



**International  
Accounting Standards  
Board**

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*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

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

## **INFORMATION FOR OBSERVERS**

**IASB Meeting: December 2005, London**

**Project: Short-term convergence: income taxes – sweep issues  
(Agenda Paper 5)**

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### **Introduction**

1. The staff has been drafting the amendments to IAS 12 arising from the short-term convergence project. During the drafting, two issues have arisen which the staff would like to discuss with the Board. In addition, we have received a number of letters commenting on the decisions made in the project. The staff wishes to raise the commentators' concerns with the Board.
2. The issues addressed in this paper are:

#### *Issues arising from drafting the amendments*

- (a) the treatment of assets and liabilities that have a tax base that differs from their initial carrying amount
- (b) the recognition of deferred tax assets and liabilities arising on the initial recognition of goodwill

#### *Concerns raised by commentators*

- (c) the allocation of tax to components of profit or loss and equity
  - (d) intra-group transfer of assets
3. The staff recommends:
- (a) extending to all assets and liabilities the Board's previous decision that assets acquired outside a business combination that have a tax base that differs from their initial carrying amount should be recognised at fair value assuming a tax base equal to fair value
  - (b) further extending that decision to all assets and liabilities that are remeasured at fair value and
  - (c) requiring deferred tax liabilities as well as deferred tax assets to be recognised for temporary differences arising on the initial recognition of goodwill.
4. If the Board agrees with these recommendations, the staff will raise them with the FASB.

**Assets and liabilities that have a tax base that differs from their initial carrying amount**

5. IAS 12 prohibits recognition of a deferred tax liability or deferred tax asset for temporary differences that arise from the initial recognition of an asset or liability in a transaction that:
- (a) is not a business combination, and
  - (b) at the time of the transaction affects neither accounting nor taxable profit.
6. Furthermore, IAS 12 states explicitly that an entity does not subsequently recognise changes in this unrecognised deferred tax asset or liability.
7. SFAS 109 does not provide this exception. The IASB and the FASB concluded that, in such cases, an asset should be recognised at *fair value assuming full deductibility for tax purposes*. The corresponding deferred tax

asset or liability should be recognised as the difference between the fair value of the asset and its tax base multiplied by the tax rate. Any difference between the consideration paid and the sum of the fair value of the asset and the recognised deferred tax amount is recognised as a purchase discount allowance on the deferred tax.

8. When the Boards discussed this issue, they considered only assets acquired outside a business combination. In a paper taken to the IASB in July 2005 on additional guidance on tax bases, the staff included examples which extended this approach to assets acquired within a business combination. The staff wishes to confirm with the Board that the principle established when considering assets acquired outside a business combination should apply to all assets and liabilities that have a tax base that differs from their initial carrying amount, ie to:
  - (a) liabilities acquired outside a business combination and
  - (b) assets and liabilities acquired within a business combination.
9. [Not reproduced in Observer Notes.]
10. [Not reproduced in Observer Notes.]
11. [Not reproduced in Observer Notes.]
12. The staff notes that at present often in a business combination assets are recognised at fair value assuming a tax base equal to fair value, because the assets traded in the market generally have a tax base equal to cost. However, clarifying the principle should help address some of the concerns that some constituents have raised with the temporary difference approach.
13. The staff therefore recommends that all assets and liabilities that have a tax base different to the amount at which they would initially be recognised should be recognised at fair value assuming a tax base equal to fair value.
14. Having established this principle for initial recognition, the staff would further extend it to all assets and liabilities that are remeasured at fair value, so that

they are remeasured at fair value assuming a tax base equal to fair value. [Not reproduced in Observer Notes.]

15. In summary, the staff recommends that on initial recognition and on remeasurement at fair value, the carrying amount of assets and liabilities should always be based on an assumption that the tax base equals the carrying amount. The effect of any difference between the tax base and carrying amount is then recognised as deferred tax. The staff would argue that this is a consistent approach that will make the temporary difference approach more transparent and acceptable.
16. However, the staff brings to the attention of the Board comments from a constituent against such an approach. That constituent argues that, by recognising an asset that has a tax base different from fair value at amount that assumes it has a tax base equal to fair value, unlike items are being treated as if they were alike. Further, in practice, often the fair value assuming a tax base equal to fair value will not be known. Entities will therefore simply gross up the asset for the tax amount determined by IAS 12. That means that the measurement errors inherent in the IAS 12 methodology (which is not fair value) will not be confined to the tax balances but will be spread across the balance sheet and the pre-tax figures in profit or loss (eg depreciation).
17. [Not reproduced in Observer Notes.]

**Recognition of deferred tax assets and liabilities on the initial recognition of goodwill**

18. Under the temporary difference approach, in principle, a deferred tax liability should be recognised on the initial recognition of goodwill if its tax base is below the carrying amount. Similarly, in principle, a deferred tax asset should be recognised on the initial recognition of goodwill if its tax base exceeds the carrying amount. In this project both the IASB and the FASB decided to continue with the existing requirements in IAS 12 and SFAS 109 prohibiting the recognition of deferred tax *liabilities* on the initial recognition of goodwill. However, in the business combination project, both Boards decided to clarify that a deferred tax *asset* should be recognised on initial recognition of

goodwill.<sup>1</sup> That clarification is a proposed consequential amendment to IAS 12 arising from the proposed amendments to IFRS 3.

19. [Not reproduced in Observer Notes.] The reasons that the IASB decided not to require recognition of deferred tax liabilities were:
- (a) the existing exception is already converged with US GAAP
  - (b) there are practical difficulties with tracking goodwill into perpetuity and
  - (c) often there may not be a difference between the tax base and the carrying amount, given that a tax deduction equal to the cost of the investment is usually available on the sale of the investment.

The staff is also aware of concerns that, because goodwill is a residual amount, calculating a deferred tax liability would be a never-ending reiterative process.

20. [Not reproduced in Observer Notes.]
21. [Not reproduced in Observer Notes.]
22. [Not reproduced in Observer Notes.]
23. [Not reproduced in Observer Notes.]
24. Requiring the recognition of a deferred tax liability for a taxable temporary difference arising on the initial recognition of goodwill would remove an exception from the temporary difference approach in IAS 12 and SFAS 109. One of the objectives of the income taxes convergence project has been to

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<sup>1</sup> The following examples were noted of situations when the tax base of goodwill may exceed the carrying amount:

- (a) The tax base of identifiable assets acquired and liabilities assumed as part of the business combination does not equal their fair values recognised as part of the business combination accounting;
- (b) Contra-asset accounts and/or liabilities are recognised for tax purposes that do not meet the definition of a liability and therefore are not separately recognised as part of the business combination accounting;
- (c) Taxation authorities provide extra tax deductions for goodwill to carry out governments policy of encouraging investment (for example, investments in goodwill might be given a tax deductibility of 150%).

eliminate as many as possible exceptions from the temporary difference, with the aim of making it more transparent. The staff recommends that the Board remove the prohibition in IAS 12 from recognising a deferred tax liability on the initial recognition of goodwill, consistent with its decision on the recognition of deferred tax assets in the Business Combinations project.

### **Allocation of tax to components of profit or loss and equity**

25. IAS 12 and SFAS 109 both include requirements on the allocation of tax to components of profit or loss and equity. The SFAS 109 requirements are more detailed. The two sets of requirements give the similar answers except in respect of changes in tax that was originally recognised in equity. Under IAS 12, those changes are also recognised in equity; under SFAS 109, they are recognised in profit or loss. The Boards agreed to converge on the SFAS 109 requirements, because they are more comprehensive than the IAS 12 requirements. In particular, SFAS 109:

- (a) specifies that continuing operations is the ‘control’ component. In other words, the tax on continuing operations is calculated first and the tax allocated to other components is the incremental effect compared to the tax on continuing operations
- (b) specifies the allocation of the incremental tax when there is more than one component other than continuing operations and
- (c) specifies the allocation of the tax effects of loss carryforwards and carrybacks.

IAS 12 is silent on these matters.

26. The Board has received many letters on this subject. [Not reproduced in Observer Notes.]
27. [Not reproduced in Observer Notes.] the staff has brought the letters to the Board’s attention to see whether the Board wishes to discuss the issue further. If so, the staff will liaise with the FASB staff and reconsider the issue.

### **Intra-group transfers of assets**

28. The Board has also received correspondence on its decision on intra-group transfers of assets. The letter has been posted to the internal website. An intercompany transfer of assets (such as the sale of inventory or depreciable assets) between tax jurisdictions is a taxable event that establishes a new tax base for those assets in the buyer's tax jurisdiction. The new tax base of those assets is deductible on the buyer's tax return as those assets are consumed or sold to an unrelated party. US GAAP requires taxes paid by the seller on intercompany profits to be deferred and prohibits the recognition of a deferred tax asset for the difference resulting from tax base differences between the jurisdictions. IAS 12 does not provide a similar exception. The Board decided not to amend IAS 12 to provide for this exception. The FASB has decided to amend SFAS 109 to eliminate this exception.
29. [Not reproduced in Observer Notes.] The staff has brought the letter to the Board's attention to see whether the Board wishes to discuss the issue further. If so, the staff will liaise with the FASB staff and reconsider the issue.