

# IFRS and the impact on tax for the retail sector

## Executive summary



Many retailers now report their financial results using IFRS (International Financial Reporting Standards). This article discusses the emerging issues that the move to IFRS has had on tax related areas, covering both cash taxes and accounting for taxes.

What emerges is that the key issues for retailers have been:

- Reporting deferred tax under IFRS on property, brands and business acquisitions. Significant liabilities arise which may never result in cash tax liabilities.
- Deciding whether or not to adopt IFRS at entity level and the impact on corporate tax liabilities.

For many groups, mitigation of deferred tax liabilities is becoming a key feature of any restructuring of property portfolios.

Goodwill that has been increased to take into account deferred tax liabilities on acquired brands and properties needs to be considered for impairment.

For retailers who can choose to use IFRS at entity level the impact on cash tax liabilities suggests that the move to IFRS can be cash positive for some.

This article looks at these issues in more detail to assist an understanding of whether trends are emerging in the retail sector.

## Tax reporting

The most obvious and immediate impact of IFRS has been tax reporting in group financial reporting. For many groups the implications of IAS 12 on deferred tax have been the most complex area to deal with. Only financial instruments and business combinations have proved more complex according to a recent PwC report (IFRS Embracing Change, July 2006).

IAS 12 requires full recognition of deferred tax liabilities with few exceptions. For retailers three areas in which deferred tax have been complex are:

- retail property;
- brands; and
- the impact of business combinations on both property and brands.

## Retail property

Many retail groups own their own property portfolios and have had to deal with recognition of significant deferred tax liabilities in two situations. Firstly on revalued property and secondly on property that is both acquired as part of a business combination and on which no tax allowances are available on an ongoing use basis – as in the UK for example.

These deferred liabilities may not crystallise for some time, if at all. Even if a gain is eventually realised the associated tax liability may be much less than the amount carried in the balance sheet. Why is this?

There are a number of aspects of IAS 12 at work here.

Firstly, IAS 12 requires that deferred tax is measured by reference to the manner in which management expects, at the balance sheet date, to recover the asset. In a tax regime which taxes buildings on a different base dependent on whether they are sold or used in the business, the measurement of deferred tax will differ dependent on what management intend. So for example, whereas a retail shopping property being disposed of in the UK would be subject to capital gains tax with a deduction available for the cost and certain other expenses, the same property attracts no tax deduction for its cost during the period it is used in the business. On a large property portfolio this can make a significant difference between a deferred tax liability measured on the basis the property is being used compared to a real eventual tax liability on a disposal.

In certain circumstances it may be that management expect to recover the asset partly through use and partly through disposal. In these cases the calculations can become complex and time consuming.

Secondly, IAS 12 requires different calculations depending on whether the property is acquired on a stand alone basis or as part of a business

combination. For example, a UK retailer acquiring a retail property for 100 and revaluing to 110 is only required to recognise deferred tax on the revaluation element. Had the retailer acquired the property as part of a business acquisition, deferred tax would be recognised on the full 110.

In the face of such complexities what is beginning to emerge is that where possible, circumstances that mitigate deferred tax liabilities are welcome. The impact on deferred tax is also a key consideration for any group restructuring its property portfolio.

Reducing these deferred tax liabilities is attractive to improve the group's balance sheet in addition to any desire to mitigate the real tax charge that may arise on a future disposal of the property portfolio. This is understandable if a group believes that any deferred tax liability being recognised exceeds any actual tax burden it may bear on a future disposal. The discrepancy between deferred tax and eventual cash tax can arise because the tax position on use may be very different to that on a disposal. However, IAS 12 imposes a measurement basis for deferred tax which reflects the way management intend to recover the asset at the balance sheet date, generally use.

The interpretation of the measurement criteria in IAS 12 has also given rise to complex calculations and interpretations in any jurisdiction where the tax base of the asset differs dependent on whether the property is being used, held for disposal or where there is a dual use/disposal intention at the balance sheet date.

IFRS has, for many retailers, increased deferred tax liabilities associated with their property. Moving forward mitigating these liabilities as part of any overall property management strategy will be increasingly important. An awareness of which deferred tax liabilities may not become real tax liabilities is also important for monitoring cash flows and when considering financing needs.

# Brands

A retailer that acquires a branded business and recognises the brand in its balance sheet may find it is required to recognise deferred tax on the intangible asset. In many cases a group may buy the shares of the entity that owns the brand and in many jurisdictions any subsequent disposal of that entity may be tax free. Even in these cases deferred tax is recognised on the value of the brand. Again, the deferred tax liability may be much higher than any tax that may arise on a disposal. In effect the liability represents future tax on income generated as the brand is used.

What such a deferred tax liability does highlight however is intellectual property which does not currently qualify for current tax deductions (as the deferred tax liability will arise on the difference between carrying value and tax deductible amounts). Whether this will increase a group's appetite to restructure their intellectual property to eliminate such tax leakage is not yet clear but the deferred tax position readily highlights the price paid for acquired brands for which no tax deductions are being obtained.

The focus on deferred tax highlights issues around the discrepancy between accounting for deferred tax and eventual cash tax liabilities on disposal. The deferred tax liability in many cases represents the tax on future trading profits generated by use of an asset..

# Cash tax liabilities

As retail groups ask themselves whether or not to adopt IFRS at entity level, where permitted, the question to address is whether there is a cash tax implication.

Many retail groups have fewer legal entities than found in other industry sectors. In many cases the retail operations in any territory are carried out by a single legal entity. If IFRS is used for consolidation purposes only, then groups need to retain local GAAP knowledge. With a small number of legal entities many retail groups have been keen to assess the impact of adopting IFRS at entity level as widely as possible, mainly for the reporting efficiencies this may bring.

Cash tax liabilities can only be impacted when profits assessable to tax are based on IFRS financial statements. Adopting IFRS at entity level is not possible in every EU jurisdiction but a number of key territories allow entities to apply IFRS in individual entity financial statements and in these territories, the UK and Ireland for example, a number incorporate the profit reported in financial statements into the tax base.

Items common to the retail sector that can have a cash tax impact include:

- revenue recognition,
- vendor rebates and allowances
- and customer incentives.

In these three areas IFRS accounting may result in revenue and expense being recognised in earlier or later periods than under local GAAP. Where the starting point for tax liabilities is profit recognised in financial statements the transition to IFRS will have an immediate impact.

The impact will arise both on a period by period basis as well as on the transition. Rent free periods and lease incentives are often features of leases entered into by retail companies.

The income from these incentives should be recognised over the lease period under IFRS which is a longer period than other GAAP. For example, under UK GAAP the period would be up to the first rent review. This can lead to a significant increase in the amounts treated as deferred income on transition to IFRS.

When such a transitional adjustment is effective for tax, as in the UK, then a reduction in tax liabilities or even a cash refund may be generated in the period in which the transition is tax effective.

On the other hand, on asset acquisitions the classification of consideration as an intangible asset such as a brand rather than as goodwill can impact tax liabilities if tax deductions follow the related amortisation in the financial statements. Intangibles of indefinite life and goodwill are not amortised under IFRS although they are subject to impairment review. This can lead to a potential deferral or loss of tax relief.

It is clear that any retailer considering adopting IFRS at entity level will need to consider the potential impact on their tax liabilities on a line by line entity by entity basis.

The impact of IFRS both on tax reported in the financial statements and on cash tax liabilities can be significant for retailers. The key areas highlighted in this article can help retailers consider the impact on tax and the implications for adapting their future tax strategy to include questions such as choice of GAAP for entity financial statements and the importance of deferred tax mitigation as a key performance indicator in cost benefit analysis in future tax planning initiatives.

## Conclusion

The impact of IFRS on tax for retailers is focussed on very specific areas. The complexity of accounting for deferred tax means that groups are beginning to review their options to reduce or eliminate deferred tax on property for example. It will be interesting to see how comparability between groups in this area emerges.

The move to IFRS at entity level is seen less often amongst industry sectors outside financial services and so the trend in retail is interesting and the potential impact on tax must be amongst the criteria on which the decision must be made.

**We can help you make sense of IAS 12 for tax reporting at group and entity level and help you understand the potential impact on cash tax.**

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