Financial Reporting for Canadian Multinationals

Tips and Traps Plus How to More Effectively Manage the Provision Process

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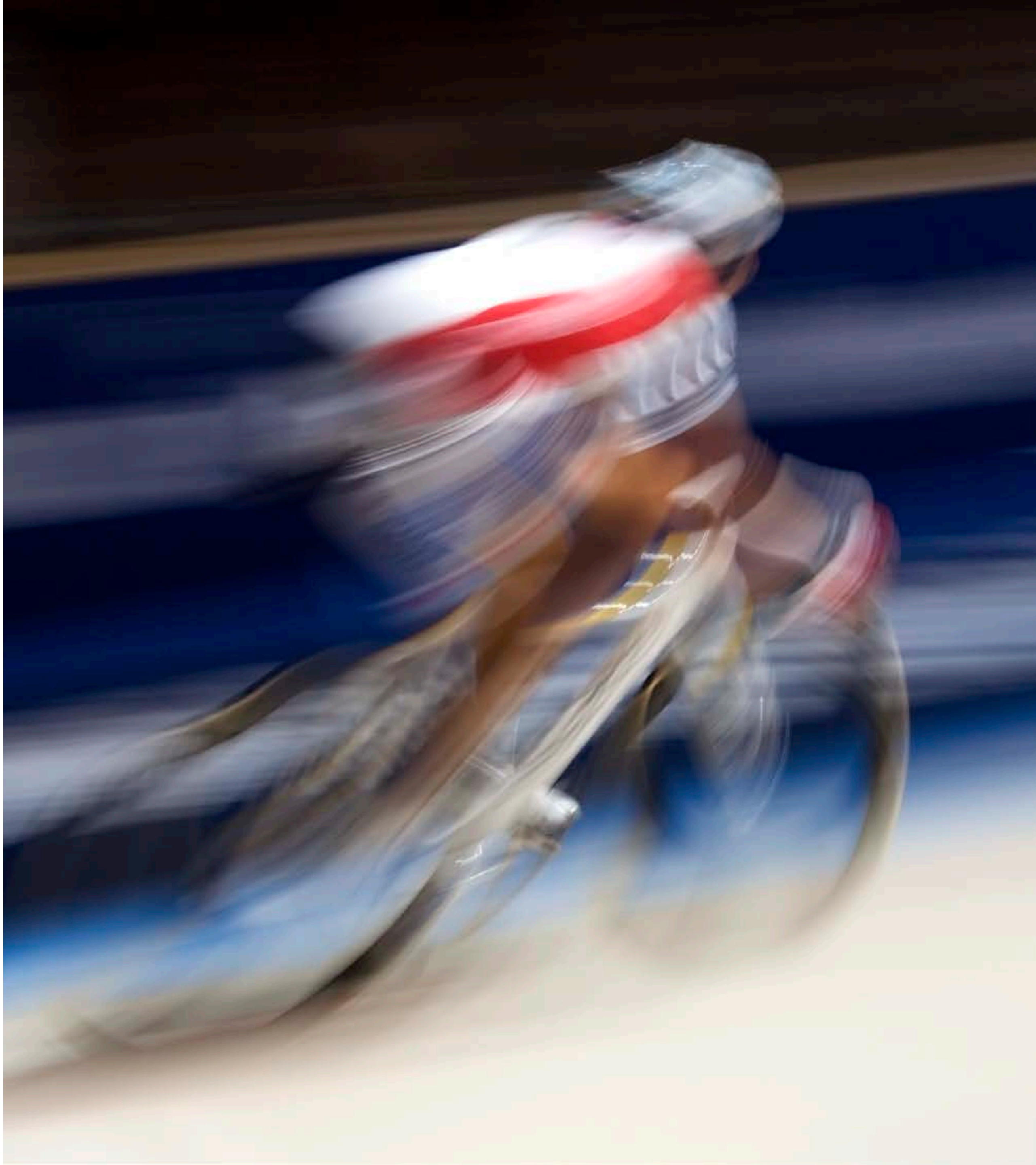


Agenda

- Tax accounting for foreign currency
- Tax accounting for investments in subsidiaries, branches and joint arrangements
- Elimination of intra-group profits and goodwill linking
- Effective management of your tax provision process

Tax accounting for foreign currency

Relevant currencies
What's the difference?

Functional currency

- The currency of the primary economic environment
- The currency in which the entity primarily generates and expends cash and maintains its books and records

Tax currency

- The currency in which tax returns are filed and/or taxes are paid
- Also referred to as "local" currency

Reporting currency

- The currency in which the financial statements are presented
- Also referred to as "presentation" currency

Tax accounting for foreign currency
Functional currency ≠ presentation currency

What happens when the functional currency of a foreign subsidiary is different from the presentation currency of the consolidated reporting group?

Assets, liabilities and equity (including current and deferred tax balances) are TRANSLATED into the presentation currency using year-end spot rates

All items of income and expense (including current and deferred tax expense) are TRANSLATED at the rate of the applicable transaction date or at average FX rates for the period (if approximate)

This gives rise to FX gains and losses which are recognized in Other Comprehensive Income ("OCI") in the consolidated financial statements

This translation process creates "outside basis" temporary differences

Tax accounting for foreign currency
Functional currency ≠ local tax currency

What happens when the functional currency of an entity is different from its local tax currency?

The non-monetary assets and liabilities of an entity are measured in its functional currency. If an entity's taxable profit and loss (and consequently, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in exchange rate give rise to temporary differences that result in a deferred tax liability or asset. The resulting deferred tax is recognized in profit or loss. [IAS 12.41]

There is no clear guidance on how this deferred tax should be calculated

US GAAP Difference
US GAAP effectively prohibits a temporary difference arising from non-monetary assets and liabilities that are re-measured from local currency to functional currency due to changes in foreign exchange rates

Accounting for foreign currency transactions

Functional currency ≠ local tax currency

- Pounds Sterling functional currency (FC) with USD local tax currency (LC), and € presentation currency (PC)
- Assume no change in net asset value from year 1 to year 2

	FX Rate	Asset Book Value FC	Tax Base LC	Tax Base FC	Temp Difference
Year 1	£0.5 = $1	£50	$120	£60	£10
Year 2	£0.52 = $1	£50	$120	£62	£12
Change					£2
Tax Recovery (at 35%)					£0.7
Presentation Currency (£1 = €1.35)					€0.95

FX gain/loss reported in the cumulative translation reserve/OCI

Convert tax base to FC using closing spot FX rate

Deferred tax recovery results solely from FX movement

Investments in subsidiaries, branches and joint arrangements

Outside basis differences of investments in foreign subsidiaries, branches and joint arrangements

Outside basis temporary differences associated with investments in subsidiaries, associates and joint arrangements generally arise in consolidated financial statements

1. The **profits** of the investee have been recognized (whether by consolidation or the equity method) but the tax base of the investment remains unchanged
2. The entity's net investment in the investee is translated from the investee's functional currency to the entity's presentation currency, giving rise to **translation FX gains and losses** recorded in OCI

The tax effects that would arise if these outside basis differences reversed should be considered, i.e. profits distributed, withholding tax, etc.

This applies for both US GAAP and IFRS

Outside basis differences of investments in foreign subsidiaries, branches and joint arrangements (cont'd)

IAS 12.39 states: [similar to ASC 740-30]

An entity shall recognize a deferred tax **liability** for all taxable temporary difference associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied

1. The parent, investor, joint venturer, or joint operator is able to control the timing of the reversal of the temporary difference
2. It is probable that the temporary difference will not reverse in the foreseeable future

Note: It is not a taxable/(deductible) temporary difference if it can be reversed without the incidence of tax (e.g., tax free distributions, etc.)

Outside basis differences

When it is probable that the temporary differences will reverse?

ASC 740-30 states

"…it shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity. This presumption may be overcome, and no income taxes shall be accrued by the parent entity….if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely."

- The entity's documented plan should demonstrate both **intent and ability** to indefinitely reinvest the undistributed earnings
- This is **NOT an 'all or none'** test

Outside basis differences

When it is probable that the temporary differences will reverse? (cont'd)

Factors to be considered include

- Any plans for reinvestment to grow the business of the subsidiary
- Past pattern of dividend payments
- Whether the parent needs funds that would be generated by the subsidiary
- Whether cash and distributable profits are available
- Whether binding agreements exist regarding dividend payments
- Whether there is intent to dispose of the subsidiary before any distributions are made
- Whether any legal or tax requirements effectively create a compulsion to pay distributions

SEC comments:

“We see that $[x] of your cash on hand is held by your foreign subsidiaries. Please reconcile the statement that you do not intend to repatriate these funds with the subsequent statement that the funds are available for general company use. Please clarify in your response how you intend to finance your operations without access to the funds held by foreign operations.

“Please explain to us how you evaluated the criteria for the exception to the recognition of deferred tax liability for undistributed earnings that are intended to be indefinitely reinvested. Describe the type of evidence and your specific plans for reinvestment for these undistributed earnings that sufficiently demonstrates that remittance of earnings will be postponed indefinitely.”

Outside basis differences (cont'd)

Temporary differences related to the Cumulative Translation Adjustment

- Deferred tax is required when an entity recognizes foreign currency translation adjustments **if the parent entity is recognizing deferred taxes on the net investment outside basis difference** in a particular investment
  - Cumulative translation adjustment can be recorded on both the capital and undistributed earnings of the investment
  - If deferred taxes are not provided for unremitted earnings of a subsidiary, deferred taxes shall not be provided on the related translation adjustments

Outside basis differences

Temporary differences related to the Cumulative Translation Adjustment (cont'd)

- US parent ($ FC & PC) owns 100% of UK sub (£ FC)
- US parent invests £1,000 in year 1; UK sub earns £ 100 in year 1, and £ 200 in year 2
- US parent does not have the intent and ability to indefinitely reinvest earnings of UK sub, but believes its original investment in UK sub is indefinite

Net Investment		FC £	FX rate	PC $	Temp Diff	Recognize DT?
Year 1	Assets	£1,000	1:1	$1,000	Nil	n/a
Year 1	Retained Earnings	£100	1:1	$100	$100	Yes
Year 2	Assets	£1,000	2:1	$2,000	$1,000	No
Year 2	Retained Earnings	£300	1.5:1	$450	$450	Yes

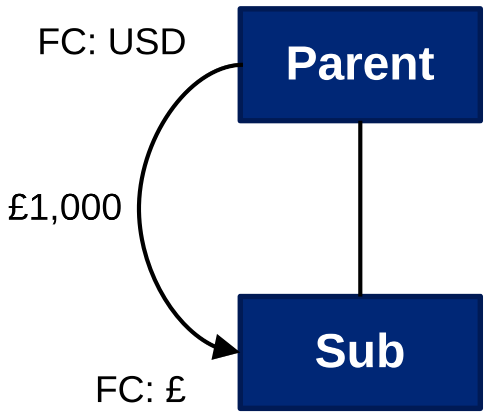
Includes temp difference on both currency translation and undistributed profits

Outside basis differences (cont'd)
Net investment in foreign subsidiaries

Foreign operation and monetary items that are part of the net investment

- A 'foreign operation' is defined as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity
  - Receivable and payable amounts between an entity and a foreign operation, the settlement of which is not expected in the foreseeable future, are included within the net investment in that foreign operation (trade accounts specifically excluded)
- If a monetary item is considered to be part of the "net investment in a foreign operation", then by extension, it is accepted that any temporary difference created by this monetary item should be considered part of the outside basis difference of the foreign subsidiary and the principles of IAS 12 and ASC 740 should be applied in determining whether to recognize deferred taxes for any said temporary differences

Tax accounting for foreign currency translation
Net investment in foreign subsidiaries

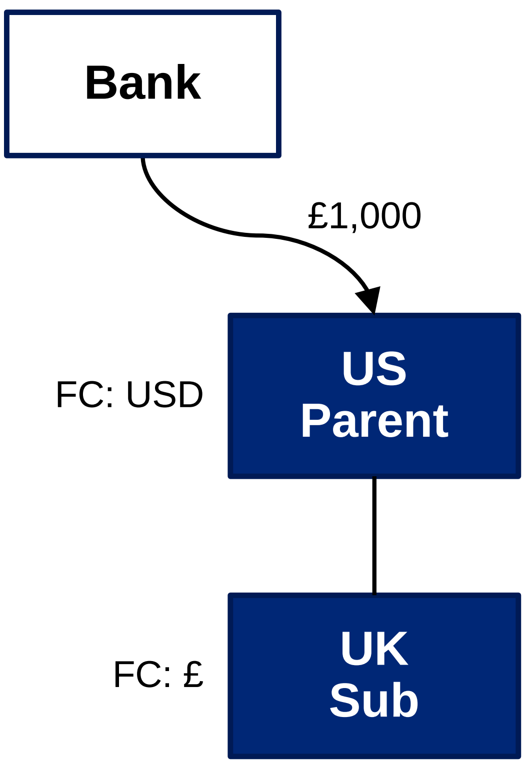


Loan is determined to form part of Parent's net investment in Sub

1. Parent makes a £1,000 loan to Sub when FX rate is 1£ = $1.54
2. At year-end, the FX rate is 1£ = $1.65
   – Parent has an unrealized FX gain of $110 (£1,000 * (1.65 – 1.54))
   – Sub has no unrealized FX as loan is denominated in functional currency
3. Parent can control repayment of the loan which forms part of its net investment, and therefore, can control when tax will be incurred on the exchange differences
   – Consider whether settlement is planned or likely in the foreseeable future and therefore if deferred taxes should be recognized

Tax accounting for foreign currency translation
(cont'd)

Net investment in a foreign sub and hedging



- US Parent has a bank loan denominated in Pounds Sterling (£) that it has used to fund the acquisition of UK Target
- Loan is determined to form part of Parent's net investment in Sub, i.e. designated hedge
- The £ debt is translated to $ at each reporting period. Assume a $100 FX gain arises and a 35% tax rate

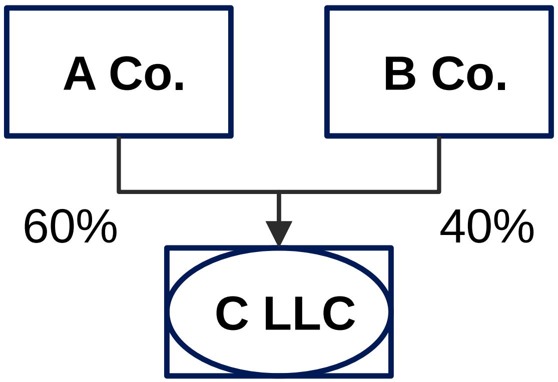
Dr. Loan	**100**		
Dr. Tax Expense	**35***		**Reclass to OCI**
Cr. FX Gain		**100**	**Reclass to OCI**
Cr. DTL		**35***	

***Deferred taxes on hedging gain must be recognized as exception criteria not satisfied**

Investments in Tax-transparent entities

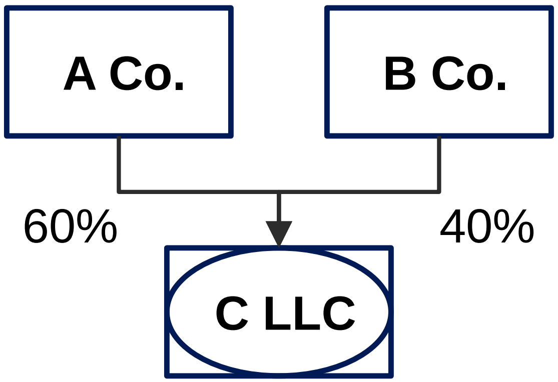
- A ‘tax-transparent’ or ‘flow-through’ entity is not taxed in its own right; the partners or members each pay tax on their share of the entity’s profits
- The tax status of a ‘tax-transparent’ or ‘flow-through’ entity is not relevant to the accounting treatment. An investor will determine whether the entity is a subsidiary, associate, joint arrangement, branch or financial asset investment and account for it accordingly, i.e. consolidation, equity method, etc.
  - However, the investor must also determine whether the basis of accounting has led to the recognition of assets or liabilities which give rise to temporary differences

Investments in Tax-transparent entities (cont'd)



- A Co. acquires 60% of C LLC for $100M in a transaction accounted for as a business combination
- The FV of the net identifiable assets of C LLC is $80M and their tax base is $60M
- A Co. is directly liable for tax at 25% on 60% of the taxable profits of C LLC
- A Co. is entitled to 60% of the tax base of C LLC's assets
- A Co. reports the non-controlling interest at its proportionate share of the net assets of C LLC

Investments in Tax-transparent entities (cont'd)



The accounting entry to record the business combination

Net assets	$80M	
Goodwill (balancing figure)	$55M	
Cash		$100M
Deferred tax liability*		$3M
Non-Controlling Interest**		$32M

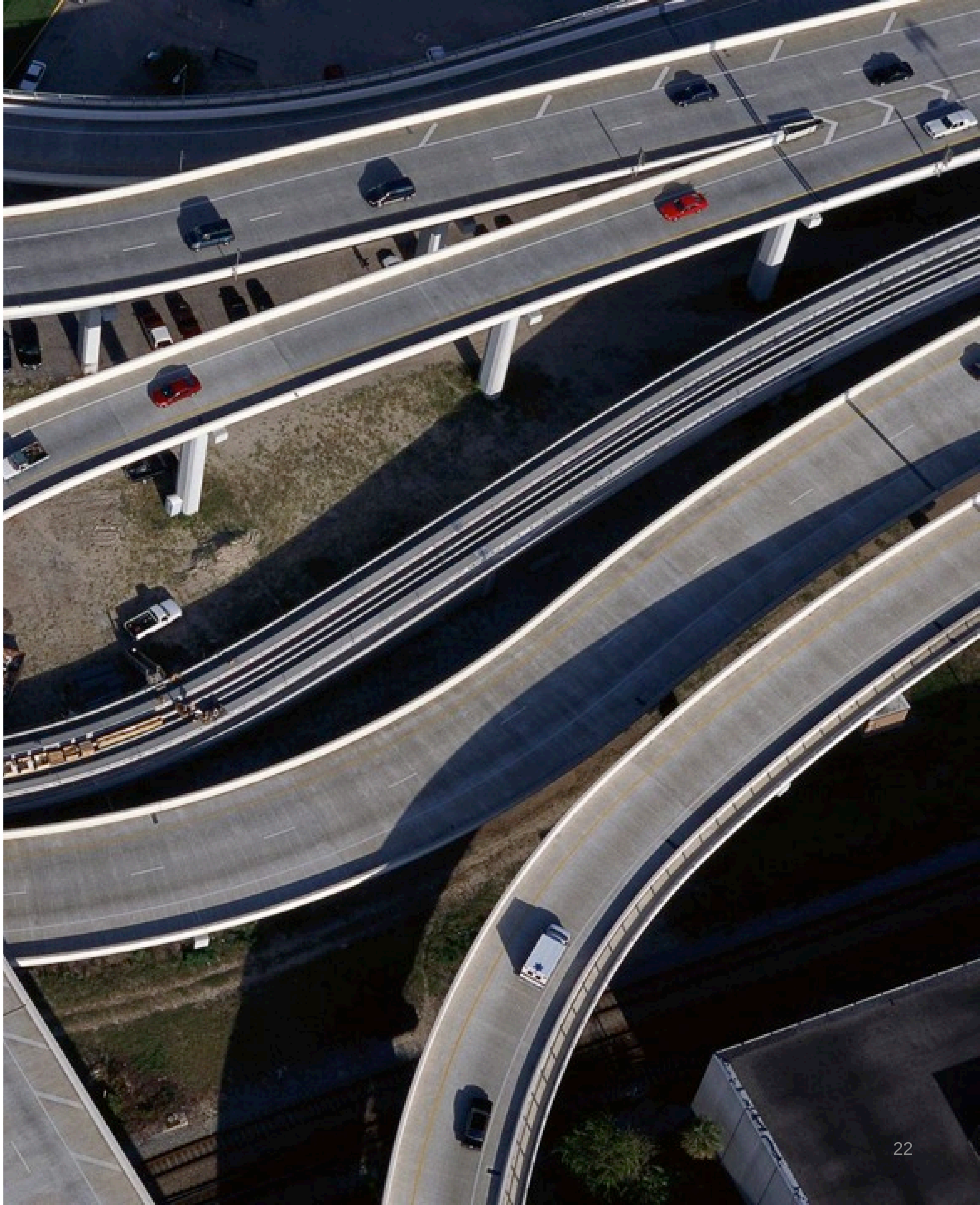
* $3M = 60% * ($80M FMV – $60M tax base) * 25%

**40% of $80M net asset value

If C LLC was a tax-paying entity

Deferred tax liability	$5M	($80M - $60M) * 25%
Non-Controlling Interest	$30M	(40% of $75M)

Elimination of intra-group profits



Elimination of intra-group profits

Does the elimination of intra-group profits have a deferred tax impact to the consolidated FS?

Yes!

IFRS

The deferred tax effects arising from temporary differences on eliminated intra-group profits should be recognized in accordance with usual principles

US GAAP

Recognition of a DTA for the difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated FS, i.e. after elimination of intra-group profit, is prohibited

Any taxes paid on eliminated intra-group profit should be deferred (as prepaid income tax or increase in carrying cost of the related asset)

Elimination of intra-group profits (cont'd)

- **In year 1,** SellCo sells $80 of inventory to PurchaseCo for $100
- The inventory is still on hand at year-end

SellCo 35% tax rate	PurchaseCo 25% tax rate	Consolidated financials IFRS	Consolidated financials US GAAP
Dr. Inter-co A/R 100 Dr. COGS 80 Dr. CT Exp. 7 Cr. Sales 100 Cr. Inventory 80 Cr. CT Pay 7	Dr. Inventory 100 Cr. Inter-co 100	Sales Nil COGS Nil NIBT Nil CT Expense 7 DT Recovery (5) Total Tax 2 Inventory 80 DTA 5 Prepaid Tax Nil CT Payable (7)	Sales Nil COGS Nil NIBT Nil CT Expense Nil DT Recovery Nil Total Tax Nil Inventory 80 DTA Nil Prepaid Tax 7 CT Payable (7)

- Temporary difference will reverse when PurchaseCo sells to third party, therefore use PurchaseCo's tax rate of 25%
- Only recognized DTA if 'probable'

Elimination of intra-group profits (cont'd)

- **In year 2,** PurchaseCo sells the inventory to a third party for $110

SellCo 35% tax rate	PurchaseCo 25% tax rate	Consolidated financials IFRS	Consolidated financials US GAAP
	Dr. Cash 110 Dr. COGS 100 Dr. CT expense 2.5 Cr. Sales 110 Cr. Inventory 100 Cr. CT Pay 2.5	Sales 110 COGS 80 NIBT 30 CT Expense 2.5 DT Expense 5 Total Tax 7.5	Sales 110 COGS 80 NIBT 30 CT Expense 9.5 DT Recovery Nil Total Tax 9.5

Note
If PurchaseCo acquired "inventory"/asset for internal use and NOT for resale, the deferred taxes should be amortized over the asset's expected life

Goodwill linking

What to do with legacy tax goodwill in a business combination?

IFRS

Factors that gave rise to pre-existing goodwill must still be present and pertain to the existing goodwill created on the business combination

Why do we care?

Either acquire a tax asset in the business combination affecting the goodwill calculation

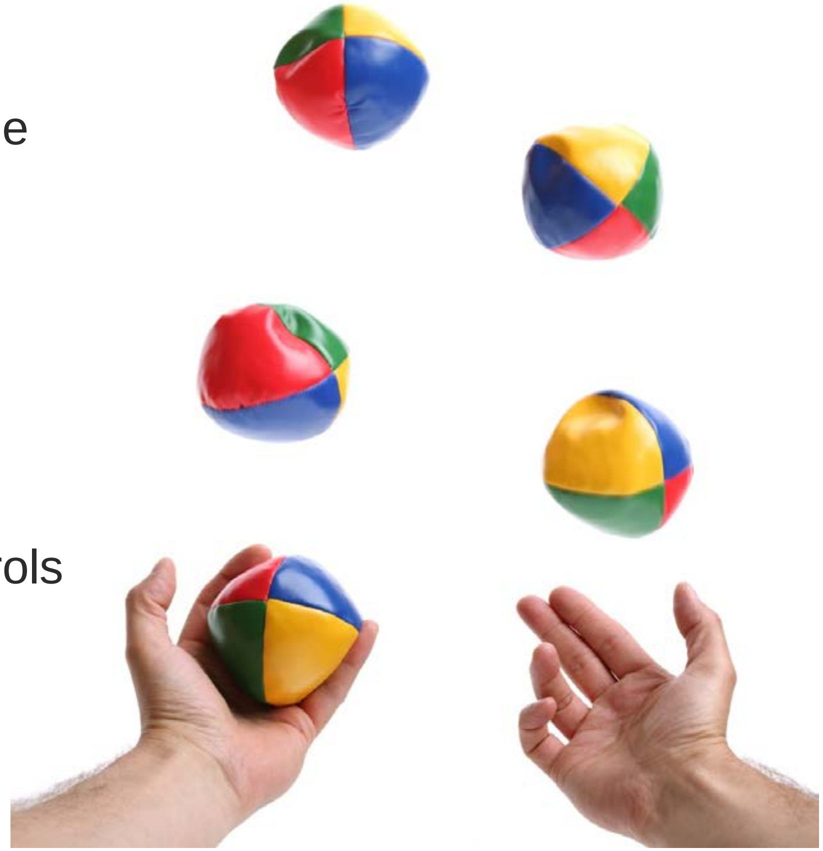
OR

Have tax basis related to goodwill in a business combination – no impact in the business combination determination of goodwill

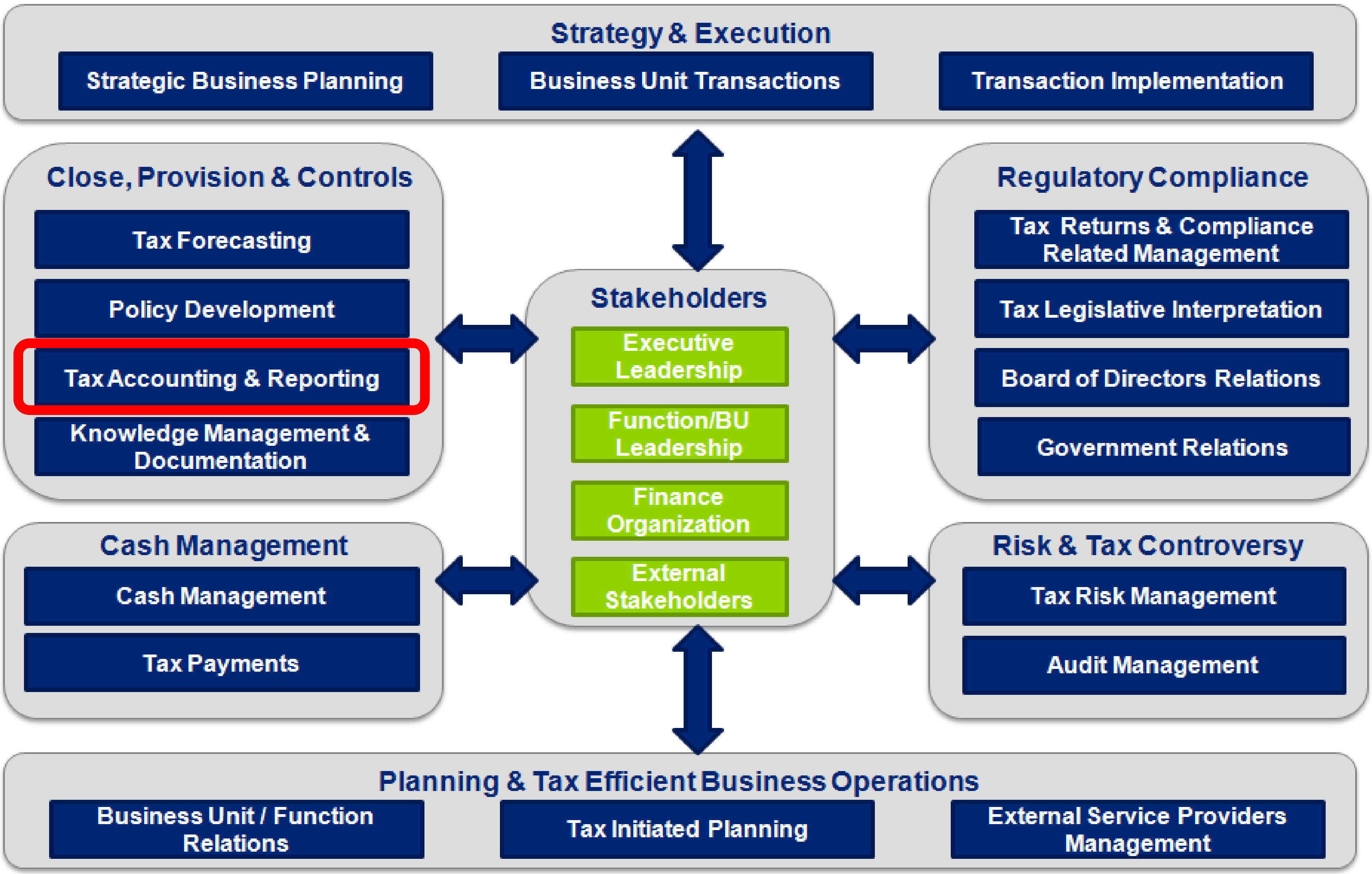
Effective management of your tax provision process

Snapshot of the Canadian landscape

- Realities of a Tax department in the 21st century
  - Responsible for multiple areas of Tax from specialist to generalist
  - Tax personnel continue to take on multiple roles beyond tax such as
    - Treasury
    - Pension
    - Insurance
  - Audit activity is increasing the need for greater governance and internal controls
  - Deadlines are increasingly shortened
  - Tax is becoming headline news (social responsibility)



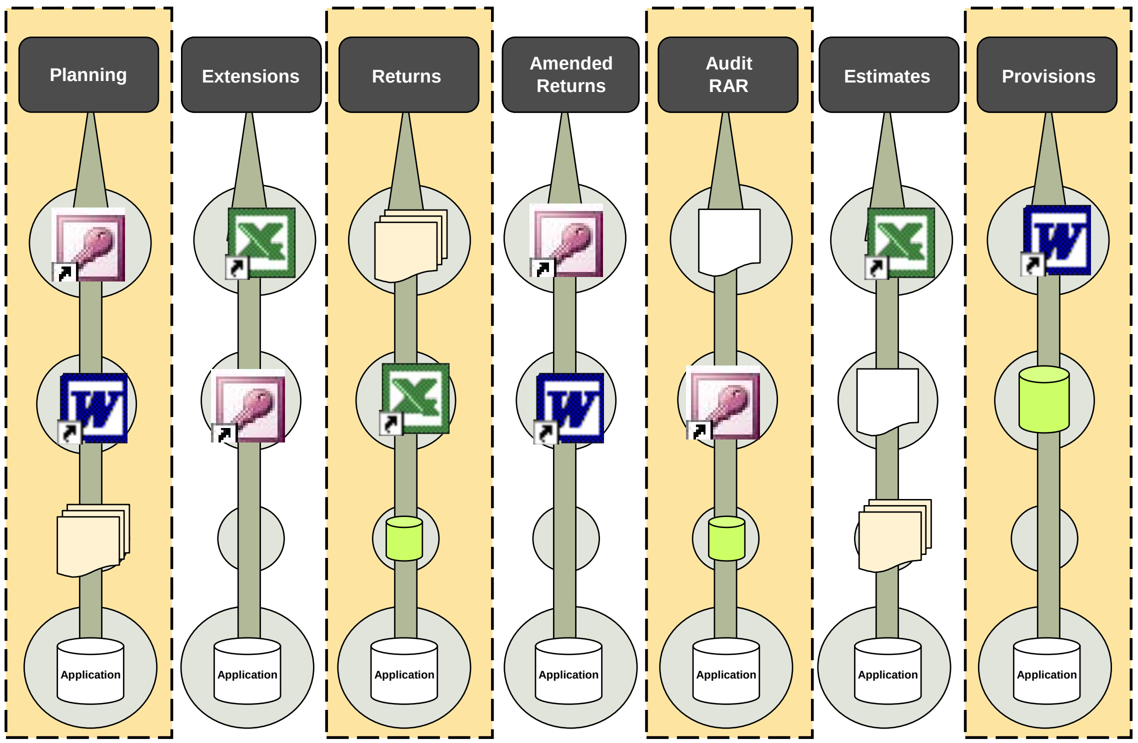
Tax department responsibilities



Typical current state for tax

Currently, many tax organizations operate in a siloed, linear environment, without leveraging possible synergies and efficiencies across key areas

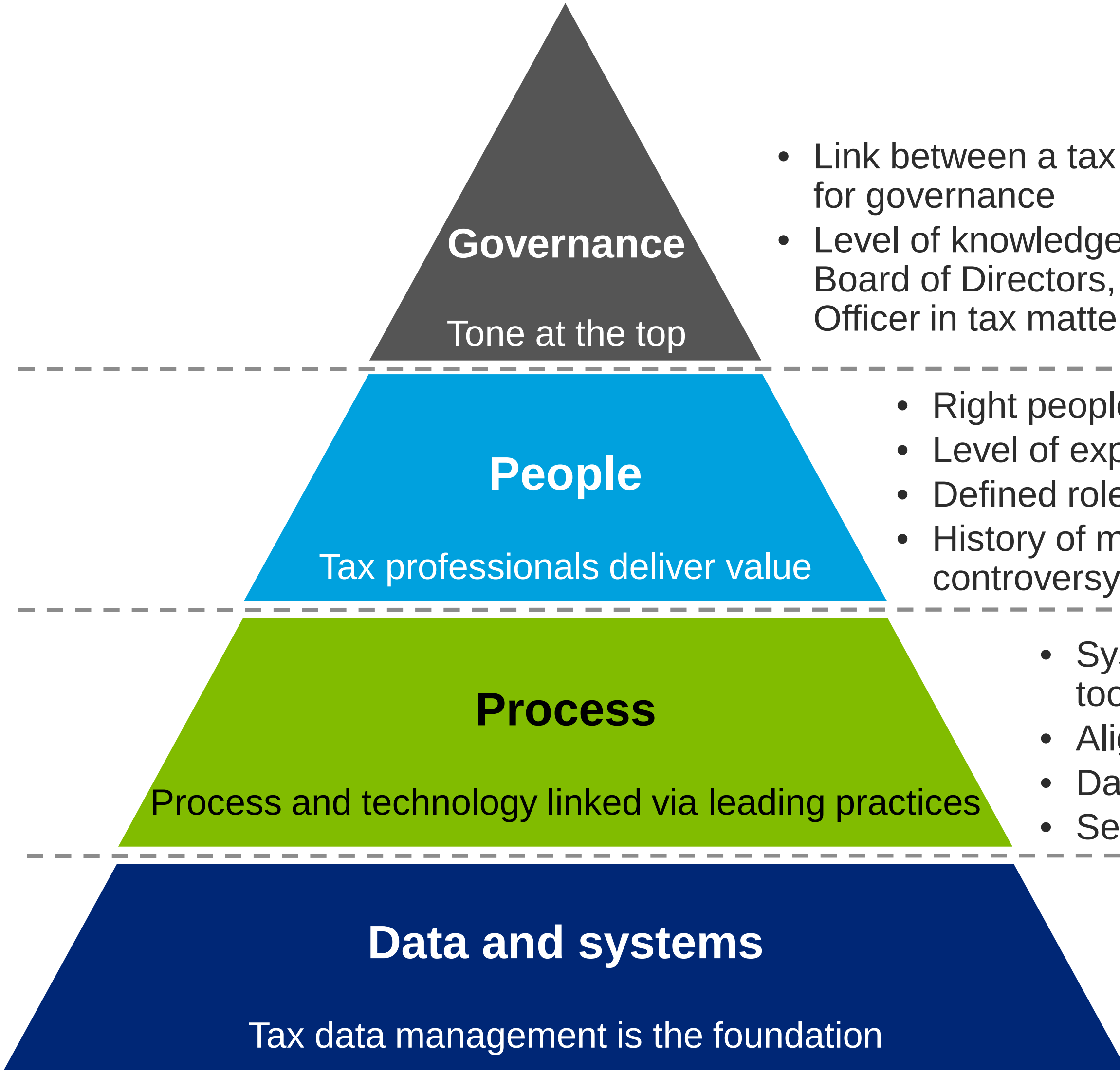
Typical current state environment



Disadvantages

- Applications/Tools are not designed to meet the needs of the entire function
- Lack of centralized tax data across functions
- Minimal capability to support an audit trail
- Limited number of control points enforced due to heavy reliance on manual checks
- Inconsistent management reporting capabilities (e.g., lack of consistency and data transparency)
- Lack of multi-scenario forecasting and analysis

Characteristics of a successful project



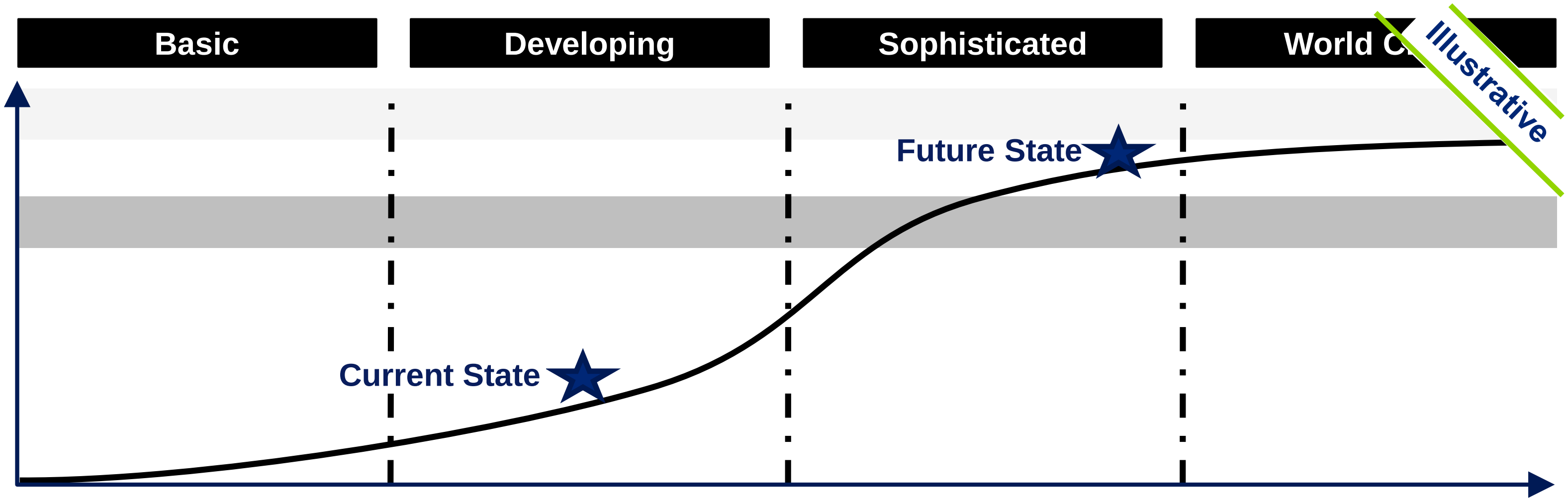
- Link between a tax strategy and the overall corporate strategy for governance
- Level of knowledge and involvement by the Chief Risk Officer, Board of Directors, Audit Committee, and Chief Financial Officer in tax matters

- Right people with the right skill in the right roles
- Level of experience and expertise on tax
- Defined roles and responsibilities
- History of missed or inaccurate tax filings and tax controversy issues

- System generated or manually prepared tax tools
- Aligning tax processes to finance systems
- Data retention and extraction processes
- Segregation of duties and functions

- Level of understanding of system capabilities
- Establishing and testing internal controls
- Ability of systems to accommodate changes in tax structures
- Assessing data integrity

Defining the future Tax function



Basic processes and systems	Developing processes and systems	Sophisticated processes and systems	World class processes and systems
• Tax processes are highly manual and require the use of multiple systems • Processes across legal entities are not standard-ized and do not appropriately leverage data across the enterprise • The burden of compliance and provisioning require-ments prevents value-added planning initiatives from being completed • No tax strategy or vision	• Tax processes are manual with some elements of automation • Documentation of key tax processes across legal entities minimizes manual workarounds • Value added tax initiatives are identified and resources are assigned to planning initiatives when available • Loosely defined tax strategy and vision	• Tax processes are partially automated with automatic data input from the GL • Data captured in a consistent structure with centralized access to support compliance and provisioning require-ments • Tax organization's involvement in planning initiatives is seen as value adding by the business • Tax strategy in place and documented	• Tax processes are fully automated with all data from a common repository • Tax planning is collaborative, involving senior management to prioritize goals and objectives • The tax organization is structured to obtain the best value out of the company's tax resources • Tax strategy is well communicated and understood across the organization

Please remember to complete your evaluation

Speaker bios

Arthur Driedger is a tax accounting partner in the Business Tax Group of Deloitte & Touche LLP. His primary focus is in the tax provision assistance and attest area. Arthur takes a lead role in Deloitte's tax risk, process and technology offerings, tax provision attest processes and tax accounting technical services. Arthur represents Deloitte Tax on the Deloitte IFRS National Steering Committee, is on Deloitte Canada's national tax accounting committee and represents Deloitte Canada Tax on the Americas IFRS Integrated Market Offering. Arthur has extensive tax accounting experience in US GAAP and IFRS.

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Peter Letal is a tax partner practicing in Canadian taxation matters where he delivers practical solutions to complex issues. Peter is the oil & gas tax leader for Deloitte & Touche LLP's Canadian practice and has assisted numerous oil & gas companies in setting up their operations in Canada in a tax efficient manner.

Peter helps his clients understand the intricacies in regards to corporate reorganizations from both a Canadian income tax and a tax accounting perspective.

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