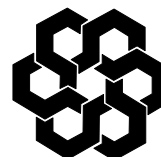


JOINT IASB/FASB MEETING



Financial Accounting
Standards Board



International
Accounting
Standards
Board

This document is provided as a convenience to observers at the IASB and FASB Joint board meeting, to assist them in following the Board's discussion. It does not represent an official position of the IASB or the FASB. Board positions are set out in Standards (IASB) or Statements or other pronouncements (FASB).

Note: These notes are based on the staff paper prepared for the joint board meeting. Paragraph numbers correspond to paragraph numbers used in the board paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Joint Meeting: October 2005, Norwalk

Project: Short-term convergence: income taxes – distributed vs. undistributed rate (Agenda Paper 4C)

INTRODUCTION

1. In some jurisdictions, income can be taxed at different rates depending upon whether or not it is distributed to shareholders. Earlier this year, the Boards separately agreed to measure deferred tax assets and liabilities using the rate applicable to undistributed earnings. The FASB staff thinks that decision will significantly change the financial reporting by some types of entities (REITs, RICs, and Coops) that currently view themselves as “tax-exempt.” Many of them do not currently report deferred taxes. The staff also thinks the upcoming FASB Exposure Draft should clearly communicate the effect of the Boards’ decision on those entities so they can understand and comment on the Boards’ proposals. This memorandum:
 - a. Briefly summarizes the Boards’ undistributed rate decision

- b. Describes how that decision would apply to REITs, RICs, and Coops
- c. Asks the Boards whether they agree with that staff analysis.

SUMMARY OF UNDISTRIBUTED RATE ISSUE

2. In some jurisdictions, income can be taxed at different rates depending upon whether or not it is distributed to shareholders. The Boards discussed whether deferred income taxes should be measured using the distributed or undistributed rate and decided that:

The undistributed rate should be used to measure income taxes until there is an obligation to distribute the earnings. When there is an obligation to distribute the earnings, the distributed rate should be used for the portion of earnings for which an obligation exists.

3. The decision is based on the view that the undistributed rate is the most appropriate rate until there is an obligation to distribute earnings (for example, when a dividend is declared). At the point that an obligation to distribute earnings exists, there would be a remeasurement of the tax balances using the distributed rate, but only to the extent of the obligation (e.g., the declared but unpaid dividend). Said differently, there is no right or obligation in respect of tax payable or recoverable on distribution until the entity is obligated to make that distribution.
4. A strong argument can also be made for measuring taxes using the distributed rate. The staff believes the entities affected by this decision will likely make this argument. That is, the requisite measurement event for the use of the distributed rate is earning the income coupled with the requirement to pay income taxes. Since income taxes are required to be paid, they represent a reduction to shareholder equity, or a “gate” that the earnings must pass through prior to receipt by the shareholder. It is argued that the ultimate distribution to shareholders, in some form, is presumed in the financial statements and therefore, the financial statements should reflect the tax on earnings with the consideration of the distribution. This approach is viewed as providing a better depiction of the amount of retained earnings available for distribution to shareholders.

CONSEQUENCES TO CERTAIN ENTITIES

5. After the Board meeting, the FASB and IASB staff (staffs) became more acutely aware of consequences of the decision on certain entities that typically regard themselves as non-taxable for financial reporting purposes. The staff concluded that the Boards' decision will likely trigger recognition of deferred taxes by many of these entities (for example, real estate investment trusts or REITs, registered investment companies or RICs, and cooperative enterprises or Co-ops), and the amounts to be recognized may be significant. As this paper explains, these entities generally are not recognizing current and deferred income taxes.

Current Tax Effects

6. To understand the consequences of the Boards' decisions, it is helpful to understand the operation of tax law for certain entities generally thought of as non-taxable, and the current and deferred tax accounting for these entities.
7. REITs, RICs, and Co-ops are entities that receive special treatment under the U.S. tax law. Provided the entities distribute a minimum amount of otherwise taxable earnings (90 percent of ordinary income) and meet other requirements under the tax code, they do not pay income taxes to the extent those earnings are paid to shareholders as dividends. Thus, the dividends received by shareholders of REITs, RICs, and Co-ops generally are not subject to double taxation.
8. If a REIT, RIC, and Co-op were to distribute 100 percent of their taxable income, they would not pay any income tax. However, if the REIT, RIC, or Co-op only distributed 90 percent of ordinary income, they would have to pay income tax on the undistributed earnings at the normal corporation income tax rate. Again, the 90 percent requirement is only to maintain the special status that allows the entity to avoid corporate income taxation.
9. Take a REIT, for instance, that earned 100 of income. To maintain REIT status, they would have to pay at least 90 in dividends. If they only paid 90 in dividends, the REIT would pay income taxes on the 10 of undistributed income. However, if the REIT dividends are 100, it would not pay any income tax.

10. The tax law also provides REITs, RICs, and Co-ops with “throwback” and carryforward rights. Provided the entities declare a dividend by the date the tax return, as extended, is due (or, September 15 for a calendar year-end company) and pay the dividend by the end of the year (December 31 for a calendar year-end company), the entity can throwback the dividends into the previous year to meet the distribution requirements. Additionally, if an entity pays excess dividends in a previous year (greater than the minimum required 90 percent), then the entity can carryforward those dividends in the next year to meet the distribution requirements.
11. If an entity fails to pay the minimum required 90 percent in dividends, the consequences are severe. First, the entity loses the dividends paid deduction to the beginning of the tax year and secondly, the entity is not able to re-elect the status (for example, REIT or RIC) status for four years. Thus, failure to maintain REIT or RIC status would significantly harm shareholders and likely eliminate access to the public capital markets.
12. The staffs are aware of similar tax arrangements for entities elsewhere around the world. However, for the sake of simplicity, the issue is summarized in this paper in the context of the U.S. tax law for a REIT. While the issues for REITs, RICs, and Co-ops are not identical, they have some similar characteristics.
13. Paragraph 145 of FASB Statement No. 109, *Accounting for Income Taxes* addresses the classification of income taxes for REITs:

The Board believes that a tax deduction received for the payment of dividends (exclusive of dividends paid on unallocated shares held by an ESOP) represents, in substance, an exemption from taxation of an equivalent amount of earnings. For that reason, the Board concluded that the tax benefit should be recognized as a reduction of tax expense and should not be allocated directly to shareholders' equity.
[Emphasis added.]

Thus, in practice, the tax deduction derived from a dividend is substantively viewed as an exemption from taxation. If all taxable income is simply distributed, there would be no payment of income taxes by the entity, and the entity would appear to be a non-taxable entity, though, in fact, it is indeed potentially subject to income tax.

14. The staff has discussed the issue with two senior REIT tax partners at two different Big 4 firms. They are not aware of a situation where a REIT has ever distributed less than 100 percent of taxable income (ordinary income and capital gains). In fact, most REITs distribute an excess of 100 percent of taxable income (and, therefore, regularly return capital to shareholders). Thus, a REIT would not present a current tax provision on its income or on the income-qualified REIT subsidiaries because it would consider the declaration of dividends each year in determining the current tax for each year.
15. However, because of the decision reached by the Boards that the distributed rate is only applicable when an obligation to pay the dividends occurs, a REIT that earns taxable income in one year and declares and pays a dividend in the following year, under the throwback rules, would need to recognize a current tax provision for the income earned but not yet distributed (or declared) and in the following year, recognize a tax benefit for simply paying the dividend.
16. To illustrate, presume the following for a calendar year-end company:
 - a. 100 of income (book and tax) is earned during 2005.
 - b. 75 of dividends are declared and paid during 2005.
 - c. At December 31, 2005, year-end, there are no dividends declared, and no liability for a dividend payable.
 - d. On January 14, 2006, the entity declares and pays a dividend of 25 that is payable on January 31, 2006.
 - e. On January 15, 2006, the entity files tax return. Taxable income of 100 is offset by a dividends paid deduction of 100. No income tax is paid.
 - f. As a simplifying assumption, book and taxable income in 2006 is zero.
17. The following is the staffs' understanding of the accounting that would occur based on the Boards' undistributed rate decision.
 - a. In the 2005 financial statements:
 - 1) A current tax expense and related liability would be recognized in the amount 10, computed as follows: 25 of taxable income (100 of gross taxable income is offset by a dividends paid deduction of 75) multiplied by a 40 percent rate.

- 2) The 2005 tax return would report taxable of nil due to the throwback of the January 2006 dividend payment to the 2005 tax year.
 - b. In the 2006 financial statements:
 - 1) When the dividend is declared on January 14 for income earned in 2005, a tax benefit of 10 is recognized and the current tax liability is eliminated.
 - c. The overall effect is a tax expense in 2005 and a tax benefit in 2006. The staff notes that the other amounts relating to 2006 are no net taxable income, no income tax expense actually paid, and a dividend recognised and paid.
18. Do the Boards agree that the application of the undistributed rate as set out above gives an appropriate result for these entities?

Deferred Tax Effects

19. The illustration above assumes that there are no temporary differences to be considered in the accounting for income taxes. In reality, many of these entities have significant temporary differences for which they are currently not recognizing deferred tax balances. The Boards' decision would require measurement and recognition of deferred taxes on those temporary differences at the undistributed tax rate.

Note: Paragraphs 20-22 not reproduced in Observer Notes.