Income Tax
Technical News

No. 42 May 31, 2010

This version is only available electronically.

In This Issue

The *Income Tax Technical News* is produced by the Legislative Policy and Regulatory Affairs Branch. It is provided for information purposes only and does not replace the law. If you have any comments or suggestions about the matters discussed in this publication, please send them to:

Income Tax Rulings Directorate
Legislative Policy and Regulatory Affairs Branch
Canada Revenue Agency
Ottawa ON K1A 0L5

The *Income Tax Technical News* can be found on the Canada Revenue Agency Internet site at **www.cra.gc.ca**.

International Financial Reporting Standards

The purpose of this article is to provide guidance on how the requirement for publicly accountable enterprises (PAEs) to adopt International Financial Reporting Standards (IFRS), effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011, will affect those enterprises' tax reporting. IFRS will replace current Canadian Generally Accepted Accounting Principles (GAAP) as the acceptable set of accounting standards in the CICA Handbook for PAEs. Most private companies will have the option to use IFRS; accordingly, the following comments also apply to companies that choose to apply IFRS.

CRA Acceptance of IFRS

The *Income Tax Act* (the "Act") does not specify that financial statements must be prepared following any particular type of accounting principles or standards to determine profit. As the Supreme Court of Canada stated in *Canderel Limited. v. The Queen* 98 DTC 6100, the determination of profit is a question of law. Accounting standards are not law. In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit, for purposes of section 3 of the Act for the given year. The Supreme Court stated that a taxpayer is free to adopt any method which is not inconsistent with: (a) the provisions of the Act; (b) established case law principles; and (c) well-accepted business principles. It is our view that financial statements based on IFRS would be an acceptable starting point to determine income for tax purposes.

In addition, where IFRS financial statements are used by a particular entity, it is our position that references to GAAP in the Act can be read as references to IFRS and all references to GAAP in any Agency publication can also be read as references to IFRS for those entities that report under IFRS.

Early Adoption

For financial reporting purposes, both PAEs and non-PAEs may adopt IFRS early. If early adoption of IFRS for tax purposes is being considered purely for the taxpayer's administrative ease because, for example, the corporation reports IFRS-based results to its parent or uses IFRS for financial reporting purposes, the CRA will accept early adoption for years commencing on or after January 1, 2009. We would expect taxpayers to file, with their tax returns, the financial statements they issue for financial reporting purposes. We also expect taxpayers to apply IFRS on a consistent basis to all calculations in order to determine income tax. For instance, a taxpayer should not use current GAAP to compute its thin capitalization limit, and switch to IFRS to compute its revenue recognition in the same year. As well, the accounting standards used for tax purposes should be applied consistently to all years after initial adoption.

A taxpayer that is not obliged to use IFRS statements for accounting purposes, and does not prepare them for other users, is not required to prepare them solely for tax purposes.

The Superintendent of Financial Institutions has prohibited the early adoption of IFRS by all federally regulated financial institutions. Part VI tax is based on amounts reflected in a financial institution's balance sheet and which are accepted by the Superintendent.

Impact

Canadian tax legislation and jurisprudence provide rules for virtually all transactions other than routine purchases and sales on income account. For instance, there is a regime for capital transactions (gains/losses and amortization), for inventory valuation and for most accruals. Courts have determined that leases are to be accounted for based on the legal rights of the parties. Given the extent of the rules that override accounting treatment, we expect that taxable income will not be significantly affected by the adoption of IFRS; however, the computation of taxable income could be much more complex because accounting treatment and tax treatment may vary in more ways than they do now. First time adopters of IFRS may need to make adjustments on Schedule 1 of a T2 return to ensure that all revenues and expenses are fully reported, and reported only once.

There may be tax impacts on capital taxes as well as certain narrow areas that affect income tax, but we expect these to be relatively minor for most companies. The analysis of the impact on these taxes is on-going.

Due to the fact that IFRS statements will present information differently than current Canadian GAAP, we expect to develop revisions to our General Index of Financial Information forms.

Examples of Accounting Changes Arising from IFRS and the Tax Effects

The following examples are not an exhaustive list.

<u>Impairment/Revaluation</u>
IFRS provides more options for write-ups of assets, such as property, plant and equipment, intangible assets and investment properties, to fair value ("FV"). Similarly, there may be more write-downs of these assets, in addition to write-downs of goodwill and investments in certain other entities, to their recoverable amounts.

For tax purposes, the realization principle is generally the rule of law. Gains and losses will be realized on the disposition of assets in accordance with sections 38, 39 and 40 of the Act. Capital cost allowance will be based on the capital cost of assets in accordance with paragraph 20(1)(a) of the Act and the *Income Tax Regulations*.

<u>Revenue Recognition</u>
As described in IFRS 1, *First-time Adoption of International Financial Reporting Standards,* an entity which initially adopts IFRS must prepare its first IFRS financial statements as though the revenue recognition requirements of IFRS had always applied. When IFRS 1 is applied, there may be amounts that are never recognized or, conversely, that are recognized in accounting income twice, due to the conversion from Canadian GAAP to IFRS. As noted above, first time adopters of IFRS may need to make adjustments on the Schedule 1 for revenue recognition differences.

There are also situations, such as a layaway sale, a bill-and-hold arrangement and membership or up-front fees, which could result in differences in the timing of revenue recognition between IFRS and Canadian GAAP, in the years subsequent to the adoption of IFRS by a corporation. For tax purposes, paragraphs 12(1)(a) and 12(1)(b) of the Act will apply, and paragraphs 20(1)(m) and 20(1)(n) may apply to many situations, resulting in revenue recognized for tax purposes, often being the same for IFRS or Canadian GAAP users.

<u>Inventory</u>
As a result of a recent harmonization project undertaken by the Canadian Accounting Standards Board, Canadian GAAP (*CICA Handbook* section 3031) has been essentially identical to IFRS on inventory since January 1, 2008. The new converged section 3031 of the *CICA Handbook* now permits an increase in the value of inventory to the extent it is a reversal of a previous write down, which is consistent with the income tax provisions concerning inventory (i.e., subsection 10(1) of the Act). Where corporations value inventory in accordance with section 1801 of the *Income Tax Regulations*, we expect adjustments on the Schedule 1 will continue to be necessary.

Thin Capitalization

The limit of interest deductibility, under the thin capitalization rule of subsection 18(4), is based on the "retained earnings" of a corporation. Although the provision does not refer to GAAP, the term "retained earnings" is an accounting term, and the CRA has maintained that retained earnings are to be computed under GAAP. When a taxpayer files under IFRS, we would expect retained earnings to be computed using IFRS.

For more information

Additional IFRS information is available on the CRA's webpage:
http://www.cra-arc.gc.ca/tx/bsnss/tpcs/frs/menu-eng.html

Who to Contact

If your corporation is currently subject to audit and you have questions regarding the impact of IFRS on your corporation's taxes, you should contact your local Tax Services Office.

Otherwise, you can contact the Income Tax Rulings Directorate at **613-957-8953** or by email at IFRS@cra-arc.gc.ca.