.com
Netherlands	Tjeerd van den Berg	+31 (0)88 792 10 19	tjeerd.van.den.berg@pwc.com
Poland	Jan Waclawek	+48 (22) 746 4898	jan.waclawek@pl.pwc.com
Singapore	Paul Cornelius	+65 6236 3718	paul.cornelius@sg.pwc.com
Spain	Alberto Vila	+34 (915) 685 782	alberto.vila@es.pwc.com
Switzerland	Reto Inauen Gil Walser	+41 (58) 792 4216 +41 (58) 792 6781	Reto.inauen@ch.pwc.com Gil.walser@ch.pwc.com
United Kingdom	Andrew Wiggins	+44 (0) 121 232 2065	andrew.wiggins@pwc.com
United States	Rick Levin	+1 (312) 298 3539	richard.c.levin@pwc.com