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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21-22 September 2006, London**
Project:	**Accounting Standards for Small and Medium-sized Entities**
Subject:	**Revised Draft of Section 29 Income Taxes of a Draft Exposure Draft of an IFRS for SMEs (Agenda Paper 15C)**

Background

1. In July, the staff explained a timing difference approach to accounting for income taxes in the IFRS for SMEs that it plans to develop and present to the Board in September. Staff noted that under that approach:

   - An SME would recognise current tax as a liability to the extent unpaid or as a receivable to the extent overpaid and recoverable.
   - An SME would recognise deferred tax on all income or expenses that are recognised in profit or loss or in equity in one period but, under tax laws or regulations, are included in taxable income in a different period.

2. The staff said that it will develop the income tax section of the IFRS for SMEs on the basis of this principle.

3. Board Agenda Paper 15C contains a draft of Section 29 *Income Taxes* that is completely rewritten from the previous draft of that Section discussed by the Board. The rewrite is based on the timing difference approach described in July. The glossary definitions related to income taxes are on the last page.

4. During August, staff invited Board members to comment informally on an early draft of Section 29. Three substantive issues arose as a result of those comments. Those issues are set out in this agenda paper for Board discussion in September.

Issues for Board consideration

Accounting for tax loss and tax credit carryforwards

5. The issue: Are tax loss carryforwards and tax credit carryforwards:

   View A. timing differences for which deferred taxes should be recognised like any other timing differences?

   View B. a separate category of items for which deferred taxes should be recognised?

   View C. items that are not timing differences and, for that reason, under a timing difference approach deferred taxes should not be recognised on them?

6. Section 29 defines timing differences as follows:

   > "Income or expenses that are recognised in profit or loss or in equity in one period but, under tax laws or regulations, are included in taxable income in a different period. Timing differences include tax losses and tax credits that, under the law, are available to offset taxable profit or tax payable in future periods."

7. The draft of Section 29 reflects View A. Staff believes that tax loss and tax credit carryforwards meet the definition of timing differences because they arise from items that are recognised for financial reporting purposes in a different (earlier) period than they enter into determination of taxable income. Recognition of deferred tax assets arising from such items would, of course, be subject to the "probable" threshold in paragraph 29.11(a):

   > "An entity shall recognise a deferred tax asset only to the extent that it is probable that there will be sufficient future taxable profit to enable recovery of the deferred tax asset."

8. Staff also supports View A because treating these as a separate category of items for which deferred taxes should be recognised (View B) would make the standard unnecessarily complicated and confusing for an SME – resulting in rules rather than a "timing-difference principle".

9. Those who favour View B believe that when the tax loss or credit carryforward arises there is uncertainty about whether it will enter into determination of future taxable income, and therefore they do not satisfy the definition of a timing difference. Nonetheless supporters of View B believe that deferred taxes should be recognised subject to a "probable" recovery threshold. They also point out that IAS 12 treats them as additions to temporary differences for which deferred taxes should be provided.

10. Like supporters of View B, those who favour View C believe tax loss and credit carryforwards do not meet the definition of a timing difference. However, unlike those who support View B, as a matter of principle, they would not recognise related deferred taxes.

Board decision requested: Does the Board support the staff view, reflected in paragraph 29.6, that tax loss carryforwards and tax credit carryforwards are timing differences for which deferred taxes should be recognised like any other timing differences?

Recognition of deferred taxes on book/tax basis differences that arise at initial recognition of an asset or liability

11. The issue: Should deferred taxes be recognised on book/tax basis differences that arise at initial recognition of an asset or liability (whether acquired in a business combination or in another transaction)?

12. Staff believes that deferred taxes should not be recognised in such cases, and this is reflected in paragraph 29.12 of Section 29:

> 29.12 In some jurisdictions, amounts that an entity initially recognises as the cost or other carrying amount of an asset or liability may differ from the amounts relating to that asset or liability that are expected to be deductible or includible in taxable income in future periods. Such differences are not timing differences, and a deferred tax asset or deferred tax liability shall not be recognised at the initial recognition of the asset or liability. For example, a deferred tax asset or liability is not recognised when the amount allocated to an asset acquired in a business combination is its fair value at the acquisition date, but the future tax deductibility is limited by law to the acquired entity's original cost basis.

13. The staff believes that such differences do not meet the definition of timing differences because the book/tax basis difference is not initiated by the recognition of an item in the income statement. Moreover, this approach relies on the notion of a tax basis and tax balance sheet which a timing difference approach does not. This would create the kind of administrative burden for an SME (required development of a tax balance sheet when none is required by local tax law) that the Board is trying to avoid by taking a timing difference approach rather than a temporary difference approach. So both as a matter of principle and practicality, staff proposes not to recognise such deferred taxes.

14. Those who would recognise deferred taxes that arise book/tax basis differences that arise at initial recognition of an asset or liability are concerned about anomalous consequences of non-recognition. For example, they note that non-recognition may increase the recognition of bargain purchases, which they view as an odd outcome.

Board decision requested: Does the Board support the staff view, reflected in paragraph 29.12, that deferred taxes should not be recognised on book/tax basis differences that arise at initial recognition of an asset or liability?

Recognition of deferred taxes on items of income and expense that are recognised in equity rather than in profit or loss.

15. The issue: Should deferred taxes be recognised on items of income and expense (such as changes in fair values of property, plant and equipment) that are recognised directly in equity, rather than in profit or loss?

16. Section 29 defines timing differences income or expenses that are recognised in profit or loss or in equity in one period but, under tax laws or regulations, are included in taxable income in a different period. The intent of the words "or in

equity" is to recognise that under the IFRS for SMEs changes in fair values of certain kinds of assets or liabilities meet the definitions of income or expense and are required or permitted to be recognised directly in equity, even though under tax laws such items will or may, at some point, enter into determination of taxable income.

17. The foregoing is illustrated in paragraph 29.10(a)(i), which notes that:

> A timing difference results in a deferred tax liability when income is taxable later than when it is recognised for financial reporting purposes. For example... an increase in the fair value of an asset is recognised in profit or loss or in equity, but that increase is taxable only when the asset is sold;

18. Paragraph 29.11(c) provides that:

> An entity shall recognise changes in a deferred tax liability or deferred tax asset directly in equity, rather than in profit or loss, if the income or expense that gave rise to the timing difference was recognised directly in equity.

19. The alternative view is that timing differences should be defined only with respect to accounting profit or loss because that is appropriate for comparison with taxable profit or loss.

Board decision requested: Does the Board support the staff view, reflected in paragraph 29.10(a)(i), that deferred taxes should be recognised on timing differences that arise on items of income and expense that are recognised directly in equity? In other words, the phrase "or in equity" should remain in the definition of timing difference.

Other matters?

20. Are there other issues Board members wish to raise regarding Section 29?

Notes for Observers

21. The revised draft of Section 29 in Agenda Paper 15C is part of an exposure draft (ED) that is not yet a public document. Accordingly, it is not available to observers. However, in August 2006 the IASB posted on its website a draft of the ED prepared by staff. Section 29 of that draft is a timing difference approach that is close to, but not identical to, the draft in Agenda Paper 15C. That draft can still be downloaded from the IASB's website.