Global tax accounting services newsletter

Focusing on tax accounting issues affecting businesses today

January – March 2016
Introduction

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The Global tax accounting services newsletter is a quarterly publication from PwC's Global Tax Accounting Services (TAS) group. In the newsletter we highlight issues that may be of interest to tax executives, finance directors, and financial controllers.

In this issue, we provide an update on the new Accounting Standards Update (ASU) on stock compensation, discuss narrow scope amendments to IAS 12, Income taxes issued by the International Accounting Standards Board (IASB) and new lease accounting standards, and outline highlights of the 2015 American Institute of CPAs (AICPA) conference.

In addition, we draw your attention to some significant tax law and tax rate changes that occurred around the globe during the quarter ended March 2016.

Finally, we discuss some key concepts that should be considered when preparing a tax provision for a carve-out financial statement. Such statements are often required due to significant transactions, such as an IPO or a business combination, or for certain statutory or regulatory filings.

This newsletter, tax accounting guides, and other tax accounting publications are also available online and on our new TAS to Go app, which you can download anywhere in the world via App Stores. Register and access quarterly TAS webcasts for periodical updates on the latest developments.

If you would like to discuss any of the items in this newsletter, tax accounting issues affecting businesses today, or general tax accounting matters, please contact your local PwC team or the relevant Tax Accounting Services network member listed at the end of this document.

You should not rely on the information contained within this newsletter without seeking professional advice. For a thorough summary of developments, please consult with your local PwC team.

Senior tax buyers name PwC as their first choice provider for tax accounting services globally*

*These results are based on an independent survey of 1,605 primary buyers of tax accounting services globally, conducted by research agency Jigsaw Research (Q1 & Q2 2015).
In this issue

Accounting and reporting updates
- New ASU on stock compensation
- Narrow scope amendments to IAS 12, Income taxes
- New lease accounting standards
- Highlights of the 2015 American Institute of CPAs (AICPA) conference

Recent and upcoming major tax law changes
- Notable tax rate changes
- Other important tax law changes

Tax accounting refresher
- Tax provisions for carve-out financial statements

Contacts and primary authors
- Global and regional tax accounting leaders
- Tax accounting leaders in major countries
- Primary authors
Accounting and reporting updates

This section offers insight into the most recent developments in accounting standards, financial reporting, and related matters, along with the tax accounting implications.

New ASU on stock compensation

Overview

On 30 March, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation – Stock Compensation.

The ASU includes provisions intended to simplify various aspects related to how share-based payments are accounted for and disclosed.

Income tax effects of share-based payments

The standard provides a new requirement to record all of the tax effects related to share-based payments at settlement (or expiration) through the income statement. This represents a substantial change and for many companies will likely have the most significant impact.

Currently, the deduction for tax purposes in excess of the compensation cost recognized for financial statement purposes (windfalls) is recorded in equity. Tax deficiencies (shortfalls) are recorded in equity to the extent of previous windfalls, and then to the income statement. This new guidance will eliminate the need for companies to track a ‘windfall pool’ going forward with all tax effects being recorded in income tax expense.

Additionally, the standard removes the requirement to delay recognition of a windfall tax benefit until it reduces current taxes payable. The changes will be required to be applied prospectively to all excess tax benefits and tax deficiencies resulting from settlements after the date of adoption of the ASU.

Finally, all tax-related cash flows resulting from share-based payments will be reported as operating activities on the statement of cash flows, rather than the current requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. Either prospective or retrospective transition of this provision is permitted.

Effective date

ASU 2016-09 is effective for public entities for annual reporting periods beginning after 15 December 2016, and interim periods within that reporting period. For all other non-public entities, it is effective for annual periods beginning after 15 December 2017, and interim periods within annual periods beginning after 15 December 2018. Early adoption will be permitted in any interim or annual...
period, as long as all elements of the new standard are adopted at the same time.

**Takeaway**

While the amendments are aimed at reducing the cost and complexity of accounting for share-based payments, they will likely result in significant changes to net income and earnings per share, with increased income tax expense volatility for many companies. Additionally, there are expected to be administrative and other challenges (such as possible changes to systems, processes, and controls) in implementing the standard for companies with significant share-based payment activities.
**Global tax accounting services newsletter**

**Introduction**

**In this issue**

- Accounting and reporting updates
- Recent and upcoming major tax law changes
- Tax accounting refresher
- Contacts and primary authors

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# Accounting and reporting updates

## Narrow scope amendments to IAS 12, Income taxes

**Overview**

In January 2016, the IASB issued amendments to IAS 12, *Income taxes*, to clarify requirements for recognising deferred tax assets on unrealised losses. This follows the exposure draft issued by the IASB in August 2014 in response to a question submitted to the IFRS Interpretations Committee regarding the appropriate accounting for deferred tax assets associated with debt investments measured at fair value.

The amendments clarify the accounting for deferred tax where an asset is measured at fair value and that fair value is below the asset’s tax base. The amendments also clarify certain other aspects of accounting for deferred tax assets.

**Key amendments**

The amendments clarify that a temporary difference is calculated by comparing the carrying amount of an asset against its tax base at the end of the reporting period.

When an entity determines whether or not a temporary difference exists, it should not consider the following:

- the expected manner of recovery of the related assets (e.g., by sale or by use); or
- whether it is probable that any deferred tax asset arising from a deductible temporary difference will be recoverable.

The IASB clarified that determining the existence and amount of temporary differences and estimating future taxable profit against which deferred tax assets can be utilised, are two separate steps. If an entity considers it is probable that it can realise more than the carrying amount of an asset at the end of a reporting period, it should incorporate this assumption into its estimate of future taxable profit.

Furthermore, the IASB noted that the tax deduction resulting from the reversal of deferred tax assets is excluded from estimated future taxable profit used to evaluate the recoverability of those assets. If the deductions were not excluded from the analysis, it was concluded that they had effectively been considered twice.

Finally, the IASB clarified that the recoverability of a deferred tax asset is assessed in the context of the relevant tax law. Deferred tax assets are considered in combination with other deferred tax assets where the tax law does not restrict the source of taxable profits against which particular types of deferred tax assets can be recovered. Where restrictions apply (e.g., if tax law limits the offset of capital losses to capital gains), deferred tax assets are only assessed in combination with deferred tax assets of the same type.

**Effective date and transition**

The amendments are effective for annual periods beginning on or after 1 January 2017, however, earlier application is permitted. An entity may, on initial application of this amendment, elect to recognise any change in the opening equity of the earliest comparative period presented in the opening retained earnings (or in another component of equity, as appropriate), without allocating the change across different equity components.
Accounting and reporting updates

Takeaway

The amendments clarify the existing guidance under IAS 12 regarding the requirements for recognising deferred tax assets on unrealised losses. Although the amendments arose from a question on the accounting for deferred tax assets associated with debt investments measured at fair value, the amendments provide broader context and are not limited to any specific type or class of assets.
Accounting and reporting updates

New lease accounting standards

Overview

During the first quarter of 2016 and after more than a decade of deliberations, the IASB and the FASB published new standards on accounting for leases (IFRS 16, Leases, and Accounting Standards Update ASU 2016-02, Leases). The new standards bring significant changes for lessees, with almost all leases going on the balance sheet.

The lease standards were originally part of the convergence project, but ultimately the Boards were not completely aligned on a number of matters due to differing feedback received during the consultation process. In particular, there are differences with regard to the single vs. dual approach for classifying how leases are recorded in the income statement. Despite these differences, both Boards noted that their respective standards fulfil the key objectives of lessee recognition of lease-related assets and liabilities on the balance sheet and enhanced transparency.

Key provisions

Under the new standards, lessees will need to recognise a lease liability reflecting future lease payments and a ‘right-of-use asset’ for virtually all lease contracts. The IASB has included an optional exemption for certain short-term leases and leases of low-value assets; however, this exemption can only be applied by lessees. The FASB retained a dual model for income statement purposes, requiring leases to be classified as either operating or finance. As such, there are no significant changes to existing guidance. Operating leases will result in straight-line expense, while finance leases will result in a front-loaded expense pattern.

Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines.

For lessors, the accounting stays almost the same. However, as the Boards updated certain definitions (e.g., the definition of a lease), lessors can also be affected by the new standard. At the very least, the new accounting model for lessees is expected to impact negotiations between lessors and lessees.

Similar to current guidance, the new standards will require judgments in a number of areas, including determining when an arrangement is or includes a lease, assumptions related to lease term and discount rate, and the allocation of consideration to lease and non-lease components.

Impact on financial statements

The new standards will likely have a significant impact on the financial statements of a number of lessees. In particular, the new standards will affect the balance sheet and related ratios, such as debt/equity ratios. Depending on the particular industry and the number of lease contracts previously classified as operating leases, the new approach may result in a significant increase in debt on the balance sheet.

The new standards will also require more extensive qualitative and quantitative disclosures, including significant judgements made by management. These disclosures are expected to assist investors and analysts in better understanding an entity’s rights and obligations under lease arrangements.

Continued
Tax accounting considerations

Multinational companies should consider the impact of the new lease standards on accounting for income taxes, including the following:

- whether there could be an impact on the company’s current tax payable, for example in jurisdictions where local taxable income is calculated based on accounting profit before tax or due to changes in the company’s thin capitalisation position
- whether changes introduced by the new lease standards could potentially affect computation of book-to-tax differences and the related deferred taxes. This assessment may be challenging as the analysis can vary by country

Companies should also consider other broader tax issues, such as whether changes to the balance sheet due to new lease accounting guidance could warrant changes to the company’s existing agreements with tax authorities (e.g., Advanced Pricing Agreements).

We strongly recommend that companies consider the tax implications of the new standards and respective tax accounting in connection with implementation planning, and address any issues in advance of the standards’ effective dates. Companies should also ensure their systems, processes and controls are ready to capture all of the necessary lease data so they can determine the impact of decisions made now on future financial reporting.

Effective date

The effective dates of both standards are substantially the same.

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted, but only in conjunction with IFRS 15, Revenue from Contracts with Customers. In order to facilitate transition, entities can choose a ‘simplified approach’ that includes relief related to the measurement of the right-of-use asset and the lease liability, rather than full retrospective application. Furthermore, the ‘simplified approach’ does not require a restatement of comparative periods. In addition, as a practical expedient entities are not required to reassess whether a contract is, or contains, a lease at the date of initial application (i.e., such contracts are ‘grandfathered’).

ASU 2016-02 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after 15 December 2018. For private companies (i.e., those not meeting the FASB’s definition of a public business entity), the standard is effective for fiscal years beginning after 15 December 2019 and interim periods beginning the following year. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition, and provides for certain practical expedients. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.

Continued
Accounting and reporting updates

Highlights of the 2015 American Institute of CPAs (AICPA) conference

Overview

The 2015 AICPA National Conference was held in December 2015 and included representatives from regulatory and standard-setting bodies, auditors, preparers, and industry experts. A key theme highlighted during the conference was the importance of shared responsibility between the preparers, auditors, audit committee members, standard setters, and regulators to maintain high-quality and reliable financial reporting. In addition, the importance of internal control over financial reporting was emphasised.

Internal control over financial reporting (ICFR)

The SEC staff reminded registrants of the importance of giving ongoing consideration to implementing or redesigning controls, as necessary, in connection with the application of new accounting standards and policies. They also reminded registrants of the requirement to consider their quarterly obligation to disclose material changes in ICFR. Interim disclosure may be warranted in advance of the adoption of a new accounting standard or policy, or when actions are taken to remediate prior material weaknesses.

A panel of representatives from the SEC, PCAOB, public accounting firms, and public companies discussed various hot topics in ICFR, including: the identification of management review controls and how to test them, the assessment of the key control population, and the sufficiency of evidence to satisfy ICFR. The panel stressed the responsibility of management and the auditor to gain an understanding of processes where review controls are operating in order to assess the ability of a control to address the associated risk at the appropriate level of precision. Observation: this should include review controls within the tax process. In our experience, such controls are frequently important.

SEC staff’s accounting areas of focus

Non-GAAP disclosures

The SEC staff noted that the use of non-GAAP measures is an area that deserves close attention. Finance and legal teams, together with audit committees, should consider why non-GAAP measures are being used, how they provide investors with useful information, how they are being described, and whether there are appropriate controls over the calculation of such measures.

Under IFRS, the reconciliation of non-GAAP measures to GAAP measures and ensuring GAAP measures have equal prominence is key. Since IFRS contains less specificity regarding the definition and composition of financial statement line items, this can create greater disparity between non-GAAP and GAAP measures under IFRS. Observation: under IFRS it is common for tax to be a non GAAP measure as companies refer to an ‘underlying’ or adjusted tax rate, excluding the impact of various items such as purchase pricing accounting, share options, etc.
Accounting and reporting updates

Management’s Discussion and Analysis (MD&A)

The SEC staff highlighted that taxes for most companies are material, and so investors are very interested in the related disclosures. One way to improve transparency is by providing the rate reconciliation on a jurisdiction-by-jurisdiction basis, although it was acknowledged that many companies would be reluctant to do so.

The SEC also noted that due to the impact of continued oil price volatility on companies across all sectors, issuers may need to re-evaluate the extent of their related disclosures. All issuers should be focused on disclosing significant exposures and possible implications, including the potential for impairments. If the issuer expects oil prices to rebound, then they should consider disclosing what would happen if it is depressed longer than expected and how it may impact management’s growth plans.

Segment reporting

The SEC staff provided key reminders regarding the identification of the Chief Operating Decision Maker (CODM) and segments, as well as considerations when aggregating operating segments into reportable segments. They also emphasised the need for effective controls specific to segment reporting.

Disclosure effectiveness

The SEC staff and preparers noted that companies should evaluate the effectiveness of their financial reporting from the perspective of both compliance with the requirements and the extent to which it conveys important information to investors. While there are likely areas where issuers can eliminate redundant, outdated, and immaterial disclosures, the SEC staff cautioned that this analysis should also consider whether additional disclosures may be warranted to meet the needs of investors.

The SEC staff challenged the perception that SEC comment letters always require additional disclosures. The comment process is intended to be a fact-finding exercise, where the staff evaluates whether disclosures are appropriate in light of additional facts obtained. In some cases, the conclusion may be that no incremental disclosure is necessary. In addition, disclosures added as a result of prior staff comment letters should be evaluated in the same manner as all disclosures, and may be deleted when the matter is no longer material.
Recent and upcoming major tax law changes

This section focuses on major changes in the tax law that may be of interest to multinational companies and can be helpful in accounting for income taxes. It is intended to increase readers' awareness of the main global tax law changes during the quarter, but does not offer a comprehensive list of tax law changes that should be considered for financial statements.

<table>
<thead>
<tr>
<th>Country</th>
<th>Prior rate</th>
<th>New rate</th>
</tr>
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<tbody>
<tr>
<td>Israel (corporate income tax)</td>
<td>26.5%</td>
<td>25%</td>
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</table>

1 This change was enacted on 4 January 2016 and is effective 1 January 2016.
Recent and upcoming major tax law changes

Other important tax law changes

Click each circle to review
Recent and upcoming major tax law changes

Australia

During the first quarter of 2016 Australia enacted a new 10% non-final withholding tax on the disposal of certain taxable Australian property by foreign residents. The amount withheld will be credited to the account of the foreign resident payee when calculating their final income tax position for the relevant income tax period. This would generally require the foreign resident to have a tax file number and to have lodged a tax return. The new regime will apply to transfers of direct and indirect interests in taxable Australian property on or after 1 July 2016.

Chile

During the first quarter of 2016, Chile enacted amendments to the country’s 2014 tax reform, including the following:

- ‘Attribution mechanism’ of shareholder-level taxation is restricted to Chilean entities with only Chilean-resident individual or non-resident shareholders. Under the ‘attribution mechanism,’ shareholders are taxed on income attributable to them as of the end of the year in which the income was generated, regardless of actual distributions by the Chilean entity.
- For shareholders in jurisdictions where Chile has tax treaties signed by 1 January 2017 (e.g., the USA, Japan and China), the new law eliminates the 65% limit on the creditability of corporate income tax (CIT) against the non-resident withholding tax (35%) on distributions under the semi-integrated mechanism. Under the semi-integrated mechanism, shareholders are taxed on actual profit distributions (i.e., cash basis) by the Chilean entity.
- The new law reduces the number of tax ledgers and records required to be maintained by Chilean entities.

European Union

During the first quarter of 2016, the European Commission (EC) announced its final decision in its formal State aid investigation into the Belgian excess profit ruling system. The EC concluded that in its opinion the excess profit provision constitutes unlawful fiscal State aid which must be recovered. In its press release, the EC noted at least 35 companies benefited from the regime and estimated the amount to be recovered at Euro 700 million. The Belgian government and/or the companies benefiting from the regime have an opportunity to appeal the EC’s decision.

In addition, the European Commission presented a package of measures for a coordinated EU-wide response to corporate tax avoidance. The anti-tax avoidance package calls on Member States to take a stronger and more coordinated position against companies that seek to avoid paying their fair share of tax and to implement the international standards against base erosion and profit shifting. Key features of the new proposals include:

- Interest limitation rule – a rule restricting deductibility of net borrowing costs to the higher of EUR 1 million or 30% of the taxpayer’s EBITDA.
Recent and upcoming major tax law changes

- **Exit taxation** – tax rules to prevent tax base erosion resulting from the transfer of assets without any ownership change (e.g., transfers of assets between a head office and its permanent establishment (PE), or between PEs).
- A “switch-over” clause – a rule to ensure a minimum level of tax on (1) profit distributions from an entity in a non-EU country, (2) proceeds from the disposal of shares held in an entity in a non-EU country, or (3) income from a PE in a non-EU country, where the entity/PE is subject to a statutory corporate tax rate which is less than 40% of the statutory rate applicable in the taxpayer’s Member State. Instead, these amounts would be subject to tax with any additional tax paid being creditable.
- **A general anti-abuse rule (GAAR)** – a rule allowing tax authorities to ignore arrangements where the essential purpose is to obtain a tax advantage that defeats the objective of the tax provision and where the arrangements are not regarded as genuine.
- **Controlled Foreign Company (CFC) rules** – rules to eradicate the incentive of shifting income. This would be achieved by reattributing non-distributed income of a low-taxed CFC, which is not a publicly listed company, to its parent company.
- **Hybrid mismatch rules** – rules to prevent outcomes where there is a double deduction or deduction with no income inclusion. These rules seek to address mismatches between Member States’ tax systems arising due to the use of hybrid entities or hybrid instruments.

**India**

During the first quarter of 2016, the Indian Finance Minister presented the 2016 Budget that included the following proposals:

- Domestic start-up companies would benefit from new incentives, including a 100% deduction of profits derived by an eligible start-up registered before 1 April 2019.
- A patent box regime would be introduced, under which an Indian resident would be subject to 10% tax rate (plus applicable surcharges) on royalty income provided the Indian resident develops and owns the patent, and the patent is registered in India.
- Country-by-country (CbC) reporting requirements would apply to Indian-headquartered multinational entities with global consolidated revenues exceeding the prescribed threshold (expected to be EUR 750 million) starting from the 2016-17 tax year.
- A new ‘equalisation levy’ of 6% would apply to income from online advertisement services, provisions for digital advertising space, and certain other services received by a non-resident from an Indian resident. It is unclear if the equalisation levy could be covered under applicable double tax treaty provisions and if a foreign tax credit would be available.

**Luxembourg**

During the first quarter of 2016, Luxembourg Finance Minister announced proposed changes to Luxembourg’s corporate tax, including the following:

- The corporate income tax rate would be reduced from 21% to 18% over the next two years, beginning in 2017.
- The minimum net wealth tax (NWT) applicable to certain holding and finance companies would be increased from EUR 3,210 to EUR 4,815 (including the solidarity surtax).
Recent and upcoming major tax law changes

- The use of losses generated after 1 January 2017 would be limited in subsequent periods. Losses carried forward would offset a maximum of 80% of the taxable profits for each period. Such losses could be carried forward only for up to 10 years.

Portugal

During the first quarter of 2016, the Portuguese government presented 2016 Budget proposals, that included the following key tax law changes:

- The participation exemption regime requirements would be amended so that the minimum holding percentage would increase from 5% to 10%, and the minimum holding period would decrease from 24 months to one year.
- The carryforward period for tax losses would be reduced from 12 years to five years. This provision would only apply to losses incurred on or after the 2017 tax year.
- The domestic capital gains exemption applicable to non-resident entities on the transfer of shares (and other securities) would apply even if the non-resident entity is held by more than 25% by Portugal-resident entities. This provision would have additional requirements, such as requiring 10% of the ownership of the entity to be held for one or more years.
- Multinational groups would be required to comply with country-by-country reporting requirements.

United Kingdom

During the first quarter of 2016, the UK issued final regulations that introduce country-by-country reporting requirements for UK-parented multinational entities with annual consolidated group revenue of £750 million. The first country-by-country report will be due for fiscal years beginning on or after 1 January 2016.

United States

During the first quarter of 2016, the US Treasury issued a new US Model Income Tax Convention, which is the baseline text Treasury will use in negotiating tax treaties. The 2016 Model includes several new provisions, including the following:

- a new article denying treaty benefits for income subject to 'special' (i.e., preferential) tax regimes
- a rule eliminating benefits for income allocable to so-called 'exempt permanent establishments'
- a mechanism for partial termination of treaties where a treaty partner reduces its corporate income tax rate below a certain threshold
- new restrictions in the treaty's Limitation on Benefits article that could add additional complexity and make it more difficult for many companies to qualify for treaty benefits
- rules denying treaty benefits for payments made by so-called inverted companies to connected persons
- provisions requiring disputes between the treaty partners to be resolved through mandatory binding arbitration

Treasury has indicated that it intends to release its Technical Explanation of the Model later this year.
Recent and upcoming major tax law changes

Other developments

CbC reporting

During the first quarter of 2016, 31 countries signed the Multilateral Competent Authority Agreement (MCAA), allowing for the automatic exchange of CbC reports as described in Action 13 of the Organisation for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) project. The MCAA is intended to facilitate consistent and swift implementation of new transfer pricing reporting standards and outlines specific requirements, terms of use, and guidance for automatic exchanges of CbC reports among its signatories.

BEPS inclusive framework

During the first quarter of 2016, the OECD announced a proposal for a new framework that allows all interested countries and jurisdictions become part of an inclusive dialogue on an equal footing to directly shape the standard setting and monitoring processes on BEPS issues. The participants would have to commit to implementing the BEPS package of minimum standards and pay an annual fee of an amount reflecting its economic circumstances. The new forum will hold its first meeting in Kyoto, Japan on 30 June and 1 July 2016.
Tax accounting refresher

In this section we discuss some key concepts that should be considered when preparing a tax provision for a carve-out financial statement. Such statements are often required for a piece of a larger parent entity or group due to a pending transaction, initial public offering, spin-off or a business combination, or for certain statutory or regulatory filings.

**Tax provisions for carve-out financial statements**

Entities that prepare consolidated (or group) financial statements are often also required to prepare separate financial statements for a part or parts of their business (e.g., one or more divisions or business units). Such statements are usually referred to as ‘carve-out’ financial statements and can be required due to a pending transaction such as an IPO, spin-off or business combination. Carve-out financial statements may also be required for certain statutory or regulatory filings on an ongoing periodic basis.

The preparation of carve-out financial statements can be complex as the carved-out ‘entity’ may not have defined legal boundaries that would exist in the case of a separate legal entity. The carve-out process involves a significant number of judgements regarding the legal, financial and operational structure of the carved-out entity. In addition, the process is particularly challenging from an accounting perspective as there are limited specific accounting rules or guidance governing the composition of the carve-out entity under US GAAP or IFRS.

Each situation is different and each set of carve-out financial statements will present unique challenges. The nature of the transaction, the structure of the reporting entity, the quality of the accounting records, the past practices and policies of the parent and the views of the relevant regulator are all important considerations.

In our discussion below, we will focus on some key concepts that should be considered when preparing a tax provision for a carve-out financial statement. While circumstances driving the financial statements can vary significantly, these general considerations should prove helpful in developing a more tailored approach.

1. **Understanding the purpose of the carve-out financial statements and the corresponding pre-tax accounting**

Carve-out financial statements are often guided by the legal or strategic form of a business transaction that involves capital formation, or the acquisition or disposal of a portion of a larger entity. Alternatively, the statements may be guided by regulatory requirements for certain filings. Understanding the overall context and intended use of the statements is important in deciding...
**Tax accounting refresher**

which tax provision allocation ‘method’ to apply and in aligning the application of the chosen tax allocation method to the pre-tax accounts.

Tax provision preparers should coordinate closely with those responsible for the pre-tax aspects of the carve-out financial statements. The tax provision should be based on the financial statement accounts that are included in the carve-out entity. Accordingly, one must fully understand the pre-tax accounts that will be included in the carve-out statements, as well as the impact of any adjustments to such accounts, in order to reflect the appropriate income tax effects.

The tax provision can be affected by methodologies being used for revenue or cost allocations that differ from historical practices. Carve-out financial statements should reflect all the costs of doing business. That typically requires an allocation of corporate overhead expenses (and the related tax effects) to the carve-out entity – even if allocations were not previously made. Similarly, it may be necessary to allocate other expenses, such as stock-based compensation, to the carve-out entity.

Furthermore, stand-alone financials may also need to reconsider ‘push-down’ accounting adjustments.

In the preparation of consolidated financial statements, such adjustments are often reflected only in the head company’s books.

Intercompany transactions that were formerly eliminated in the consolidated financial statements generally would not be eliminated in the carve-out financial statements (e.g., sales of inventory to a sister company). Consequently, additional attention may need to be given to the measurement of revenues and costs (i.e., transfer pricing) from a stand-alone perspective. The income tax accounting for certain intercompany transactions may also change. For example, the current exception under ASC 740-10-25-3(e) which prescribes the accounting for income tax effects for intercompany transactions) would not apply to such transactions in the carve-out financial statements.

Similarly, it may be appropriate to reflect in carve-out statements intercompany transaction gains or losses that were previously deferred in a consolidated tax return, and to assess whether the respective income tax accounting effects should be recognised in equity.

### 2. Choosing the appropriate tax allocation method

Once preparers have obtained an understanding of the purpose of the carve-out financial statements and the corresponding pre-tax accounting, an appropriate tax allocation method should be considered.

Under IFRS and US GAAP, the main approach applied in practice to carve-out financial statements is the separate tax return method. Other methods may be acceptable depending on the individual facts and circumstances.

In choosing the appropriate allocation method preparers should consider how IFRS or US GAAP guidance (e.g., standards, interpretations) apply to their specific circumstances and consult with their advisor or auditor, if necessary. It is also important that the rationale as to why the chosen method is appropriate, is properly documented.

**Separate return method**

Under the separate return method, the carve-out entity would calculate its tax provision as if it were filing its own separate tax return based on the pre-tax accounts included in the carve-out entity.
Tax accounting refresher

This can result in perceived inconsistencies between the tax provision of the carve-out entity and the tax provision of the consolidated group.

For example, it is possible that the carve-out entity could recognise a deferred tax asset for a loss or credit carryforward, even if there is no carryforward on a consolidated basis. In other cases, the carve-out entity could reflect a current-year loss as being carried back against its taxable income in the carryback period, even though the consolidated group was in a loss carryforward position. In some situations under US GAAP, a valuation allowance might be necessary for the carve-out entity even though no valuation allowance is needed for the consolidated group (because it cannot rely on the taxable income of the group). This might be the case if the carve-out entity has been generating losses while the other members of the group are profitable. Alternatively, the converse may be true: a profitable carve-out entity may require a tax provision even though the remaining members of the group are generating losses. As a result, a valuation allowance may not be needed for the carve-out entity, even though a valuation allowance is required for the consolidated group.

Because the separate return method requires the carve-out entity to prepare its tax provision as if it were filing its own separate tax return, it may be appropriate to consider whether calculations performed for the consolidated financial statements (e.g., foreign tax and research credits) should be adjusted.

Nonetheless, the separate return method is an “allocation” of the group tax provision. Accordingly, certain aspects of historical tax provision accounting should not be changed. For example, it is generally not appropriate to revisit historical assertions made by management of the consolidated group on the basis that the assertions would have been different if made by the stand-alone entity. Thus, it would generally not be appropriate for the carve-out financial statements to reflect a different assertion regarding the indefinite reinvestment of foreign earnings or uncertain tax positions. Elections made in a group’s tax return should also generally be followed in the carve-out tax provision.

Other methods

Under IFRS, another acceptable allocation method of determining tax provision is the tax-incurred method. It is less commonly used than the separate return method but may be appropriate if the parent recharges taxes to the business that will comprise the carve-out entity. Under this method, the actual recharged tax is considered together with the tax effect of other adjustments relating to the carve-out entity, e.g., intercompany expenses, corporate overheads, stock compensation, etc.

Under US GAAP, a method called ‘benefit-for-loss’ may be considered. Under this method, net operating losses (or other current or deferred tax attributes) are characterised as realisable by the subsidiary when those tax attributes are realisable by the consolidated group even if the subsidiary would not have otherwise realised the attributes on a stand-alone basis.
3. Reflecting differences between the tax allocation method and the tax sharing agreement in equity

Companies that file consolidated tax returns often have tax sharing agreements which govern the intercompany settlement of tax obligations. Although a tax sharing agreement could be a factor in determining what method the company will use to allocate its tax provision, the tax sharing agreement does not dictate the choice of tax provision allocation policy. If a tax-sharing agreement differs from the chosen method of allocation, the difference between the amount paid or received under the tax-sharing agreement and the expected settlement amount based on the method of allocation is treated as a dividend or a capital contribution (i.e., recorded in equity).

4. Realisation of deferred tax assets and uncertain tax positions

We generally believe that hindsight should not be used when preparing carve-out financial statements. As such, assumptions made in assessing the realisation of deferred tax assets and establishment of uncertain tax positions should reflect the facts as they existed at the historical dates.

In addition, the preparation of carve-out financial statement, in itself, should not be considered to constitute new information that would justify recording a change with respect to uncertain tax positions. Therefore, management should generally not change the historical amounts of uncertain tax positions, even if it believes that it would have applied different assumptions for the carve-out entity on a standalone basis.

5. Clear disclosures

The carve-out financial statements would need to comply with general disclosure requirements. In addition, the financial statements would need to disclose sufficient details regarding the allocation method used and significant assumptions and judgements made in the calculation of the tax provision.

In certain situations, a carve-out financial statement may be prepared for a specific purpose where the financial statement does not reflect what the business will likely look like in the future. With different transactions, tax attributes and basis may or may not carry over depending on the manner in which the deal is structured. If the carve-out entity expects its tax profile to look significantly different in the future (e.g., after it has been separated from the consolidated group), it may be appropriate to disclose such expectations.
Contacts

For more information on the topics discussed in this newsletter or for other tax accounting questions, including how to obtain copies of the PwC publications referenced, contact your local PwC engagement team or your Tax Accounting Services network member listed here.

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