

**Applying IFRS**

# **Uncertainty over income tax treatments**

November 2017

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow diagonal bar is positioned above the 'Y'.

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## What you need to know

- ▶ The IFRS IC observed that entities apply diverse reporting methods when the application of tax law is uncertain.
- ▶ The IFRS IC developed IFRIC 23 to clarify how to apply the recognition and measurement requirements in IAS 12 when there is uncertainty over income tax treatments.
- ▶ The Interpretation provides guidance on considering uncertain tax treatments separately or together, examination by taxation authorities, the appropriate method to reflect uncertainty and accounting for changes in facts and circumstances.
- ▶ The Interpretation does not apply to items outside the scope of IAS 12 such as other taxes, levies and interest and penalties associated with uncertain tax treatments.
- ▶ The Interpretation does not add any new disclosures, rather it refers to disclosures in IAS 1 and IAS 12.
- ▶ The Interpretation is effective for annual reporting periods beginning on or after 1 January 2019. Earlier adoption is permitted. The Interpretation provides two transition methods.

# 1. Introduction

In July 2014, the IFRS Interpretations Committee (the IFRS IC) issued an agenda decision in response to a submission related to a particular situation in which an entity was required to make a payment to a taxation authority in respect of a disputed tax treatment that had not yet been resolved. The IFRS IC noted that IAS 12 *Income Taxes*, and not IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, provides relevant guidance on the recognition of a current tax asset in such a situation and that paragraph 12 of IAS 12 states that if the amount already paid exceeds the amount of tax due for current and prior periods, the excess shall be recognised as an asset. The IFRS IC concluded that IAS 37 and, in particular, the requirement to recognise such an asset only when it is virtually certain that the entity would receive a refund from the taxation authorities, does not apply to the recognition and measurement of income taxes in the scope of IAS 12.

Nevertheless, the IFRS IC observed that IAS 12 does not specify how uncertainty in tax treatments is reflected in the measurement of current and deferred tax assets and liabilities. As a result, this has led to diversity in practice. Accordingly, the IFRS IC developed IFRIC 23 *Uncertainty over Income Tax Treatments* (IFRIC 23 or the Interpretation) to address how to reflect uncertainty in the recognition and measurement of income taxes.

## Extract from IFRIC 23

- 2 It may be unclear how tax law applies to a particular transaction or circumstance. The acceptability of a particular tax treatment under tax law may not be known until the relevant taxation authority or a court takes a decision in the future. Consequently, a dispute or examination of a particular tax treatment by the taxation authority may affect an entity's accounting for a current or deferred tax asset or liability.

The Interpretation defines the following terms:

- ▶ 'Tax treatments' refers to the treatments used by an entity or that it plans to use in its income tax filings.
- ▶ 'Taxation authority' refers to the body or bodies that decide whether tax treatments are acceptable under tax law. This might include a court.
- ▶ An 'uncertain tax treatment' is a tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. For example, an entity's decision not to submit any income tax filing in a tax jurisdiction, or not to include particular income in taxable profit, is an uncertain tax treatment if its acceptability is uncertain under tax law.

IFRIC 23 is effective for annual periods beginning on or after 1 January 2019, with early application permitted. The Interpretation should be applied either retrospectively, by applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* if it is possible to do so without the use of hindsight, or by using a modified retrospective approach with an initial catch-up adjustment recorded in the opening equity of the period of initial application. See section 5 below on transition.

This publication sets out our views on the requirements in the Interpretation and explains certain concepts that might be helpful to entities when they first apply IFRIC 23.

## How we see it

In applying the definition of 'taxation authority', entities should consider the actions of other governmental and legislative bodies that could affect the application of tax laws and regulations.

IFRIC 23 is applicable to taxes within the scope of IAS 12. The Interpretation applies to both current and deferred taxes.

## 2. Scope of IFRIC 23

IFRIC 23 was developed as an interpretation of IAS 12 and so it relates only to income taxes within the scope of that standard. In addition, the Interpretation applies when there is uncertainty over income tax treatments that may affect both current and deferred taxes.

### Extract from IFRIC 23

- 4 This Interpretation clarifies how to apply the recognition and measurement requirements in IAS 12 when there is uncertainty over income tax treatments. In such a circumstance, an entity shall recognise and measure its current or deferred tax asset or liability applying the requirements in IAS 12 based on taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates determined applying this Interpretation.

In assessing whether uncertainty over income tax treatments exists, an entity may consider a number of indicators including, but not limited to, the following:

- ▶ Ambiguity in the drafting of relevant tax laws and related guidelines (such as ordinances, circulars and letters) and their interpretations
- ▶ Income tax practices that are generally applied by the taxation authorities in specific jurisdictions and situations
- ▶ Results of past examinations by taxation authorities on related issues
- ▶ Rulings and decisions from courts or other relevant authorities in addressing matters with a similar fact pattern
- ▶ Tax memoranda prepared by qualified in-house or external tax advisors
- ▶ The quality of available documentation to support a particular income tax treatment

In defining 'uncertainty', the entity only needs to consider whether a particular tax treatment is probable, rather than highly likely or certain, to be accepted by the taxation authorities. As explained at 3.3.1 below, if the entity determines it is probable that a tax treatment will be accepted, then it will measure its income taxes on that basis. Only if the entity believes the likelihood of acceptance is not probable, would there be an uncertain tax treatment to be addressed by IFRIC 23.

### **Example 1 - Current tax impact**

Entity A, a profitable entity, pays management fees to an affiliated entity, Entity B, and claims the cost as a deduction for tax purposes. The management fees amount to 5% of the gross revenues realised by Entity A. Such management fees are allowable under the tax law as a deduction if it can be demonstrated that the price charged is commensurate with the services provided by Entity B. Therefore, there is a risk that the taxation authorities may disallow a part of the management fee. On application of IFRIC 23, Entity A should reflect the impact of such uncertainties in the measurement of its current tax assets and liabilities as at the reporting date.

### **Example 2 - Current and deferred tax impact**

Entity C, operating a chemical plant, records a provision for restoration costs in its financial statements which is also claimed as a deduction on its corporate income tax return. However, the amount of the restoration costs that would eventually be incurred is uncertain as the scope of remediation work is unclear. The local tax law allows the taxation authorities to deny a tax deduction for any restoration costs provision that they consider unreasonable. On application of IFRIC 23, Entity C should reflect the impact of such uncertainties in the measurement of current and deferred tax assets and liabilities as at the reporting date.

## **2.1 Interest and penalties**

The IFRS IC decided not to add to IFRIC 23 specific requirements relating to interest and penalties associated with uncertain tax treatments despite requests from a number of respondents to the draft Interpretation that it should do so. The IFRS IC noted that neither IAS 12 nor other IFRSs explicitly refer to interest and penalties payable to, or receivable from, a taxation authority.

Instead, the IFRS IC noted that if an entity considers a particular amount payable or receivable for interest and penalties to be an income tax, then that amount is within the scope of IAS 12 and, when there is uncertainty, also within the scope of the Interpretation. Conversely, if an entity does not apply IAS 12 to a particular amount payable or receivable for interest and penalties, then the Interpretation does not apply to that amount, regardless of whether there is uncertainty.

In September 2017, the IFRS IC issued an agenda decision stating that a project on interest and penalties would not be added to its standard-setting agenda. The IFRS IC confirmed its earlier conclusion that, if an entity considers a particular amount payable or receivable for interest and penalties to be an income tax, then the entity applies IAS 12 to that amount. If an entity does not apply IAS 12 to a particular amount payable or receivable for interest and penalties (interest and penalties outside its scope), it applies IAS 37 to that amount. The IFRS IC further observed that entities do not have an accounting policy choice between IAS 12 and IAS 37.

### **Example 3 - Interest and penalties**

Tax legislation in Country A provides that an underpayment of income tax leads to late interest charges of 8% per year of the underpaid tax. The late interest charge is applied regardless of whether the underpayment is due to an error notified by the tax payer or the result of an adjustment made by the taxation authorities on inspection. Interest so charged is not deductible for income tax purposes. The entity has applied judgement and concluded that the interest amount payable falls within the scope of IAS 12. In addition, tax legislation imposes penalties of up to 100% of the transfer price charged between affiliated entities where the entity fails to provide sufficient transfer pricing documentation. This penalty is added to the taxable income recorded by the selling entity. The entity has applied judgement and concluded that the penalty amount payable does not fall within the scope of IAS 12. Accordingly, when there is uncertainty as to whether interest and penalties will be charged by the taxation authority, the entity would apply IFRIC 23 to the interest charges in Country A, but not to the transfer pricing penalty.

## **2.2 Other taxes and levies**

Since IFRIC 23 is an interpretation of IAS 12, the IFRS IC decided not to expand the scope of the Interpretation to other taxes and levies outside the scope of IAS 12 even though those other taxes and levies may have uncertainty over their treatments that is similar to the uncertainties over income taxes.

### **Example 4 - Other taxes and levies**

Entity A operates in the banking and financial services industry and some of its revenues are subject to VAT, whereas other revenues are exempt from VAT. Therefore, the entity cannot benefit from input VAT credits arising from the associated expenses. Entity A can only claim input tax credit for costs related to activities subject to output VAT. Entity A purchases substantial general administrative services from external service providers but the invoices from those suppliers do not identify whether those services relate to the activities of Entity A that are subject to, or outside the scope of VAT. Therefore, Entity A applies an allocation method in preparing its VAT return. The available VAT guidance in Entity A's jurisdiction is largely silent about the calculation of the input VAT credit reduction and, as a result, tax payers apply different methods to calculate the input VAT credit. Although uncertainty exists in the determination of Entity A's VAT liability, IFRIC 23 is not applicable since such taxes are not in the scope of IAS 12.

## How we see it

The Interpretation applies when an entity is unable to determine that acceptance by the taxation authorities of a particular tax treatment is probable and it applies only to income taxes and those particular amounts of interest and penalties determined to be within the scope of IAS 12. Entities should continue to apply IAS 37 to the recognition and measurement of other taxes and levies (e.g., duties, sales taxes and payroll taxes) and to interest and penalties that are outside the scope of IAS 12.

It would not be appropriate to apply the Interpretation by analogy to taxes and levies outside the scope of IAS 12 when this conflicts with the requirements of IAS 37.

Entities may need to apply significant judgement firstly in identifying uncertainties over income tax treatments and, thereafter, in the application of the Interpretation. For example, significant judgement may be required in distinguishing interest and penalties from the underlying uncertain tax treatments because the two may be highly interrelated.

## 3. Recognition and measurement

If an entity concludes that uncertainty over income tax treatments exists, it applies the guidance in IFRIC 23 which addresses:

- ▶ Whether to consider uncertain tax treatments separately (see 3.1 below)
- ▶ The assumptions it makes about the examination of tax treatments by taxation authorities (see 3.2 below)
- ▶ How it determines taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates (together referred to as 'tax positions') (see 3.3 below)
- ▶ How it considers changes in facts and circumstances (see 3.4 below)

### 3.1 Considering uncertain tax treatments separately

One of the key aspects in the application of IFRIC 23 is to determine the unit of account. In practice, this might be an entire tax computation in a particular jurisdiction, each uncertain tax treatment separately, or a group of two or more uncertain tax treatments (e.g., all uncertain treatments in a particular tax jurisdiction, or all positions of a similar nature or relating to the same interpretation of tax legislation). IFRIC 23 requires an entity to make this determination based on a judgement of which approach better predicts the resolution of the uncertainty.

#### Extract from IFRIC 23

6 An entity shall determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments based on which approach better predicts the resolution of the uncertainty. [...]

In determining which approach better predicts the resolution of the uncertainty, an entity might consider the following factors:

- ▶ How it prepares its income tax filings and supports tax treatments



- ▶ How the entity expects the taxation authority to make its examination and resolve issues that might arise from that examination
- ▶ The extent to which the outcomes of uncertain tax treatments are mutually dependent
- ▶ The resolution of similar tax issues by taxation authorities in prior years

#### **Example 5 - Unit of account**

Entity A is part of a multinational group and provides intra-group loans to affiliates. It is funded through equity and deposits made by its parent. Whilst the entity can show that its interest margin earned on many loans is at an appropriate market rate, there are loans where the rate is open to challenge by the taxation authorities. However, Entity A determines that, across the loan portfolio as a whole, the existence of rates above and below a market comparator results in an overall interest margin that is within a reasonable range accepted by the taxation authorities.

Depending on the applicable tax law and practice in a specific jurisdiction, a taxation authority may accept a tax filing position on the basis of the overall interest margin if it is within a reasonable range. However, there might be other taxation authorities that would examine the interest rate separately for each loan receivable. In considering whether uncertain tax treatments should be considered separately for each loan receivable or combined with other loan receivables, Entity A should adopt the approach that better reflects the way the taxation authority would examine and resolve the issue.

#### **How we see it**

Significant judgement may be required in the determination of the unit of account. In making the judgement, entities would need to consider the approach expected to be followed by the taxation authorities to resolve the uncertainty.

We believe that interdependent tax positions (i.e., where the outcomes of uncertain tax treatments are mutually dependent) should be considered together.

The judgement required in the selection of a unit of account may be particularly challenging in groups of entities trading in various jurisdictions where the relevant tax laws or taxation authority treat similar elements differently.

### **3.2 Examination of tax treatments by taxation authorities**

The Interpretation requires an entity to assume that the taxation authority can, and will, examine amounts it has a right to examine and have full knowledge of all related information when making those examinations. As such, IFRIC 23 requires an entity to assume a 100% detection risk. In making this decision, the Interpretations Committee noted that paragraphs 46 and 47 of IAS 12 require an entity to measure tax assets and liabilities based on tax laws that have been enacted or substantively enacted by the end of the reporting period.

## Extract from IFRIC 23

- 8 In assessing whether and how an uncertain tax treatment affects the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, an entity shall assume that a taxation authority will examine amounts it has a right to examine and have full knowledge of all related information when making those examinations.

IFRIC 23 requires entities to assume a 100% detection risk. This could be a change from current practice.

In some jurisdictions, examination by taxation authorities is subject to a time limit, sometimes referred to as a statute of limitations. In others, examination by taxation authorities might not be subject to a statute of limitations, which means the authorities can examine the amounts at any time in the future. Some respondents to the draft Interpretation suggested that an assessment of the probability of examination would be relevant in this latter case. However, the IFRS IC decided not to change the examination assumption, nor to create an exception to it, for circumstances in which there is no time limit on the taxation authority's right to examine income tax filings. The IFRS IC also noted that the assumption of examination by the taxation authority, in isolation, would not require an entity to reflect the effects of uncertainty. The threshold for reflecting the effects of uncertainty is whether it is probable that the taxation authority will accept an uncertain tax treatment. In other words, the recognition of uncertainty is not determined based on whether a taxation authority examines a tax treatment. One rationale suggested is that, in jurisdictions with no statute of limitations, there could be a point in time after which it becomes increasingly probable that the taxation authority would accept a tax treatment, simply because so much time has elapsed. Although the entity may, in such situations, conclude that it has become probable that the taxation authority would accept a tax treatment, it should consider the requirements in paragraph 13 of the Interpretation as discussed in section 3.4 below.

### Example 6 - Detection risk

Entity A is based in Country B. It is generally known that the taxation authorities in Country B have limited resources. As a consequence, their examination procedures are usually limited to a desktop review of the income tax filings. On-site tax examinations are only performed in very rare circumstances and if there is a clear indication of a tax fraud. Entity A has never been subjected to such an on-site examination by the taxation authorities.

Prior to the application of IFRIC 23, Entity A argued that it was unlikely that the taxation authorities would identify any key income tax exposures not already identified through their desktop reviews, because they could be identified only by analysing the underlying accounting records. Therefore, Entity A did not recognise any uncertain tax treatments.

With the adoption of IFRIC 23, Entity A would need to consider underlying tax positions even though examination by the taxation authorities is unlikely. Entity A should assume that the taxation authority can and will examine amounts it has a right to examine and have full knowledge of all related information when making those examinations.

## How we see it

IFRIC 23 requires an entity to assume a detection risk of 100%. An entity should not take any credit for the possibility that uncertain tax treatments could be overlooked by the taxation authority. This is a different approach compared to existing practice that may lead to changes when the Interpretation is first applied.

The Interpretation does not explain what is meant by 'results of examinations'. The examination procedures vary by jurisdiction and, in some jurisdictions, an examination can have multiple phases. In our view, the communication between an entity and the taxation authorities during the course of such examinations may provide relevant information that could give rise to a change in facts and circumstances before the actual 'results' of the examination are formally issued.

IFRIC 23 provides two methods to reflect uncertainty over income tax treatments: (a) most likely amount; and (b) expected value approach.

### 3.3 Determination of tax positions

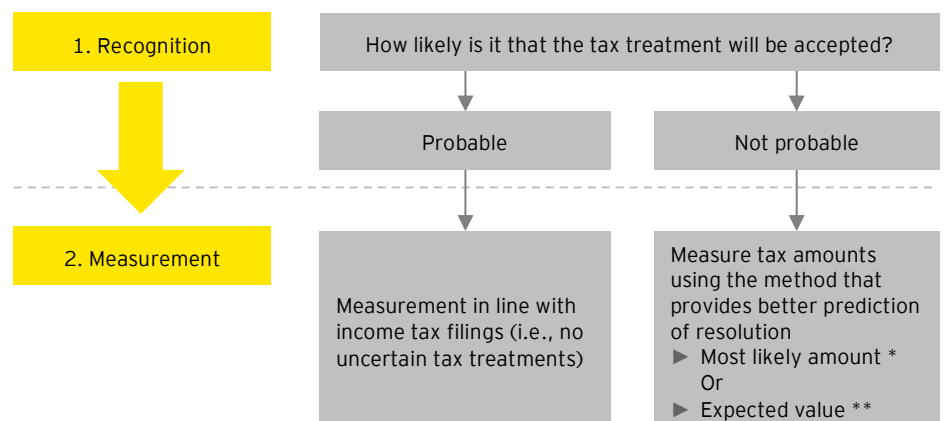
If an entity concludes that uncertainty exists in its tax treatment, it has to consider whether it is probable that the taxation authority will accept such tax treatment (or group of uncertain tax treatments if it has been determined that they should be considered together, as discussed at 3.1 above).

The threshold in IFRIC 23 is 'probable'. This is consistent with other principles in IAS 12, for example, the 'expected amount' approach in paragraphs 46 and 47 to the measurement of tax, and paragraph 24 of IAS 12, which requires the recognition of deferred tax assets to the extent that it is probable that an entity will be able to use deductible temporary differences against future taxable profit. The term 'probable' is defined in IFRS as 'more likely than not'.

#### Extract from IFRIC 23

9 An entity shall consider whether it is probable that a taxation authority will accept an uncertain tax treatment.

The following diagram summarises the approach taken in IFRIC 23 to assess how uncertain tax treatments are measured:



\* Better predicts resolution of uncertainty if the possible outcomes are binary or are concentrated on one value.

\*\* Better predicts resolution of uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

Under IFRIC 23, if the entity determines that a treatment used in the tax return is more likely than not to be accepted by the taxation authorities, that treatment is applied for the measurement of income taxes (see 3.3.1 below). The probable threshold therefore treats all likelihoods beyond that threshold the same way. That is, any likelihood of acceptance by the taxation authority beyond the probable threshold is treated the same way as 100 per cent likelihood of acceptance. If the likelihood of acceptance is determined to be probable, an entity would not reflect the effect of uncertainty in determining the applicable taxes.

If the entity is unable to conclude that acceptance by the taxation authorities is probable, it reflects the uncertainty in the manner that better predicts the resolution of the uncertain tax treatment (see 3.3.2 below).

An entity may need to apply judgement in concluding whether it is probable that a particular uncertain tax treatment will be acceptable to the taxation authority. An entity may consider the following:

- ▶ Past experience related to similar tax treatments
- ▶ Legal advice or case law related to other entities
- ▶ Practice guidelines published by the taxation authorities that are applicable for the specific case
- ▶ The entity obtains a pre-clearance from the taxation authority on an uncertain tax treatment

### **3.3.1 Determination of tax positions when it is 'probable'**

If an entity concludes that it is probable that the taxation authority will accept an uncertain tax treatment, then it will measure all applicable taxes consistently with its income tax filings.

#### **Extract from IFRIC 23**

10 If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.

#### **Example 7 - Measurement of tax positions**

The management of Group A decides to undertake a group-wide reorganisation that will have significant impacts on various group entities. As part of the reorganisation plan, Entity B records a restructuring liability of CU 1,000,000 as it expects that it will need to substantially reduce its workforce according to group instructions. Entity B has tax loss carry-forwards of CU 1,200,000 and unused tax credits of CU 300,000. Excluding the restructuring liability, taxable profit for the current year is CU 2,000,000.

Entity B is uncertain whether the local taxation authorities will accept a deduction for the reorganisation costs. However, it analyses all available evidence and concludes that it is probable that the taxation authorities will accept the deduction of the CU 1,000,000 in the year when it is recorded.

### Example 7 - Measurement of tax positions (*continued*)

Entity B therefore estimates its taxable profit to be CU 1,000,000 and that this will be fully offset with tax loss carry-forwards from the CU 1,200,000 available. As a consequence, there is no current income tax charge in the period and Entity B determines a remaining tax loss carry-forward balance of CU 200,000 and unused tax credits of CU 300,000. As management believes that Entity B will realise sufficient taxable profits in the future, it records a deferred tax asset for the unused tax losses and unused tax credits of CU 200,000 and CU 300,000 respectively.

### How we see it

Once an entity decides that it is probable that an uncertain tax treatment will be accepted by the taxation authorities, the basis adopted in its income tax filings is followed in the measurement of applicable taxes in the financial statements.

As explained in section 3.3.1 above, the measurement requirements in IFRIC 23 do not distinguish between a probability of 51% and a probability of 100%. This is consistent with the objective of IAS 12 that refers to a probable threshold and with the *Conceptual Framework for Financial Reporting* which refers to a probability threshold for the recognition of assets and liabilities in general.

In some situations, entities may have recognised an additional liability for uncertain tax treatments that do not meet the probable threshold described in the Interpretation. Such additional liabilities may need to be released upon transition.

The 'tax base' used for IAS 12 purposes does not always correspond to the tax return that is subsequently filed. The financial statements are typically completed well ahead of the tax return, which means that certain adjusting events after the reporting period may be included in the tax returns that are only later considered for accounting. For example, the final tax return may claim deductions for items that had not been identified at the time the IFRS financial statements were prepared.

#### 3.3.2 *Determination of tax positions when it is 'not probable'*

If an entity concludes that it is not probable that the taxation authority will accept an uncertain tax treatment, IFRIC 23 provides two methods to reflect the effect of uncertainty in the measurement of applicable taxes. An entity selects either: (a) the most likely amount; or (b) the expected value method, based on which approach better predicts the resolution of the uncertainty. This is similar to the approach used in IFRS 15 *Revenue from Contracts with Customers* to estimate the amount of variable consideration in a revenue contract.

The IFRS IC considered and rejected a proposal to permit or require a third measurement method, such as the 'cumulative-probability approach' that is followed in US GAAP. It decided that including a measurement method not used elsewhere in IFRS might have reduced comparability.

## Extract from IFRIC 23

- 11 If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty:
- the most likely amount—the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.
  - the expected value—the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.
- 12 If an uncertain tax treatment affects current tax and deferred tax (for example, if it affects both taxable profit used to determine current tax and tax bases used to determine deferred tax), an entity shall make consistent judgements and estimates for both current tax and deferred tax.

Examples 8 and 9 below are based on the Illustrative Examples 1 and 2 that accompany IFRIC 23:

### Example 8 - Expected value method used to reflect effect of uncertainty for tax treatments considered together

Entity A's income tax filing in a jurisdiction includes deductions related to transfer pricing. The taxation authority may challenge those tax treatments. In the context of applying IAS 12, the uncertain tax treatments affect only the determination of taxable profit for the current period.

Entity A notes that the taxation authority's decision on one transfer pricing matter would affect, or be affected by, the other transfer pricing matters. Applying paragraph 6 of IFRIC 23, Entity A concludes that considering the tax treatments of all transfer pricing matters in the jurisdiction together better predicts the resolution of the uncertainty. Entity A also concludes it is not probable that the taxation authority will accept the tax treatments. Consequently, Entity A reflects the effect of the uncertainty in determining its taxable profit applying paragraph 11 of IFRIC 23.

Entity A estimates the probabilities of the possible additional amounts that might be added to its taxable profit, as follows:

	Estimated additional amount CU	Probability %	Estimate of expected value CU
Outcome 1	-	5%	-
Outcome 2	200	5%	10
Outcome 3	400	20%	80
Outcome 4	600	20%	120
Outcome 5	800	30%	240
Outcome 6	1,000	<u>20%</u>	<u>200</u>
		<u>100%</u>	<u>650</u>

### **Example 8 - Expected value method used to reflect effect of uncertainty for tax treatments considered together (*continued*)**

Outcome 5 is the most likely outcome. However, Entity A observes that there is a range of possible outcomes that are neither binary nor concentrated on one value. Consequently, Entity A concludes that the expected value of CU 650 better predicts the resolution of the uncertainty.

Accordingly, Entity A recognises and measures its current tax liability applying IAS 12 based on taxable profit that includes CU 650 to reflect the effect of the uncertainty. The amount of CU 650 is in addition to the amount of taxable profit reported in its income tax filing.

### **Example 9 - Most likely amount method used to reflect effect of uncertainty when recognising and measuring deferred tax and current tax**

Entity B acquires for CU 100 a separately identifiable intangible asset that has an indefinite life and, therefore, is not amortised applying IAS 38 *Intangible Assets*. The tax law specifies that the full cost of the intangible asset is deductible for tax purposes, but the timing of deductibility is uncertain. Applying paragraph 6 of IFRIC 23, Entity B concludes that considering this tax treatment separately better predicts the resolution of the uncertainty.

Entity B deducts CU 100 (the cost of the intangible asset) in calculating taxable profit for Year 1 in its income tax filing. At the end of Year 1, Entity B concludes it is not probable that the taxation authority will accept the tax treatment. Consequently, Entity B reflects the effect of the uncertainty in determining its taxable profit and the tax base of the intangible asset applying paragraph 11 of IFRIC 23. Entity B concludes the most likely amount that the taxation authority will accept as a deductible amount for Year 1 is CU 10 and that the most likely amount better predicts the resolution of the uncertainty.

Accordingly, in recognising and measuring its deferred tax liability applying IAS 12 at the end of Year 1, Entity B calculates a taxable temporary difference based on the most likely amount of the tax base of CU 90 (CU 100 - CU 10) to reflect the effect of the uncertainty, instead of the tax base calculated based on Entity B's income tax filing (CU 0).

Similarly, as required by paragraph 12 of IFRIC 23, Entity B reflects the effect of the uncertainty in determining taxable profit for Year 1 using judgement and estimates that are consistent with those used to calculate the deferred tax liability. Entity B recognises and measures its current tax liability applying IAS 12 based on taxable profit that includes CU 90 (CU 100 - CU 10). The amount of CU 90 is in addition to the amount of taxable profit included in its income tax filing. This is because Entity B deducted CU 100 in calculating taxable profit for Year 1, whereas the most likely amount of the deduction is CU 10.

## How we see it

Entities may need to apply significant judgement in selecting the method that better predicts the resolution of the uncertainty. Although entities might apply a particular method to all similar uncertain tax treatments, they need to assess each situation separately to ensure that the method adopted better reflects the resolution of the uncertainty. In our view, applying a measurement method to reflect uncertainties is not an accounting policy choice; rather the selection should be made on a case-by-case basis based on which approach better predicts the resolution of the uncertainty.

The outcome of an uncertain tax treatment will often be binary. For example, a deduction might be allowed or rejected in full. In such circumstances, measurement using the single most likely amount might be more appropriate. However, when a number of interdependent uncertainties are considered together, or when a single uncertain tax treatment can be partially accepted by the taxation authorities, the expected value approach might better predict the resolution of the uncertainty. Entities will have to exercise judgement, based on their knowledge of how the relevant taxation authority operates and using professional advice, where required.

Further, in our view, entities should assess the impact of uncertainties on current and deferred taxes separately. Entities should not consider the effect of uncertainties on the net current and deferred taxes for recognition and disclosure purposes just because the net impact in many cases could be zero.

### 3.4 Consideration of changes in facts and circumstances

The Interpretation recognises that entities make judgements and estimates in considering uncertainty over tax treatments based on the available information at the time and that the information available can change over time. IFRIC 23 requires an entity to reassess those judgements and estimates if:

- ▶ The facts and circumstances on which the judgement or estimate was based change
- Or
- ▶ New information that affects the judgement or estimate is available

#### Extract from IFRIC 23

- 13 An entity shall reassess a judgement or estimate required by this Interpretation if the facts and circumstances on which the judgement or estimate was based change or as a result of new information that affects the judgement or estimate. For example, a change in facts and circumstances might change an entity's conclusions about the acceptability of a tax treatment or the entity's estimate of the effect of uncertainty, or both. [...].
- 14 An entity shall reflect the effect of a change in facts and circumstances or of new information as a change in accounting estimate applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. An entity shall apply IAS 10 *Events after the Reporting Period* to determine whether a change that occurs after the reporting period is an adjusting or non-adjusting event.

Effect of a change in facts and circumstances or of new information is reflected as a change in accounting estimate applying IAS 8.



### Example 10 - Change in facts and circumstances

Entity A claimed a tax-deduction for a particular expense item. In the prior year, Entity A had concluded that it was probable that the taxation authority would accept the tax deduction. However, during the current year, Entity A is alerted by its tax advisor that another company in the jurisdiction with a similar issue was denied a tax deduction in a ruling by the Supreme Court. The recent court ruling is considered a change in facts and circumstances. As a result, Entity A has to reassess the uncertain tax treatment, taking into account the recent Supreme Court decision.

### Example 11 - Explicit and implicit acceptance

Entity B paid interest at a mutually agreed rate of 10% to an affiliated foreign company. However, the taxation authorities in Entity B's jurisdiction normally only accept interest rates that are based on LIBOR plus a margin (which is significantly lower than 10%). Entity B made a statement in its corporate income tax return that it performed a transfer pricing study that substantiates the arm's length nature of the 10% interest rate. Upon request, it could provide this documentation to the taxation authorities. The taxation authority may accept the tax treatment either implicitly or explicitly as described below:

- ▶ The taxation authorities perform an on-site tax audit and the 10% interest rate is specifically discussed with the tax inspector. The taxation authority agrees with the interest rate and explicitly confirms this in its final tax audit report

Or

- ▶ The taxation authority performs a tax audit based on the income tax return filed and without asking for additional documentation. Although it appears that they have implicitly accepted the 10% interest rate, the entity should consider the guidance in paragraph A3 of IFRIC 23, as discussed below

### Example 12 - Events after the reporting date

#### *Scenario A*

Entity C had claimed a tax deduction for a particular expense item in its tax return related to the financial year ending 31 December 2018. However, for the purpose of recognising current and deferred taxes in that year, Entity C had concluded that it is not probable that the taxation authorities will accept the tax deduction. Accordingly, Entity C had recognised an additional tax liability relating to the uncertainty. In February 2020, before the approval of the financial statements for the year ending 31 December 2019, Entity C receives the final tax assessment for 2018. The tax assessment confirms the full deductibility of the expense item. The confirmation of tax deduction received after the reporting period and prior to authorisation of the financial statements for 2019 is considered as an adjusting event after the reporting period. Accordingly, the additional tax liability that was recognised in 2018 relating to the uncertainty is released in the 2019 period.

## Example 12 - Events after the reporting date (continued)

### Scenario B

Entity B claimed a tax-deduction pertaining to interest expense on a loan granted by an affiliated company, amounting to CU 500,000 in its tax return related to the financial statements for the year ending 31 December 2018. However, for the purposes of recognising current and deferred taxes for that year, Entity B had concluded that the taxation authorities will only accept a deduction of CU 100,000. In March 2020, before the approval of the financial statements for the year ending 31 December 2019, Entity B learns from its tax advisor that the taxation authorities have confirmed that they will accept, on a retrospective basis, another method of determining interest rate at arm's length that would lead to a tax deduction of CU 300,000 in year 2018. In this example, it appears that the taxation authorities have issued a new guideline on deductibility of interest expenses relating to a loan from an affiliated company. Accordingly, in contrast to Scenario A above, the information received in March 2020 is considered as a non-adjusting event after the reporting period for the 2019 financial statements.

IAS 10 is applied to determine whether a change that occurs after the reporting period is an adjusting or non-adjusting event.

The challenge for entities is to determine what represents a change in facts and circumstances that should result in a need to reassess judgements and estimates previously made by the entity.

The Application Guidance in Appendix A to the Interpretation provides the following examples:

- ▶ Examinations or actions by a taxation authority. For example:
  - ▶ Agreement or disagreement by the taxation authority with the tax treatment or a similar tax treatment used by the entity
  - ▶ Information that the taxation authority has agreed or disagreed with a similar tax treatment used by another entity
  - ▶ Information about the amount received or paid to settle a similar tax treatment
- ▶ Changes in rules established by a taxation authority
- ▶ The expiry of a taxation authority's right to examine or re-examine a tax treatment

An uncertain tax treatment is resolved when the treatment is accepted or rejected by the taxation authorities. The Interpretation does not discuss the manner of acceptance (i.e., implicit or explicit) of an uncertain tax treatment by the taxation authorities. In practice, a taxation authority might accept a tax return without commenting explicitly on any particular treatment in it. Alternatively, it might raise some questions in an examination of a tax return. Unless such clearance is provided explicitly, it is not always clear if a taxation authority has accepted an uncertain tax treatment.

An entity may consider the following to determine whether a taxation authority has implicitly or explicitly accepted an uncertain tax treatment:

- ▶ The tax treatment is explicitly mentioned in a report issued by the taxation authorities following an examination

- ▶ The treatment was specifically discussed with the taxation authorities (e.g., during an on-site examination) and the taxation authorities verbally agreed with the approach

Or

- ▶ The treatment was specifically highlighted in the income tax filings, but not subsequently queried by the taxation authorities in their examination

Paragraph A3 of IFRIC 23 clarifies that the absence of agreement or disagreement by a taxation authority with a tax treatment, in isolation, is unlikely to constitute a change in facts and circumstances or new information that affects the judgements and estimates required by this Interpretation. In such situations, an entity has to consider other available facts and circumstances before concluding that a reassessment of the judgements and estimates is required.

Upon reassessment, if an entity concludes that the judgements and/or estimates have changed, the entity will reflect that change prospectively in accordance with IAS 8 as a change in accounting estimate.

When facts and circumstances change after the reporting period and before the financial statements are authorised for issue, the entity must apply IAS 10 *Events after the Reporting Period* to determine whether a change that occurs after the reporting period is an adjusting or non-adjusting event.

### How we see it

Paragraphs 46 and 47 of IAS 12 require tax assets and liabilities to be measured using tax laws that are enacted or substantively enacted. However, paragraph A1 of IFRIC 23 refers to applicable tax laws. We believe that, although a different term is used in IFRIC 23, the overall principle in IAS 12 to consider enacted or substantively enacted tax laws in the measurement of tax assets and liabilities would be appropriate.

IFRIC 23 does not provide detailed guidance on the consideration of changes in facts and circumstances. In practice, it might not always be clear whether facts and circumstances have changed. An entity will need to apply significant judgement in the assessment of changes in facts and circumstances.

The Interpretation has not introduced any new disclosures.

## 4. Disclosures

IFRIC 23 has not introduced any new disclosures. Instead, the application guidance to the Interpretation refers to the existing disclosure requirements in IAS 1 *Presentation of Financial Statements* and IAS 12, as explained below:

### Extract from IFRIC 23

- A4 When there is uncertainty over income tax treatments, an entity shall determine whether to disclose:
- judgements made in determining taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates applying paragraph 122 of IAS 1 *Presentation of Financial Statements*; and
  - information about the assumptions and estimates made in determining taxable profit (tax loss), tax bases, unused tax losses,

### Extract from IFRIC 23 (continued)

unused tax credits and tax rates applying paragraphs 125-129 of IAS 1.

A5 If an entity concludes it is probable that a taxation authority will accept an uncertain tax treatment, the entity shall determine whether to disclose the potential effect of the uncertainty as a tax-related contingency applying paragraph 88 of IAS 12.

As required by paragraph 122 of IAS 1, an entity must disclose, along with its significant policies or other notes related to income taxes, the judgements (apart from those involving estimations) that management has made in the process of applying the entity's accounting policy on uncertain income tax treatments that have the most significant effect on the current and deferred tax amounts recognised in the financial statements.

As required by paragraph 125 of IAS 1, an entity must disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the current and deferred tax assets and liabilities within the next financial year.

As required by paragraph 88 of IAS 12 and paragraph 86 of IAS 37, an entity must disclose tax-related contingencies that includes a brief description of the nature of the uncertain income tax treatments, an estimate of its financial effect, indication of the uncertainties and reimbursements, if any. Similar disclosures are required for tax-related contingent assets.

### How we see it

The Interpretation does not contain any new requirements or guidance on the presentation of interest and penalties. We believe that, in line with the IFRS IC's discussion in June 2004, interest and penalties would continue to be presented based on their nature and the broader principles of IAS 12 and IAS 1.

## 5. Transition

The Interpretation is applicable for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies this Interpretation for an earlier period, that fact must be disclosed.

The Interpretation provides a choice of two transition methods on initial application, as follows:

### Extract from IFRIC 23

B2 On initial application, an entity shall apply this Interpretation 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 recognised at the date of initial application. If an entity

### Extract from IFRIC 23 (continued)

selects this transition approach, it shall not restate comparative information. Instead, the entity shall recognise the cumulative effect of initially applying the Interpretation as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate). The date of initial application is the beginning of the annual reporting period in which an entity first applies this Interpretation.

### How we see it

As with other parts of the Interpretation, entities may need to apply significant judgement in selecting an appropriate transition method that provides useful information to the users of the financial statements. For example:

- ▶ Entities may decide to early adopt the Interpretation to enhance transparency and understandability of the financial statements

Or

- ▶ Entities may elect to retrospectively adopt the Interpretation with the cumulative effect of initially applying the Interpretation recognised at the date of initial application

## 6. Other issues addressed in the Interpretation

### 6.1 Business combinations

The IFRS IC considered whether the Interpretation should address the accounting for tax assets and liabilities acquired or assumed in a business combination when there is uncertainty over income tax treatments. The IFRS IC noted that IFRS 3 *Business Combinations* applies to all assets acquired and liabilities assumed in a business combination. Consequently, the IFRS IC concluded that the Interpretation should not explicitly address tax assets and liabilities acquired or assumed in a business combination.

Nonetheless, paragraph 24 of IFRS 3 requires an entity to account for deferred tax assets and liabilities that arise as part of a business combination applying IAS 12. Accordingly, the Interpretation applies to such assets and liabilities when there is uncertainty over income tax treatments that affect deferred tax.

### 6.2 First-time adopters

The Interpretation includes a consequential amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* that provides relief for first-time adopters whose date of transition to IFRSs is before 1 July 2017, such that they do not have to present in their first IFRS financial statements comparative information that reflects IFRIC 23. In this case, the entity would recognise the cumulative effect of applying IFRIC 23 as an adjustment to the opening balance of equity at the beginning of its first IFRS reporting period.

Entities may face several challenges implementing the requirements of IFRIC 23. Entities should start assessing the impact well in advance of the effective date.

## 7. Implementation

The implementation of IFRIC 23 will require an entity, especially large multinational groups, to adopt structured processes and procedures for gathering information and documenting the judgments applied in recognition and measurement of uncertain tax treatments and the disclosure of information that is helpful to users of the financial statements. Entities need to consider the five-step process described below when implementing IFRIC 23:

- ▶ **Diagnose**
  - ▶ Entities must develop an understanding of the requirements in the Interpretation and the information that needs to be reported in their financial statements to provide useful information.
  - ▶ Entities must start raising awareness now, particularly around transition options.
- ▶ **Understand the magnitude**
  - ▶ The accounting and tax functions in organisations must engage in initial discussions to understand the potential sensitivity and magnitude of the issue.
  - ▶ Entities must consider both quantitative and qualitative factors to assess the impact of uncertain income tax treatments.
- ▶ **Develop the solution**
  - ▶ As the mandatory application date of 1 January 2019 approaches, entities need to bring together a cross-functional team to build an appropriate response.
  - ▶ Entities must include the requirements and guidance provided in the Interpretation in the group accounting manual. The accounting manual should include clear and robust guidelines related to the application of the probable threshold, judgements, estimates, requirements regarding consultation with internal tax advisors and involvement of external advisors.
  - ▶ The guidelines must, where possible, also include a standardised template for the technical analysis, risk assessment and measurement.
  - ▶ Entities must implement robust controls around review and sign-off procedures. For example, significant judgements that affect the group as a whole might need to be signed off by the group head of taxation.
  - ▶ Entities must establish a process whereby the latest information, such as decisions by the court on issues similar to those they are facing, is gathered and communicated internally on a timely basis.
- ▶ **Implement**
  - ▶ Entities must implement a process for identifying and assessing uncertainty over income tax treatments that is consistent across the group. For example, entities in a group should neither be too aggressive nor too conservative when assessing or identifying uncertain tax treatments.

▶ **Post-implementation**

- ▶ Entities must establish a process of monitoring issues around uncertain tax treatments, for example, by including information on uncertain tax treatments in monthly management reporting packs.
- ▶ Entities must monitor and optimise changes to secure all compliance and business benefits.

Challenges that entities and their auditors might face in the identification of uncertain tax treatments include the following:

- ▶ Issues concerning uncertainty over income taxes often raise highly complex questions that could relate to several years (e.g., transfer pricing exposures). Resolving such issues generally requires significant judgement.
- ▶ Uncertain tax treatments might be one-off issues that have no precedents.
- ▶ Preparation and audit of appropriate documentation to support an entity's position might be challenging.
- ▶ The tax examination by the taxation authorities and consequent discussions might be carried out over a long period of time, as such, the resolution of such issues is more challenging.

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