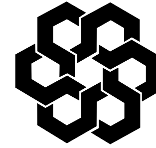

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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

INFORMATION FOR OBSERVERS

Board Meeting: **17 April 2007, London**

Project: **Short-term convergence income taxes**

Subject: **Goodwill, and assets and liabilities with a tax base that differs from initial carrying amount (Agenda Paper 3)**

Introduction

1. Last month the FASB discussed two issues in the short-term convergence project on income taxes on which the IASB made initial tentative decisions in December 2005. The issues are:

   (a) whether the existing exception to the temporary difference approach prohibiting the recognition of deferred tax liabilities on the initial recognition of goodwill should be removed and

   (b) the treatment of acquired assets and assumed liabilities which have a tax base different from their initial carrying amount, both in a business combination and outside a business combination.

2. On issue (a), the FASB decided to retain the current exception whereas the IASB had decided to remove the exception. On issue (b), the discussions with the FASB raised questions of how the previous IASB decision should be interpreted. The IASB staff understood one interpretation, some IASB Board

members understood another. The FASB decided on the interpretation made by those Board members.

3. This paper therefore brings the issues back to the IASB for reconsideration. The FASB memos discussing the issues are attached as Agenda Paper 3A and 3B and the minutes of its discussion as Agenda Paper 3C.[Agenda Papers 3A-C omitted from observer notes.] This paper gives some further IASB staff analysis.

4. The staff recommends:

   (a) keeping the existing exception in IAS 12 from the temporary difference approach that prohibits the recognition of deferred tax liabilities on the initial recognition of goodwill (ie reversing the IASB decision in December 2005) and

   (b) requiring an asset or liability that has a tax base different from its fair value on initial recognition to be disaggregated into (i) an asset or liability with a tax base equal to fair value and (ii) a tax advantage or disadvantage. The asset or liability would be recognised and measured in accordance with applicable IFRSs. IAS 12 would apply to any resulting temporary differences. The tax advantage or disadvantage on initial recognition outside a business combination would be measured as the difference between the purchase consideration and sum of the carrying amount of the asset or liability and any related deferred tax balances. The tax advantage or disadvantage on initial recognition in a business combination would form part of goodwill. (This is the same as the IASB staff interpretation of the IASB decision in December 2005, but expressed in different terms.)

Deferred tax liabilities on the initial recognition of goodwill

5. 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 (assuming that difference has taxable consequences). 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 the income taxes convergence project, both the IASB and the FASB originally 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. That clarification is a proposed consequential amendment to IAS 12 arising from the proposed amendments to IFRS 3.

6. In December 2005, the IASB staff argued for the recognition of a deferred tax liability for a taxable temporary difference arising on the initial recognition of goodwill. The staff noted that doing so would remove an exception from the temporary difference approach in IAS 12. One of the objectives of the income taxes convergence project has been to eliminate as many as possible exceptions from the temporary difference, with the aim of making it more transparent. The staff recommended 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.

7. The Board agreed with the staff recommendation but with the following caveats:

    (a) it did not wish to diverge with the FASB on this issue and

    (b) it noted that the proposal was linked to the full goodwill method in the business combinations project. If the Board did not proceed with the full goodwill method, it would want to reconsider the decision about deferred tax.

8. On considering this issue, the FASB staff set out the issues in paragraphs 26-44 of Agenda Paper 3A and Agenda Paper 3B. They recommended that the prohibition on recognition of a deferred tax liability on the initial recognition of goodwill should be retained. The FASB agreed with the FASB staff recommendation.

9. [Paragraph omitted from observer notes.]

10. [Paragraph omitted from observer notes.]

11. [Paragraph omitted from observer notes.]

12. [Paragraph omitted from observer notes.]

13. [Paragraph omitted from observer notes.]

14. [Paragraph omitted from observer notes.]

15. So, the IASB staff thinks the reasons for the IASB's original decision are still valid. However, the IASB caveats on that decision need to be considered. First, the FASB has decided to retain the existing exception. Second, in the redeliberations in the business combinations the IASB decided to change the focus from full goodwill to measuring the fair value of NCI, leaving goodwill as a residual. The Board also decided to allow an exception to measuring the NCI at fair value if it would impose undue cost or effort on the acquirer. In that case, the acquirer would measure the NCI at its proportional interest in the recognized net identifiable assets.

16. The staff notes that the arguments for removing the exception were founded on goodwill being an asset like any other, so the tax attributes of goodwill should be treated like the tax attributes of any other asset. However, if goodwill is measured as a residual and not like any other asset, this argument is weakened. Given the Board's discussions on goodwill in the business combination project and the aim to converge with the FASB, the staff recommends retaining the exception from the temporary difference approach prohibiting the recognition of a deferred tax liability on the initial recognition of goodwill.

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

17. 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.

18. Furthermore, IAS 12 states explicitly that an entity does not subsequently recognise changes in this unrecognised deferred tax asset or liability.

19. SFAS 109 does not provide this exception. In this project, 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 or premium on the deferred tax.

20. When the Boards discussed this issue, they considered only assets acquired outside a business combination. In December 2005, the IASB decided to extend the decision to recognise the asset at fair value assuming full deductibility for tax purposes to assumed liabilities and assets and liabilities acquired/assumed in a business combination.

21. In discussing the extension of the decision with the FASB, different interpretations of the meaning of *fair value assuming full deductibility for tax purposes* have emerged. The IASB staff has interpreted it as meaning *fair value assuming full deductibility for tax purposes* even when no participant in the market gets full deductibility. The FASB staff questioned whether instead it meant *fair value*, which would assume full deductibility for tax purposes if participants in the market would make such an assumption. That would generally be the case, but not always. The examples below illustrate the difference between the two views.

22. Example 1: Assume that an entity separately acquires a license for 150 in cash in a jurisdiction that limits the tax basis on all intangible assets to 100. The tax basis of this asset will be limited to 100 for all market participants. The fair value of this license in this jurisdiction is 150. *If* acquired in a tax jurisdiction

that did not limit the deductibility of the intangible asset, the fair value of the same license *would* be 200.

23. Example 2: Assume that a company pays 750 for a license in a transaction that is structured so that the acquirer assumes the tax basis of the seller. If the license was acquired in a typical transaction (for example, a direct purchase of the license from the regulator), then the entity would have paid 1,000 for the license (its fair value). There are no limits on the tax basis in this jurisdiction.

24. Example 3: Assume that a company pays 10,000 for a piece of equipment in a jurisdiction that grants a deduction equal to 150 percent of the purchase price for that specific type of equipment. If that same piece of equipment was purchased in a different jurisdiction that did not enhance its tax basis, its fair value would be 7,500. There are no restrictions on the deduction and the tax basis incentive transfers to all market participants.

25. The amount recorded[1] for the assets acquired in each of the examples under the two views is:

Examples / Views	**Fair value**	**Fair value assuming full deductibility for tax purposes**
Example 1	$150	$200
Example 2	$1,000	$1,000
Example 3	$10,000	$7,500

26. At the FASB meeting in January, the FASB decided that the requirement should be fair value. The arguments put to the FASB are set out in paragraphs 4-25 of Agenda Paper 3A.

[1] The amounts recorded would require other entries including those for the deferred tax effects which are not illustrated.

27. When the issue was discussed by the IASB in December 2005, the IASB staff intended the proposal to be *fair value assuming full deductibility for tax purposes*. The staff acknowledges that a measurement attribute of *fair value assuming full deductibility for tax purposes* sounds more complex than just fair value. The staff also acknowledges that Board members may have concerns about moving away from a pure fair value objective. However, the IASB staff has developed a different analysis for the issue, namely that this is a unit of account and display issue, rather than a question of measurement attribute, as follows.

28. The IASB staff argues that an entity that acquires an asset with a tax base different to fair value is acquiring two items, an asset with a 'normal' tax base and a tax advantage or disadvantage. So in example 1 above, the entity acquires a licence with a deduction equal to fair value and a tax disadvantage because it does not get deductions equal to fair value. The staff argues that the asset with a 'normal' tax base should be measured (and when appropriate remeasured) at fair value (subject to the discussion in paragraphs 37-38 below). IAS 12 would apply to any resulting temporary difference. The tax advantage or disadvantage on initial recognition outside a business combination would be measured as the difference between the purchase consideration and sum of the carrying amount of the asset or liability and any related deferred tax balances.[2] That approach achieves a consistent display of assets and tax effects.

29. An approach that does not disaggregate assets in this way means that assets with identical operating capacities but with different tax attributes would be recognised at different carrying amounts. So, in example 1 above, the licence bought in the jurisdiction with the limit on tax deductibility would be recognised at 150, but if bought in a jurisdiction with no such limit would be recognised at 200. But the operational capacity of the licence is the same in each case.

---

[2] The tax advantage or disadvantage on initial recognition in a business combination would not be measured directly and would form part of goodwill.

30. Such an approach also raises the problem that, if the market assumption is of a tax base different to fair value, the effect of that difference is recognised twice. It is in the carrying amount of the asset at fair value and in the deferred tax balance, as illustrated below.

31. Again consider example 1 above and assume the applicable tax rate is 30%. If the asset is not disaggregated into an asset with a tax base equal to fair value and a tax disadvantage, but instead treated as one asset, it will be recognised at its fair value of 150. A temporary difference of 50 arises and a deferred tax liability of 15 is recognised. But the fair value of the single non-disaggregated asset of 150 already reflects the fact that the tax base is only 100. Recognising a deferred tax liability of 15 because the tax base is only 100 double counts the effect of the temporary difference.

32. Now, in an asset purchase this problem is resolved by the recognition of a purchase discount allowance to bring the total amounts recognised back to the purchase consideration of 150. That purchase discount allowance of 15 is included in the deferred tax balance, reducing it to nil. The effect of the temporary difference is left in the carrying amount of the asset at 150. As noted above, the same licence bought in a jurisdiction that gave a full tax deduction would be recognised at 200.

33. Further, in a business combination, we are not proposing that a purchase discount allowance should be calculated. There is no separate purchase consideration for the asset so there is no direct comparison that can be made between the amount paid and the sum of carrying amount of the asset and the deferred tax balance. So in the above example the asset would be recognised at 150 and a deferred tax liability would be recognised of 15. The fact that the temporary difference is recognised twice in those amounts will impact goodwill.

34. Another problem arises if this approach is applied to remeasurements at fair value. Assume an asset has a tax base of nil for all participants in the market. Assume its fair value is 50 and the fair value it would have if its tax base equalled fair value is 71. Assume a year later its fair value has increased to 150 and the fair value it would have if its tax base equalled fair value has

increased to 214. The tables below show the remeasurements that would arise under a fair value approach and an approach using fair value assuming the tax base equalled fair value.

Fair value

	Initial carrying amount	Remeasured carrying amount	Remeasurement
Asset	50	150	100
Deferred tax liability	(15)	(45)	(30)
Purchase discount allowance	15	15	0
Total	50	120	70

Fair value assuming the tax base equals fair value

	Initial carrying amount	Remeasured carrying amount	Remeasurement
Asset[3]	71	214	143
Deferred tax liability	(21)	(64)	(43)
Purchase discount allowance	0	0	0
Total	50	150	100

35. Under the fair value approach the total remeasurement of 70 is understated because the increase in the temporary difference is recognised twice in the remeasured amounts, once in the carrying amount of the asset and again in the deferred tax liability. [Paragraph omitted from observer notes.]

36. All these problems can be avoided by disaggregating the asset acquired into an asset with a tax base equal to fair value and a tax advantage/disadvantage. Doing so allows the non-tax attributes of the asset to be presented consistently with other assets and avoids double-counting any tax effects. The staff therefore recommends such a disaggregation.

[3] For simplicity the staff has assumed fair values assuming full deductibility that do not give rise to a purchase discount allowance. In practice, a purchase discount allowance could still arise under this approach because the measurement attribute under IAS 12 is not fair value. But under this approach a purchase discount allowance will never be needed to counter the effect of double counting the temporary difference.

Inadvertent extension of a fair value measurement requirement

37. In considering this issue, the staff has become aware of another question. The original decision was that assets with a tax base different to their initial carrying amount should be recognised at fair value or fair value assuming full deductibility. That decision was extended to liabilities. But under IFRSs, not all assets and liabilities are initially recognised at fair value. For example, some are recognised at cost, others at fair value less transactions costs and others under IAS 37 are recognised at settlement value.

38. The staff does not think that the income taxes project is the place to impose fair value measurement on assets and liabilities that would not otherwise be required to measured at fair value. The objective of these proposals was only to deal with the 'abnormal' tax attributes of the assets and liabilities in question.

39. The staff therefore recommends that the proposal be worded so that an asset or liability with a tax base different from fair value should be disaggregated into an asset or liability with a tax base equal to fair value and a tax advantage or disadvantage. The asset or liability would be recognised and measured *in accordance with applicable IFRSs*, and IAS 12 would apply to any resulting temporary differences. The tax advantage or disadvantage on initial recognition outside a business combination would be measured as the difference between the purchase consideration and sum of the carrying amount of the asset or liability and any related deferred tax balances. The tax advantage or disadvantage on initial recognition in a business combination would form part of goodwill.

40. Doing this pulls out the 'abnormal' tax attributes and deals with them separately but does not change the measurement requirements for the non-tax attributes of the asset or liability in question.

Extent of divergence

41. The IASB staff acknowledges that the FASB does not agree with this recommendation. Divergence is clearly undesirable. However, the IASB staff notes that the divergence is limited to assets and liabilities for which market

participants do not get a tax base equal to fair value. This is a relatively rare situation. The staff also notes that proposing a divergence in an exposure draft, and asking a question, allows respondents to give opinions on both views. Doing so may provoke information which will enable the Boards to agree on a converged treatment for the final standard.