IFRIC 23 AND TRANSFER PRICING

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Introduction

The IFRS Interpretations Committee (IFRIC) issued IFRIC 23, which clarifies how the recognition and measurement requirements of IAS 12 income taxes, are applied where there is uncertainty over income tax treatments.

Transfer pricing is not an exact science and rules are open to different interpretation by Revenue Authorities, the tax authorities in the foreign jurisdiction and the taxpayer. As a transfer pricing risk is often uncertain, the transfer pricing position taken by a taxpayer should be carefully considered in light of IFRIC 23.

History and commencement

Historically, there was little guidance on the accounting treatment of uncertain tax positions.

Of all the tax areas, transfer pricing is arguably often subject to greater uncertainty, or at least judgement. Furthermore, the disclosure of certain provisions, for example in respect of the deductibility of a cross-border interest charge, in a company's annual financial statements may have lacked ultimate clarity.

IFRIC 23 is an interpretation that attempts to clarify how to apply the ***recognition*** and ***measurement*** requirements in IAS 12 when there is uncertainty over income tax treatments.

The change was effective for accounting periods on or after 1 January 2019 and applies to all aspects of income tax accounting when there is uncertainty about the income tax treatment of an item, including taxable profit or loss, the tax basis of assets and liabilities, tax losses and credits, and tax rates.

What is an uncertain tax treatment?

An 'uncertain tax treatment' is a tax treatment for which there is uncertainty (lack of clarity) over whether the relevant taxation authority will accept the tax treatment under tax law. Examples include tax deductibility of certain expenses, tax-exemption of certain income, and transfer pricing rules to allocate income between jurisdictions.

Scope

IFRIC 23 is an interpretation, which is to be applied, in the case of an uncertainty over a tax treatment under IAS 12, to the determination of taxable profit/loss, and other income tax related matters such as tax bases, unused tax losses, unused tax credits and tax rates.

The interpretation clarifies that when a company considers the uncertainty, it must assume that the taxing authorities have full knowledge of all relevant information in assessing the proposed tax treatment. Accordingly, detection risk is ignored when assessing tax uncertainties.

Probability of acceptance of each tax treatment

Each uncertain tax treatment is considered separately or together as a group, depending on which approach better predicts the resolution of the uncertainty. The factors that an entity might consider in order to make this determination include:

(1) how it prepares and supports the tax treatment; and

(2) the approach that it expects the tax authority to take during an examination.

An entity has to consider whether it is remote, possible or probable that the relevant authority will accept or reject each tax treatment, or group of tax treatments, that it used or plans to use in its income tax filing.

If the entity concludes that it is probable that a particular tax treatment will be accepted, the entity has to determine taxable profit/loss, tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment included in its income tax filings.

If the entity concludes that it is not probable that a particular tax treatment is accepted, the entity has to use the most likely amount or the expected value of the tax treatment when determining taxable profit /loss. The decision should be based on which method provides better predictions of the resolution of the uncertainty.[1]

The entity should measure the impact of the uncertainty using the method that best predicts the resolution of the uncertainty (that is, the entity should use either the most likely amount method or the expected value method when measuring an uncertainty):

> a. 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.
>
> b. 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. IFRIC 23 requires consistent judgements and estimates to be applied.

[1] Refer http://www.iasplus.com.

The IFRIC supports that based on the assumptions in either (a) or (b) above, the credit entry should be allocated to the SARS liability, i.e. within the scope of IAS 12, rather than against a provision in terms of IAS 37. Accordingly, the SARS liability may be higher when using the IFIC 23 interpretation.

There are no new disclosure requirements in IFRIC 23. However, entities are reminded of the need to disclose, in accordance with IAS 1, the judgements and estimates made in determining the uncertain tax treatment.

Changes

If any of the facts and circumstances change or when there is new information that affects those judgements, the entity is required to reassess its judgments.

New information might include actions by the tax authority, evidence that the tax authority has taken a particular position in connection with a similar item, or the expiry of the tax authority's right to examine a particular tax treatment. IFRIC 23 states specifically that the absence of any comment from the tax authority is unlikely to be, in isolation, a change in circumstances or new information that would lead to a change in estimate.

Transfer pricing aspects

Given that transfer pricing is "not an exact science" a company needs to consider the transfer pricing position taken under IFRIC 23 and whether or not a provision is required.

Involving experts as part of the statutory audit should assist in testing the reliability of transfer pricing risk. So too, it may be that opinions from independent experts, or transfer pricing analyses prepared by experts could support the judgement of risk.

The most likely amount determination is more appropriate in cases where the transfer pricing risk is more certain, and conversely, where the transfer pricing risk is more uncertain, the expected value is more appropriate, in our view.

Examples of where the most likely amount determination could be appropriate are:

- the provision of services to affiliates for no compensation, where such services should have been charged for at arm's length. In this example, it would be useful to confirm whether any regulatory justification, or veto of minority shareholders in the service recipient exist for not charging for services intra-group.
- Some African countries have currency controls or other regulatory limitations that prevent the payment for service fees.
- A taxpayer procured foreign intra group financial assistance and the interest rate and/or the quantum of the debt is not arm's length.

In these cases, a determination of the risk of a probable (singular) outcome could be made. There is a debate of course whether if the risk is certain, the taxpayer should make payment, as opposed to just providing for the risk. Not doing so, could trigger NOCLAR considerations in an audit.

Examples of where the estimated amount determination could be appropriate are:

- A group has a so-called marketing/ procurement/ IP hub in a country with a low tax rate, and there could be a debate about the level of substance in the group company. There are various outcomes of this risk. A tax authority could assert that:
    - the effective management (with consequent tax residency risk) is not in the country of incorporation;
    - the company is a controlled foreign company of a South African parent and would not qualify for the foreign business establishment exemption; **or**
    - a transfer pricing adjustment(s) should be considered.

    The above three scenarios are arguably binary, but, dependent on the facts, may have different probabilities and different risk amounts. All outcomes should ideally be considered.
- A distributor's classification for transfer pricing purposes is misaligned with its economic return. This is a subjective determination with numerous analyses and outcomes to consider. The probability of an array of outcomes should be considered and quantified.

Conclusion

It is also important to consider penalties, interest and secondary adjustments, and also the likelihood that a corresponding adjustment through a mutual agreement procedure could be secured (if a double taxation agreement exists). Consideration should be given as to whether this should be disclosed.