Tax Alert

Deloitte & Touche

International Accounting Standards – Don't Forget The Taxman

August 2003

Action Points

- **Determine your organisation's current thinking, plans and timeframe as regards adopting IAS.**
- **Carry out a high level review to identify potential differences in accounting treatment under IAS.**
- **Analyse your current tax charge for areas affected by a move to IAS.**
- **Analyse your deferred tax balances for areas affected by a move to IAS.**
- **Quantify the overall tax impact of adopting IAS.**
- **Highlight material impacts at Finance Director and Board level.**
- **Identify key areas where you may want to make representations to the Inland Revenue.**

IAS Milestones

July 2002: European Commission agrees to apply International Accounting Standards (IAS) to the consolidated accounts of EU listed companies from 1 January 2005.

June 2003: IAS Board issues International Financial Reporting Standard 1 for UK companies adopting IAS in 2005. With limited exceptions, 2004 financial statements (and 2003 for SEC registrants) must be restated.

July 2003: DTI confirms that any, not just listed, UK companies may use IAS in preference to UK GAAP from 2005. Groups should be able to use IAS for consolidated accounts but UK GAAP for single company accounts. At the Inland Revenue's behest, the final regulation is expected to require all companies in a group to use the same accounts basis.

August 2003: The Inland Revenue announces a working party under the auspices of the Business Tax Forum, to monitor the impact of IAS and the case for changes to the tax system.

Most UK groups have less than two years to determine and implement their IAS strategy. Tax consequences must be central to this debate as in many areas a change in accounting will have a major tax effect – accelerating, deferring or crystallising liabilities – with consequent implications for cashflow and earnings per share.

International Accounting Standards (IAS) are a business priority, with wide ranging impact far beyond the simple amendment of an accounting policy. The goals for IAS include improving the efficiencies of international investment, financing and M&A, all of which can involve tax sensitive issues. While increased transparency is one expected outcome, another is increased volatility of balance sheets and accounting profits.

Various reforms of the last decade mean that tax increasingly follows the accounts. As a result tax liabilities are also likely to be more volatile. It is therefore important that, in conjunction with the accounting policy review, companies start reviewing the tax issues and determining the likely impact on their current tax position.

The Inland Revenue position is that they do not believe IAS requires wholesale tax changes but there are circumstances where it is, or would be, 'good policy' to depart from following the accounts for tax purposes. They are listening to representations and are conscious that IAS will impact some of the latest proposals for corporate tax reform (*see Corporate Tax Reform - A Consultation Document 12 August 2003*). In practice, therefore, we can expect that the tax system will be modified as a result of IAS. However, the extent and timing of any changes remains uncertain.

We can help evaluate the impact of IAS change on tax cashflows and identify any tax planning opportunities that might be available on adoption of IAS. Many current strategies and situations will be affected. Some of these are identified below.

Areas to watch

Financial Instruments (IAS 32 & 39)

This is probably the most affected area and these are two of the more controversial standards (and may yet change). They affect all companies with holdings of financial assets, liabilities or derivatives.

As compared with UK GAAP, many more financial assets and all financial derivatives must be accounted for at fair values on the balance sheet. Movements in fair value will be booked to profit or equity (reserves) depending upon classification. As things stand, all such movements will be taxable as they arise. Hedge accounting will also be fundamentally different, with hedged assets and liabilities being recorded at fair value (at least in part). Without a change in the tax regime, matching may no longer be effective for tax purposes thereby accelerating the tax point.

Financial derivatives embedded in other instruments will need to be accounted for separately from the host contract. This 'hybrid' accounting would not constitute an authorised accounting method without a change to the current tax rules.

To find out more...

For general IAS updates, news and developments, including our June 2003 **IAS Healthcheck**, visit our dedicated IAS website: **www.iasplus.com**

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Deferred Tax (IAS 12)
Several changes will potentially increase the deferred tax charge. These include:
- having to establish deferred tax provisions for revaluations with no account taken of potential roll over relief claims;
- a prohibition on discounting; and
- having to provide for profits retained by overseas subsidiaries.

Intangible Assets & Goodwill (IAS 38 & 22)
There is likely to be a requirement to recognise separately intangibles arising from contractual or legal rights which are currently subsumed within goodwill. These elements should have relatively short lives and thus accelerated tax deductions. On the other hand, goodwill itself is likely to be subject to impairment rather than amortisation which could defer relief.

Research & Development (IAS 38)
R&D tax relief in the form of a 125% superdeduction (or for a SME 150%) is currently given when costs are expensed through the profit and loss account. To the extent that development expenditure is capitalised under IAS where it would not have been under current GAAP, the benefit of this relief will be diluted and deferred.

Transfer Pricing
IAS will have a number of different influences on transfer pricing policies and companies will need to look at all these in some detail to determine how they are affected. For example, volatility due to the increased use of fair value accounting will affect recharges under some transfer pricing methods and contributions under cost sharing agreements. Similarly, existing covenants on thin capitalisation ratios/interest cover may require renegotiation, particularly for example, where equity instruments are reclassified as debt under IAS. Similarly, the need to recognise new intangibles could give rise to issues on royalty flows.

Compensation & Share Based Payments
Following recent Finance Act changes, the accounting for share plans will have less importance for the corporate tax treatment than previously as under many plans, corporate tax relief will be available for the value realised by the employee irrespective of whether that cost is recognised in the accounts. Nevertheless, under IAS:
- There will be a requirement to recognise the cost of granting all share awards regardless of whether these are satisfied through newly issued shares or through shares bought in the market.
- For grants of conventional share options with a strike price equal to the market value at the date of grant, a cost equal to the value of the options at the date of grant must be recognised and spread over the vesting period of the options. This treatment will require the development of appropriate valuation methodology such as the application of the Black Scholes model.

Just the beginning

The above list is far from exhaustive – leasing and revenue recognition are two further and well publicised examples – and it's likely that more tax consequences will emerge as IAS' are applied in practice.

There are some areas which are currently neutral in IAS terms but which may be affected by the interaction with other developments such as corporate tax reform. For example, under IAS unrealised gains and losses in respect of investment properties are likely to be recognised in the income statement, but if they relate to capital assets, they will continue to be taxed on a realisation basis. The latest tax reform proposals could upset this status quo if they remove the capital/revenue distinction.

Similarly, IAS is expected to lead to a new style of accounting performance statement in which ‘remeasurements’, such as gains arising from the restatement of financial instruments, or the revaluation of investment properties are shown separately. If this happens, how and to what extent will these be recognised for tax purposes?

In the meantime, the more focus that is applied to identifying potential tax issues, the more chance these have of being remedied before it is too late. Watch this space!