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A&A Accounting Technical

Clarity in financial reporting

Deferred tax accounting for indefinite life intangibles

Talking Points

- The IFRS Interpretations Committee (IC) has clarified that the measurement of deferred tax on indefinite life intangibles assets should reflect the **expected manner of recovery** of the carrying amount of the asset rather than an **assumption that the asset will be sold.**
- The biggest impact will be on indefinite life intangibles acquired in a business combination for which historically no deferred liability was recognised. For example, brands, trade names, licenses or management rights.
- If the intangible asset is expected to be recovered through use (revenue account), a deferred tax liability will arise based on the full carrying amount of the asset.
- Often any deferred tax asset attributable to the excess of the capital tax base over the amount of the carrying value expected to be recovered through sale will not meet the 'probable' criteria for recognition.
- This could represent a significant change for some of our clients as it is an area where previously there has been diversity of practice.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Background
Within Australia, there has been diversity of practice in the measurement of deferred tax on indefinite life intangibles since the introduction of IFRS in 2005.

Australia operates a dual tax system. Generally indefinite life intangibles will not be eligible for a tax deduction as the asset is used, however there may be a recovery of the capital gains tax base on the occurrence of certain events such as sale, other disposal, abandonment and forfeiture, amongst others.

IAS 12 *Income Taxes* requires that measurement of any deferred tax balances should reflect the tax consequences which follow from the manner in which management expects to recover the carrying amount of its assets and liabilities at the reporting date. In determining the 'expected manner of recovery' many entities historically assumed that the intangible would be recovered through sale because the asset is not being amortised. This was by analogy to the guidance in IAS 12.51B which states that the carrying amount of a non-depreciable asset measured using the revaluation model in IAS 16 (i.e. land) is presumed to be recovered through sale.

The IC has clarified that this analogy is not appropriate. In their view, land is a non-depreciable asset because it has an unlimited (or infinite) life whereas IAS 38 *Intangible Assets* explains that indefinite is not infinite and the reason these intangibles are not amortised is merely because the determination of the amortisation period would be arbitrary. It is therefore not possible to presume that the asset will be sold and consequently deferred tax accounting should not presume the manner of recovery will be through sale whereby a deferred tax liability is not recognised.

As a result, the general principles and requirements of IAS 12.51 and 51A (namely, that temporary differences will be recognised based on the expected manner of recovery) apply when measuring deferred tax on assets with indefinite useful lives.

This publication summarises the accounting implications of the IC's decision and outlines next steps if the IC clarification has a material impact on any of your clients.

Measurement of deferred tax
A key principle in measuring deferred tax liabilities and deferred tax assets is to *'reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of the asset or liability'* (AASB 112.51).

AASB 112.51A explains further that *'the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:*
- *(a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and*
- *(b) the tax base of the asset (liability)'.*

From this paragraph it is clear that a 'separate components' approach is applicable when applying AASB 112 (i.e. revenue base and capital base of an asset). This means that tax consequences flowing from income tax and capital gains tax (arising from the recovery of the asset) should be considered separately. This approach can result in both a deferred tax liability and potential deferred tax asset in respect of the same asset.

The expected manner of recovery is a matter of judgment and the facts and circumstances of the entity will need to be considered. Where management has no plan to sell the intangible (either directly or through sale of the business), this generally would imply that recovery is expected through use. Where management expects to recover through sale of the intangible asset, we would expect this to be supported by a plan to sell. Consideration should also be given to whether the expected sale is reasonable. Factors to consider include:
- Whether the asset is integral to company's business
- Restrictions on transfer of the asset, or title to the asset
- Possible markets for sale
- Past history of selling similar assets
- Tax attributes of the asset i.e. will a sale crystallise the benefits of the capital gains tax base?
- Consistency with impairment models.

Examples
<u>Expectation of recovery through use (in the consolidated financial statements)</u>
An intangible asset is acquired as part of a business combination. The intangible asset has a carrying amount of $500 and obtains a reset capital gains tax cost base ('CGT cost base') of $500 on joining the acquirer's tax consolidated group. The intangible asset is not amortised for accounting purposes and no capital allowance (tax depreciation) is available for tax purposes on revenue account. However, the CGT cost base is deductible on capital account on the occurrence of any 'CGT event' under the Australian tax law, including sale, other disposal, abandonment or forfeiture, amongst others. There is currently no intention to sell the intangible asset and therefore management expects to recover the carrying value of the asset through use.

	Revenue	Capital
Carrying amount	500	-
Tax base	-	500
Taxable/(deductible) temporary difference	500	(500)
Deferred tax liability (asset) at 30%	150	(150)

The deferred tax asset of $150 would be unlikely to be recognised as it effectively represents an anticipated capital loss, which would only meet the 'probable' recognition criteria in AASB 112.24 where it could be shown that taxable capital gains were probable in the same or subsequent tax accounting period to which the CGT loss is expected to crystallise.

<u>Expectation of recovery through sale (in the consolidated financial statements)</u>

In the example above, if management's intention is to sell the intangible in the short term, which is evidenced by an announcement to the market of its intention to do so, no deferred tax liability would be recognised.

	Revenue	Capital
Carrying amount	-	500
Tax base	-	500
Taxable/(deductible) temporary difference	-	-
Deferred tax liability (asset) at 30%	-	-

<u>Expectation of recovery through sale and use (in the consolidated financial statements)</u>

Where management expects to use the intangible for a period of time and then sell (or otherwise trigger a capital gains tax base) the analysis will be more complicated because management will need to estimate separately that portion of the carrying amount that will be recovered through use and the portion that will be recovered through sale. This analysis should be supported by reasonable and supportable assumptions and should be appropriately documented. A deferred tax liability will arise on the portion expected to be recovered through use. This is illustrated in the example below.

	Revenue	Capital
Carrying amount	200	300
Tax base	-	500
Taxable/(deductible) temporary difference	200	200
Deferred tax liability (asset) at 30%	60	(60)

A deferred tax liability of $60 would be recognised in respect of the portion expected to be recovered through use. As above, the deferred tax asset of $60 would be unlikely to be recognised as it effectively represents an anticipated capital loss, which would only meet the 'probable' recognition criteria in AASB 112.24 where it could be shown that taxable capital gains were probable in the same or subsequent tax accounting period to which the CGT loss is expected to crystallise.

Who is impacted?

The biggest impact is likely to be on indefinite life intangible assets arising in business combinations, where those assets have a CGT cost base but no tax depreciation allowable on revenue account. For example, brands, trade names, licenses or management rights.[1] In the absence of a committed plan to sell the intangible, in our view, it is likely that the carrying amount of the intangible asset would be expected to be recovered through use in the entity's operations through the generation of taxable income (i.e. on revenue account), leading to the recognition of a deferred tax liability based on the full carrying amount of the asset and (usually) no recognition of a deferred tax asset arising on sale/capital account.

[1] A deferred tax liability is recognised for all temporary differences, except to the extent that the liability arises from the initial recognition of goodwill or the initial recognition of an asset/liability in a transaction which is not a business combination and, at the time of the transaction, affects neither accounting profit nor taxable profit. (AASB 112.15)

Recognising the impact
This clarification by the IC represents a change in accounting policy in the application of AASB 112 *Income Taxes* which should be applied retrospectively in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors.*

The guidance in AASB 3 *Business Combinations* on measurement periods is not applicable because AASB 3 provides a recognition and measurement exception for deferred tax liabilities arising from assets acquired in a business combination.

The impact may differ depending on whether the original business combination was recognised in accordance with AASB 3 or not.

<u>AASB 3 was **not** applied to the business combination</u>
When the business combination occurred before the date of transition[2] to Australian Accounting Standards, an entity could make an election under AASB 1 *First-time Adoption of Australian Accounting* Standards not to apply AASB 3 retrospectively to past business combinations. In this case, the adjustment to deferred tax is recognised as a reduction of retained earnings as follows:

Dr Retained earnings
    Cr Deferred tax liability.

<u>AASB 3 **was** applied to the business combination</u>
Where the business combination occurred after the date of transition to Australian Accounting Standards or before the date of transition and the entity elected under AASB 1 to apply AASB 3 retrospectively to that business combination, the adjustment to deferred tax is recognised as an increase in goodwill as follows:

Dr Goodwill
    Cr Deferred tax liability.

Impairment considerations
Where additional goodwill is recognised, careful consideration should also be given to the requirements of AASB 136 *Impairment of Assets*. In considering any impairment considerations, it is our view that the deferred tax liability may be deducted from the carrying amount of the cash-generating unit being tested for impairment. Where impairment is recognised in relation to the intangible asset, the deferred tax balance will reduce, therefore it is important to also consider how the deferred tax liability unwinds when calculating any impairment.

Disclosures
A description of the change in accounting policy should be provided in the notes to the financial statements. This would normally be included as part of the summary of significant accounting policies or the deferred tax note. An illustration of this note is provided below:

<u>Illustrative change in accounting policy – only goodwill impacted</u>
Change in accounting policy – deferred tax measurement relating to indefinite life intangible assets
The IFRS Interpretations Committee has issued an agenda decision related to the expected manner of recovery of indefinite life intangible assets. The Committee was asked to clarify how an entity determines the expected manner of recovery of an intangible asset with an indefinite useful life for deferred tax measurement purposes. The Committee indicated that the fact that an entity does not amortise an indefinite life intangible asset does not necessarily mean that the carrying amount will be recovered only through sale and not use. Therefore the entity should determine the expected manner of recovery of the carrying amount of the intangible asset.

Previously Company A measured deferred tax liabilities on the assumption of the tax consequences that would arise solely from the sale of the assets. Under its new policy, Company A considers its expected manner of recovery. Company A has implemented this guidance on a retrospective basis as a change in accounting policy to AASB 112 *Income Taxes*.

The impact of these changes at 1 July 2015 and 30 June 2016 was to increase goodwill and deferred tax liabilities by $xxx.

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[2] The date of transition is the beginning of the earliest period for which an entity presents full comparative information under Australian Accounting Standards in its first Australian-Accounting-Standards financial statements.

that the carrying amount will be recovered only through sale and not use. Therefore the entity should determine the expected manner of recovery of the carrying amount of the intangible asset. Previously Company A measured deferred tax liabilities on the assumption of the tax consequences that would arise solely from the sale of the assets. Under its new policy, Company A considers its expected manner of recovery. Company A has implemented this guidance on a retrospective basis as a change in accounting policy to AASB 112 *Income Taxes*.

On conversion to Australian Accounting Standards, Company A utilised the exemption in AASB 1 *First-time Adoption of Australian Accounting Standards* to not restate business combinations prior to the date of transition. Accordingly Company A has reduced retained earnings for changes to business combinations that occurred prior to the transition to Australian Accounting Standards and

The impact of these changes at 1 July 2015 was to reduce retained earnings and increase deferred tax liabilities by $xxx.

<u>Illustrative change in accounting policy – both retained earnings and goodwill impacted</u>
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- reduced retained earnings for changes to business combinations that occurred prior to the transition to Australian Accounting Standards and
- increased goodwill for changes to business combinations that occurred subsequent to the transition to Australian Accounting Standards.

The impact of these changes at 1 July 2015 and 30 June 2016 was to increase Goodwill by $xxx, reduce retained earnings by $xxx and increase deferred tax liabilities by $xxx.

<u>Other considerations</u>
Consideration should also be given to whether a third statement of financial position should be presented as a result of the change in accounting policy in accordance with AASB 101.40A *Presentation of Financial Statements*. This is only required where it is determined that the retrospective application has a material effect on the statement of financial position at the beginning of the comparative period.

Next steps
We recommend that entities review their accounting policy for the measurement of deferred tax on indefinite life intangibles to determine whether it is in line with the IC clarification.

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