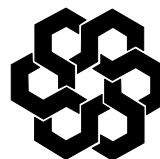


JOINT IASB/FASB MEETING



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 –
uncertain tax positions (Agenda Paper 4A)**

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1. Uncertain tax positions are (a) positions taken on an income tax return and (b) positions anticipated to be taken in a to-be-filed tax return and reflected in the effective tax rate in an entity's financial statements.
 2. Many tax positions are based on unambiguous tax law and there is little uncertainty as to their ultimate sustainability based on the technical merits. However, some tax positions are subject to significant interpretation and there may be significant uncertainty about their ultimate sustainability. The uncertainty generally pertains to either the technical merits of the tax position, or the valuation assumptions used in computing a credit or deduction.
 3. Both FASB Statement 109 *Accounting for Income Taxes* and IAS 12 *Income Taxes* are silent on how to deal with uncertainty over the amounts underlying current and deferred tax balances. The FASB staff narrowly addressed the

question of uncertainty in Q&A 4 and Q&A 17 on Statement 109, but this interpretative response pertained to tax basis in a business combination. In the FASB Q&A, the staff indicated that tax basis is a matter of the application of the tax law, and did not give prescriptive guidance on any confidence level to be established prior to recognition.

4. During 2004, the FASB identified significant diversity in practice in the accounting for income taxes relating to uncertain tax positions. To address the significant diversity in practice, the FASB published an Exposure Draft of a proposed Interpretation of FASB Statement 109 *Accounting for Uncertain Tax Positions* in July 2005.
5. The comment period ended on September 12, 2005. The FASB staff is currently analyzing the comment letters and the comment letter analysis will be circulated to the Boards in a supplemental memorandum.¹
6. To research the project issues, the FASB staff met with:
 - a. A number of preparers that would be affected by the Interpretation
 - b. US taxing authorities
 - c. Tax attorneys
 - d. Tax and audit practitioners

The FASB staff prepared four papers analyzing the issues and the FASB has deliberated the project issues at three meetings.

7. The IASB considered the FASB proposals at its June and September meetings. The IASB concluded that a different approach to uncertain tax positions would arise under IFRSs.
8. The staff think that the central questions the Boards must deliberate and answer are:

¹ The FASB will hold a roundtable discussion on the Exposure Draft on October 10, 2005. The supplemental memorandum on the comment letter analysis will also summarize the roundtable discussion.

- a. Is convergence an appropriate goal or necessary outcome for uncertain tax positions? Given that the FASB and IASB currently have different approaches to accounting for contingencies,² on which certain provisions of the approaches are generally founded, is a similar approach to accounting for uncertain tax positions necessary?
 - b. Is it more important for each Board to be consistent in this project with its current guidance on uncertainty, or would a difference in the accounting for uncertain tax positions be of such importance that a converged answer, which is not entirely consistent with other GAAP for one Board, should be an overriding concern?
9. To assist Board members in answering these questions, the remainder of this paper will describe the major differences between the two approaches, and present both arguments in favour and against each approach. The staff will not present a recommendation for the Board's consideration.

Differences between the FASB and IASB approaches

10. Simply stated, the fundamental difference between the two approaches is that the FASB's approach addresses uncertainty through both recognition and measurement whilst the IASB's approach addresses all uncertainty through measurement.
11. This fundamental difference is reflected in the following aspects of the two approaches:
- a. the context in which the issue is addressed
 - b. whether a probability based recognition threshold should be applied
 - c. the measurement basis to be applied
 - d. disclosures.

² ie under their respective standards: Statement 5 *Accounting for Contingencies* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The context in which the issue is addressed

12. The FASB's approach focuses on the initial recognition of the benefit of the tax position. Since the reduction of a liability is an increase in net assets, and uncertain tax positions reduce the income tax liability or the amount of income tax paid, many uncertain tax positions result in an increase in net assets. Because of this, the FASB staff has used the term "asset approach" to discuss the FASB's approach. However, the staff believes it is often confusing to think about assets in the context of tax liabilities, and has begun to discuss the project in the context of benefit recognition.
13. The FASB believes that when the enterprise takes a tax position, a discrete accounting judgment should be made about recognition and measurement. Under the FASB approach, an enterprise must affirmatively prove, to a specified confidence level, that it is entitled to the economic benefits of the tax position.
14. The IASB approach regards the entity as having a stand-ready liability to pay more tax than is recognised based on the filed tax position.
15. So the FASB proposals address the recognition of an asset (the reduction of a liability through the recognition of the tax benefit) and the IASB approach addresses the recognition of a liability.
16. It should be noted that the context in which the issue is addressed (ie a perspective of recognition of a benefit versus recognition of a liability) does not of itself create divergence. The same requirements could be set up under both perspectives given an appropriate choice of recognition and measurement requirements. For example, the requirements under the IASB liability approach could be set up under an asset approach if there were no probability recognition threshold and an expected outcome measurement. Equally the requirements under the FASB asset approach could be set up under a liability approach. However, questions of recognition under one perspective become questions of measurement under the other (see example in paragraphs 23-25). This means that different decisions about recognition and measurement may seem more natural under each perspective.

Use of a probability-based recognition threshold

17. As noted above, the FASB's proposed Interpretation approaches the issue from the perspective of recognition of a tax benefit (an increase in net assets). The FASB's proposed Interpretation addresses uncertainty as to the ultimate sustainability of the tax position through a recognition threshold. The FASB has selected an asymmetric recognition/derecognition threshold, as follows:
 - a. A tax position is recognized when it is probable of being sustained based solely on the technical merits of the tax position.
 - b. The tax position must be derecognized when it becomes more likely than not that the position will not be sustained.
18. The proposed Interpretation has discrete recognition and measurement attributes. The FASB terms the approach a two step approach. A tax position must first meet the recognition criterion; thereafter, the tax position is measured using a best estimate approach.
19. The FASB selected probable, as the term is used in FASB Statement 5 *Accounting for Contingencies* to mean that "the future event or events are likely to occur" as the appropriate recognition criterion. The staff notes that the FASB's probable recognition threshold is similar to the confidence level expressed by the term *highly probable* used in IFRS. If the tax position does not meet the probable recognition threshold, no benefit is recognized until the probable recognition threshold is subsequently met. The result of not meeting the recognition threshold is that an additional liability will be recognised (effectively derecognising the tax benefit) unless it is probable the deduction in question will be accepted.
20. The IASB has considered their approach within the context of their thinking behind the recently issued Exposure Draft, *IAS 37 Non-financial Liabilities*. The IASB approach regards the entity as having a stand-ready liability to pay more tax than the amount in the as filed tax position. Under the IASB's most recent thinking, there should not be a probability recognition threshold when

accounting for a stand-ready obligation.³ The IASB acknowledges that IAS 37 has a transaction-driven, settlement value measurement objective, which IAS 12 does not. The IASB approach is not therefore a full application of IAS 37 within IAS 12. Nonetheless, the IASB finds merit in extending the IAS 37 approach of no probability recognition threshold to IAS 12, for the reasons set out later in the paper. As a result, an additional tax liability will be recognised whenever there is a possibility of additional tax payments.

21. It is worth noting that the thinking behind the amendments to IAS 37 would also not impose a probability based recognition threshold on assets that have uncertain outcomes. However, from an asset perspective there is a question of whether an asset even exists.⁴ It could be argued that a probability recognition threshold could be applied to determine whether an asset exists in relation to the tax benefits claimed, before questions of recognition and measurement are considered. However, the IASB staff would argue that there is an asset, being the right to have the tax position considered by the taxing authority. If the tax position is unlikely to be accepted, the value of the asset may be small. Nonetheless the asset exists.
22. The recognition threshold in the FASB model also creates a measurement difference with the IASB model, as follows. Under the FASB approach, if the filed tax position is not probable of being accepted, no benefit is permitted to be recognized and a liability is recognised at the full amount of the claimed deduction. However, under the IASB approach, there would be no recognition threshold and a tax benefit would be recognized and measured at a probability weighted average of the expected outcomes.
23. Consider an entity that claims a benefit (credit or tax effect of a deduction) of 100 but expects the tax authorities only to accept a deduction of 20. Under the FASB approach, when evaluating the technical merits of the tax position, large differences between the as filed amount and the amount anticipated to be realized could call into question whether the recognition threshold had been

³ Under the existing IAS 37, there is a 'more likely than not' probability recognition threshold for contingent liabilities.

⁴ From a liability perspective, there is no question that an entity has a stand-ready liability to pay more tax.

initially met. Presume, in this example, that the expected realization of only 20% of the total benefit claimed calls into question whether the recognition threshold had been met. Then, when evaluating the technical merits of the tax position, assume that it is deemed that it is not probable that enterprise is entitled to the economic benefits of the tax position. Thus, no benefit would be recognized, and a liability for the full amount of 100 is recognised.

24. Under the IASB approach, a stand ready liability for additional current tax would be recognised but its measurement would reflect the expected deduction of 20, ie a liability of 80 would be recognised.
25. It should be noted that the two approaches give relatively close answers for the most aggressive tax filers. Suppose a benefit of 100 is claimed that is very unlikely to be accepted, say with a probability of 3%. The FASB approach would result in an additional liability of 100, the IASB approach would result in an additional liability of 97. However, as the probability of a claim being accepted approaches the recognition threshold, the difference between the IASB and FASB approaches becomes more substantial. Suppose a benefit of 100 is taken with a 65% chance of being accepted. The FASB approach would result in no benefit being recognized and, hence, an additional liability of 100. The IASB approach would result in a benefit of 65 being recognized and, hence, an additional liability of 35.

Measurement

26. Under the FASB approach, if the filed tax position is probable of being accepted, the benefit is measured at a single-point best estimate. Under the IASB approach, the benefit is measured at the probability weighted average of the expected outcomes (referred to hereafter as expected outcome). Consider an entity that claims a 100 deduction. A deduction of some amount is probable and the best estimate of the amount to be allowed is 90. The expected outcome for the amount to be allowed is 85. Under the FASB approach a benefit of 90 would be recognized, ie an additional liability of 10 would be recognized. However, under the IASB approach, a benefit of 85 and an additional liability of 15 would be recognised.

Disclosures

27. The Exposure Draft of amendments to IAS 37 proposes changes to the disclosures in IAS 12 relating to uncertainties surrounding tax balances. The proposed disclosures are:

88. An entity shall disclose the following information about the key estimation uncertainties relating to taxes:

- (a) a description of the uncertainty; and
- (b) an indication of its possible financial effects on amounts recognised for taxes and the timing of those effects.

88A. Estimation uncertainty may relate to both recognised and unrecognised tax assets and liabilities. The entity discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing (for example, the effects of unresolved disputes with the taxation authorities).

28. The FASB has considered these disclosures and decided not to include them in Statement 109. The FASB decided that disclosures should continue to be made in accordance with FASB Statement No. 5, *Accounting for Contingencies* and that uncertainty will be addressed by the use of a recognition threshold.

Staff analysis and conclusions

29. The staff notes below the arguments for and against the different approaches.

30. The arguments for the FASB benefit recognition model with a probability-based recognition threshold are:

- a. There would be a high level of confidence that previously recognized benefits represent tax positions for which the enterprise is “entitled” to, to a specific confidence level.
- b. The estimates and judgments would have greater verifiability. The weight of available evidence would be considered to determine if the

technical merits of the tax position are sufficient to meet the recognition criterion. Only outcomes that meet the recognition criterion would be considered for measurement.

31. The arguments for the IASB stand-ready liability approach with no recognition threshold are:

- a. All tax positions would be available for measurement, and there would be less potential for systematic overstatement of tax liabilities
- b. A threshold creates a cliff hanger effect and results in all items that do not meet the threshold to be treated alike, even though they may be different. For example, with such a threshold, a claimed deduction of 100 with a 1% chance of being accepted and a claimed deduction of 100 with a 65% chance of being accepted both result in the recognition of an additional liability of 100. Relevant information about the claimed deductions is lost.
- c. From an IASB perspective, a recognition threshold would be inconsistent with its thinking in the recent proposals to amend IAS 37. Imposing such a threshold could undermine those proposals.

32. In respect of measurement, the arguments for a single-point best estimate are:

- a. it is simpler and less complex to implement than an expected outcome approach and
- b. A single point best estimate would have greater verifiability than the multiple estimates needed under an expected outcome approach.
- c. The FASB staff has talked with income tax subject matter experts at Big 4 firms as well as several large preparer constituents who report under U.S. GAAP and IFRS. Many have expressed concern about the ability to implement an expected outcome approach for income tax contingencies. Given the recent implementation of internal control testing pursuant to the Sarbanes Oxley Act of 2002, significant concern was expressed about potential for regulator second-guessing.

33. The arguments for an expected outcome measurement are:
- a. It includes more information about the item being measured and
 - b. Unlike items are less likely to be measured at the same amount.
34. In respect of disclosures, the argument for the proposed IASB disclosures is, from an IASB perspective, that they are consistent with the general requirements for disclosures relating to uncertainties in IAS 1 *Presentation of Financial Statements*
35. The arguments against the proposed IASB disclosures are that, from an FASB perspective, the proposed disclosures add to the general requirements for disclosures relating to uncertainties in Statement 5.
36. [Not reproduced in Observer Notes.]
37. [Not reproduced in Observer Notes.]