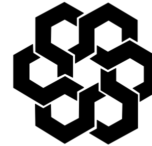

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

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: **23 January 2007, London**

Project: **Business Combinations II**

Subject: **Income Taxes (Agenda paper 2E)**

INTRODUCTION

1. The purpose of this memo is to ask the Boards to consider certain aspects of the accounting for income taxes in a business combination. The Boards first addressed the accounting for income taxes in a business combination in their joint acquisition method project. The basic approach in that project was to retain the existing guidance for accounting for income taxes in a business combination. However, the Boards proposed limited amendments to Statement 109 and IAS 12 to further converge those standards and to make those standards more consistent with the business combinations principles. Those amendments were exposed for comments in the Business Combinations Exposure Draft (BC ED).

2. The Boards also addressed other issues related to the accounting for income taxes in a business combination as part of their convergence income tax project. Those issues arose from the IASB's consideration of changes that potentially could simplify or improve the income tax guidance in IAS 12. For purposes of the FASB's January 2007 meetings, the staff plans to discuss the

issues in this memorandum and the issues in the convergence income tax project team's FASB-only Memorandum 17 together, rather than discussing them separately within the business combinations and convergence income tax projects. After the Boards conclude on the all the issues raised in the two projects the staff will assess whether the decisions would require exposure in the income tax convergence project or if they would be included in the final business combination standard.

Overview of the Current and Proposed Guidance

3. The proposed accounting for income taxes requires an approach that is similar to the existing requirements in Statement 141 and IFRS 3. Under those requirements, deferred taxes are an exception to the fair value measurement principle. Statement 141 and IFRS 3 require an acquirer to recognize and measure deferred tax assets and liabilities using the income tax guidance in Statement 109 and IAS 12. The basic principles of Statement 109 and IAS 12 require recognition of deferred tax assets and liabilities for all taxable and deductible temporary differences. An exception to this basic principle prohibits the recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes.

4. Limited amendments to Statement 109 and IAS 12 were proposed in the BC ED to address the following areas:

a. Changes in the **acquirer's** deferred tax assets and liabilities that occur because of the acquisition (proposed amendments to Statement 109 to be consistent with IAS 12)
b. Recognition of acquired deferred tax benefits subsequent to the business combination (proposed amendments to both Statement 109 and IAS 12)

5. Some respondents to the BC ED also suggest that the Boards consider:

a. Whether the changes proposed for subsequent recognition of acquired deferred tax benefits should be extended to changes in acquired tax uncertainties subsequent to the acquisition
b. Whether an exception to the recognition requirements for deferred taxes should be added to Statement 109 and IAS 12 for taxable and deductible temporary differences related to indefinite lived intangible assets.

6. This memo is divided into five issues:

Issue 1: Whether to affirm an exception to the fair value measurement principle for assets and liabilities for income taxes

Issue 2: Whether to affirm that changes in the **acquirer's** deferred tax assets that occur because of the acquisition should be accounted for separate from the acquisition accounting

Issue 3: Whether the recognition of acquired deferred tax benefits subsequent to the acquisition should be accounted for as adjustments to goodwill or recognized in income (in U.S. GAAP, the recognition of deferred tax benefits are referred to as decreases in the acquiree's valuation allowance)

Issue 4: Whether changes to uncertainties for acquired tax positions subsequent to an acquisition should be accounted for as adjustments to goodwill or recognized in income

Issue 5: Whether an exception to the recognition requirements for deferred taxes should be added to Statement 109 and IAS 12 for taxable and deductible temporary differences related to indefinite-lived intangible assets.

Within each issue, this memo summarizes the current and proposed guidance, discusses comments received on the proposed guidance, and recommends that the Boards affirm the proposed accounting with some clarifications. A summary of the staff's recommendations is included at the end of this memorandum.

ISSUE 1: MEASUREMENT EXCEPTION FOR DEFERRED INCOME TAXES

7. Statement 141 and IFRS 3 currently require that income tax assets and liabilities in a business combination be measured in accordance with existing income tax guidance in Statement 109 and IAS 12, respectively, rather than at fair value. The proposal by both Boards in the BC ED is to retain that exception, primarily because of the complexities that would arise in periods subsequent to the acquisition under the temporary difference approach for income tax accounting. That is, if the Boards required acquired deferred tax assets and liabilities to be measured at fair value as of the acquisition date, their subsequent measurement in accordance with the income tax guidance would result in postcombination gains or losses without any change in the underlying economic circumstances. To overcome that result, the Boards would have to comprehensively consider the income tax guidance and

develop subsequent accounting guidance for acquired deferred tax assets and liabilities. The Boards concluded that the benefits of applying the BC ED's fair value measurement principle are not sufficient to warrant the costs and complexities that would cause.

8. *[Paragraph omitted from observer note]*

Issue 1 Staff Recommendation

9. The staff recommends that the Boards affirm their decision to require that income taxes be accounted for in accordance with the guidance in Statement 109 (and related interpretive guidance) and IAS 12, as amended by the forthcoming final BC Statement.

ISSUE 2: CHANGES TO THE *ACQUIRER'S* DEFERRED TAXES BECAUSE OF THE BUSINESS COMBINATION

Current Requirements

10. IAS 12 and Statement 109 presently require different accounting for changes to the **acquirer's** deferred taxes because of a business combination. IAS 12 requires the acquirer to recognize separately from the business combination accounting any changes in its deferred tax assets that become recognizable because of the business combination. Such changes are recognized in postcombination *profit and loss or equity.* Statement 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the *acquirer's* valuation allowance) that results from a business combination to be accounted for *as part of the business combination,* generally as an adjustment of goodwill.

Proposed Requirements

11. The BC ED proposes that an acquirer recognize any changes in the *acquirer's* deferred tax benefits as a transaction separately from the business combination. The BC ED proposes to amend Statement 109 to require such changes (that is, changes in the acquirer's previously recognized valuation allowance) be recognized either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances.

12. The FASB BC ED's basis for conclusions observes that, for practical reasons, the FASB limited its consideration of this issue to the existing alternatives prescribed by Statement 109 and IAS 12, rather than requiring an assessment of whether a change in the acquirer's deferred taxes are part of the business combination. FASB members acknowledged that the existing requirements in Statement 109 and IAS 12 are both defensible on conceptual grounds. They also observed that neither alternative is entirely consistent with the requirements in the BC ED because both alternatives (retaining Statement 109 or adopting the approach in IAS 12) remove the judgment that is required in assessing whether other assets or liabilities are part of the business combination. Some FASB Board members prefer that an acquirer recognize any changes in *its* deferred tax benefits:

a. As a transaction separately from the business combination. Those members prefer that approach because it is consistent with the business combinations model of excluding the effects that are not part of the exchange. That is, the change in the acquirer's circumstances upon a business combination should be accounted for as a separate event.

b. As part of the business combination accounting. Those members prefer that approach because it would emphasize consistency with the Statement 109 model. They view the business combination as the triggering event for the recognition of the change.

13. The FASB considered whether to amend Statement 109 to converge with the approach in IAS 12. Given that both approaches have conceptual merit, the reasons that the FASB supported the exclusion of the acquirer's changes from the business combination are as follows:

a. The acquirer's deferred tax asset is an attribute of the **acquirer** rather than the **acquiree**.

b. The benefits of converging to the IAS 12 alternative outweigh the costs related to a change in the accounting in accordance with Statement 109.

Question 17 in the Notice/Introduction asked respondents whether they agreed with this proposal.

Comments Received

14. Respondents' views on this issue were generally supportive. The reasons given are consistent with the business combinations model for identifying the components of a business combination. The guidance for identifying the components was recently affirmed and clarified by the Boards at their July 2006 meetings. In July 2006, the Boards affirmed that the acquirer should assess whether the business combination includes any transactions that are substantively separate from the business combination. They also clarified that only the consideration transferred and the assets acquired or liabilities assumed **that make up the acquiree** should be accounted for using the acquisition method. Other transactions should be accounted for separately in accordance with other IFRS/U.S. GAAP. Changes in the *acquirer's* deferred tax benefits that result from the acquisition are not part of the assets acquired from the acquiree.

15. The majority of respondents commented that the requirement in the BC ED seems like a logical extension of excluding effects that are not part of the exchange from the accounting for the business combination. Those respondents agree with the Boards' rationale that the acquirer's tax benefits are not part of the fair value of the acquiree and should not be included as part of the business combination. Additionally, respondents support the proposed (or, in the case of the IASB, the required) accounting because it is consistent with the accounting for other "acquirer effects." For example, the Technical Issues Committee of the AICPA's Private Companies Practice Session Executive Committee (CL #116) stated:

> There are various effects of the acquiree on the acquirer (i.e., restructuring, synergies, etc.) that are accounted for separately from the business combination.

16. Respondents that disagree with the Boards' conclusion do so because they believe that an acquirer's tax synergies are factored into the price that the

acquirer is willing to pay and, therefore, constitute goodwill. Some respondents essentially view the changes to the acquirer's deferred taxes that occur because of a business combination as a reduction in the amount of capital invested in the acquiree (or as part of the investment). Additionally, some respondents view the acquirer's ability to utilize its deductible temporary differences or carryforwards as a result of the business combination as being the same as other synergies. For example, Eastman Kodak Company (CL#84) wrote:

> There are many synergies that are acquired as a part of the acquisition of another business. The separation of this particular synergy from business combination accounting is inconsistent with the accounting for other synergies acquired. It should also be noted that one of the few exceptions to the proposed business combination model relates to Statement 109. It seems inconsistent to continue to apply most of the concepts of Statement 109 while choosing to ignore others . . . business combinations usually are effected to take advantage of a large number of potential synergies. These synergies can result from economies of scale, enhancing a particular business process for which a competitor (acquired) excels, or for tax benefits. These synergies are the very definition of theoretical goodwill. To exclude one motivating benefit from business combination accounting, while retaining others, seems inappropriate to us.

17. Because those respondents believe that the acquirer would pay more for the acquiree in order to utilize its own deferred tax assets, some raise concerns about the potential for double counting (once in the consideration and a second time by recognizing the income or expense for the acquirer's changes as a result of the business combination). Others have concerns about impairment difficulties.

18. *[Paragraph omitted from observer note]*

19. In its prior deliberations on this issue, the staff and Boards considered concerns about double-counting and the relationship with impairment. The Boards considered which party receives the majority of benefits from the acquirer's ability to realize its own deferred tax asset and what portion (if any)

of those benefits would be reflected in the consideration transferred for the acquiree. Prior Board materials stated:

> There is a range of potential scenarios on who receives the *primary benefits.* At one end of the range, the acquirer (or combined entity) might receive substantially all of the benefits; whereas, at the other end of the range, the acquiree (or former shareholders of the acquiree) might receive substantially all of the benefits. Moreover, while the reasons for entering into the business combination transaction are known to an entity and its managers, they are not necessarily observable except in the extremes; thus, it may be problematic for auditors and others to judge whether and how much of the total consideration paid is paid for reasons other than to acquire the business. [February 16, 2005 FASB Board Meeting Business Combinations Memo 1 of 5, page 28]

20. The Boards also considered the effect of expected tax synergies and observed that a buyer would not knowingly "overpay" for the acquiree. To the extent that the utilization of tax benefits is unique to the acquirer, the acquirer would not pay for those benefits. Rather, rational economic behavior would suggest that the buyer would be willing to pay only $1 more than its competing bidders. Information about the price that competing bidders are willing to pay may not be available. However, unless competing acquirers have the same type and amount of unrecognized deferred tax benefits from deductible temporary differences or tax loss carryforwards, the consideration paid may include none or a small portion of the expected benefits from those tax synergies.

21. Additionally, some of those that disagree with the Boards' conclusion did so because of the direct and integral relationship between the realization of the acquirer's deferred taxes and the business combination. They commented that the acquirer's DTAs become valuable solely as a result of the acquisition and view the acquisition as the triggering event for recognition of a change. The staff believes that those comments support the conceptual merit of the current approach in Statement 109, but the IAS 12 approach also has conceptual merit. Because both approaches require that all changes be accounted for similarly, the staff continues to believe that the benefits of

converging to the IAS 12 alternative outweigh the costs related to changing the accounting in Statement 109.

Issue 2 Staff Recommendation

22. *[Paragraph omitted from observer note]*

23. *[Sentence omitted form observer note]*. [The] staff recommends that the Boards affirm their decision to require that the acquirer recognize separately from the business combination accounting any changes in its deferred tax assets because of the business combination. Such changes would be recognized in postcombination *profit and loss or equity.*

ISSUE 3: CHANGES TO THE ACQUIRED DEFERRED TAX BENEFITS AFTER THE BUSINESS COMBINATION

Current Requirements

24. Below is a summary of the requirements for accounting for the acquired deferred income taxes. Tax uncertainties are addressed separately in Issue 4.

	Statement 109	**IAS 12**	**Similarities and Differences**
Initial Recognition			
An acquiree's deductible temporary differences or operating loss or tax credit carryforwards	Recognize a deferred tax asset (the full potential benefit)	Recognize a deferred tax asset to the extent that realization is probable (meaning more likely than not).	Statement 109 and IAS 12 are similar in that a deferred tax asset (net of a valuation allowance) is recognized if it meets the specified level of realization. Statement 109 and IAS 12 are different in that:
Tax benefits that may not be realized	Recognize a valuation allowance to the extent that the deferred tax assets are *not* more likely than not to be realized (i.e., the acquirer would recognize an allowance for the portion of the deferred tax asset that are less than		a. Theoretically, if realization is 50% probable, then Statement 109 and IAS 12 are different and b. Statement 109 requires gross recognition of a deferred tax asset with the realizability recognized in a valuation allowance, whereas IAS 12 is based on net recognition of realizable deferred tax assets. The IASB agreed to move to the Statement 109 valuation

	50% likely to be realized).		allowance approach as part of the Convergence Income Taxes project.

Subsequent Recognition			
Acquired tax benefits that are recognized after the acquisition	Recognize by reversing all or a portion of the valuation allowance and applying the resulting credit first to reduce to zero any goodwill related to the acquisition, second to reduce to zero other noncurrent intangible assets related to the acquisition, and third to reduce income tax expense.	Recognize a deferred tax asset. If the potential benefit of the acquiree's income tax loss carry-forwards or other deferred tax assets did not satisfy the criteria for separate recognition when a business combination is initially accounted for but is subsequently recognized, IAS 12 requires the acquirer to: . Recognize the resulting deferred tax **income** in profit or loss. . Reduce the carrying amount of goodwill to the amount that would have been recognized if the deferred tax asset had been recognized as an identifiable asset from the acquisition date (limited to zero). . Recognize the reduction in the carrying amount of goodwill as an **expense**.	Statement 109 and IAS 12 are similar in that the subsequent recognition of the acquired tax benefits reduces goodwill. Statement 109 and IAS 12 are different in that IAS 12 (a) does not permit the reduction of other noncurrent intangible assets and (b) IAS 12 requires the recognition of offsetting income and expense in the acquirer's profit and loss.

Proposed Requirements

25. The BC ED proposes to amend paragraph 68 of IAS 12 and paragraph 30 of Statement 109 to:

a. Include a rebuttable presumption that acquired deferred tax benefits recognized within one year from the acquisition date be recognized as an adjustment to goodwill until goodwill is reduced to zero.

b. Require acquired deferred tax benefits recognized after one year from the acquisition date be recognized in income, rather than as an adjustment to goodwill.

Comments Received

26. Few respondents addressed this issue and the responses received were mixed. Those that disagree with the proposal support reducing goodwill indefinitely because deferred tax assets are not measured at fair value. For example, KPMG (CL #88) stated that:

> We propose to apply consistent accounting for all changes of the acquiree's valuation allowance regardless of whether the changes occur before or after the measurement period. As a result, changes would be accounted for as part of the business combination rather than post combination gains or losses. Consequently, we disagree with the amendments proposed to paragraph 30 of Statement 109 and to paragraph 68 of IAS 12, whereby future changes to the valuation allowance subsequent to a one-year period after the acquisition date would be recognized in income, rather than as an adjustment to goodwill. **Since deferred tax assets are not measured at fair value, we believe future reductions in the valuation allowance, including those that occur after a one-year period, should be applied first to reduce goodwill to zero before being recognized in income tax expense**. [Emphasis added.]

27. *[Paragraph omitted from observer note]*

28. Other respondents support ending the indefinite reduction of goodwill and believe that, conceptually, changes in estimates pertaining to deferred taxes recognized in a business combination should be the same as other revisions to the amounts recorded at acquisition.

29. Because of the limited responses to this issue, the staff solicited additional feedback from resource group members. Some agreed and some

disagreed with the Boards' proposal. Those resource group members who agreed with the Boards' proposal did so because:

a. Changes often relate to postcombination results. Changes in estimates that occur after the business combination often relate more to conditions that emerge after the combination and, therefore, should be correlated with the postcombination operating results.
b. Goodwill recognized at the acquisition date would not reflect the full undiscounted amount of the tax attribute. While it may be true that the acquirer "paid something" for the acquired tax benefits (such as net operating losses of the acquiree), it is particularly unclear how much the acquirer paid for them in a scenario where it was not more likely than not that it could use them at the time it did the deal. An acquirer certainly would not pay the full undiscounted amount of the attribute.

Additionally, resource group members observed that eliminating the ongoing adjustment of goodwill simplifies the application of Statement 109 in this area—it alleviates intra-period allocation issues and avoids potential issues about what to do if goodwill is partially or fully impaired prior to reducing a valuation allowance.

30. Those resource group members who disagreed did so primarily because they believe that the requirements for income taxes result in a measure that is drastically different than fair value. They view the indefinite adjustment to goodwill as a "true-up" of the estimate, based on what actually comes to fruition. They view income taxes as a significant area of judgment and have concerns that small changes in judgment could have significant and unrepresentative impact to income in future periods.

31. *[Paragraph omitted from observer note]*

Issue 3: Other Comments Raised

Clarification about the Length of the Period of Adjustment

32. The BC ED proposal included a rebuttable presumption that acquired deferred tax benefits recognized within one year from the acquisition date (that is, decreases to the valuation allowance within one year from the acquisition date) would be recognized as an adjustment to goodwill. Mittal Steel USA (CL #86) suggests that instead of a fixed one-year limit for adjustments, adjustments to the recognized acquired deferred tax benefits should be subject to the measurement period described in the BC ED:

With respect to the subsequent adjustments to the valuation allowance, I agree with the Exposure Draft ending the indefinite reduction of goodwill when tax benefits are recognized, but I do not understand the one-year limit. Shouldn't adjustments occur only during the measurement period? Why would this time-frame be different than for other adjustments? Conceptually changes in estimates pertaining to deferred taxes recognized in a business combination should be the same as other revisions to the amounts recorded at acquisition. If the Board retains the one-year adjustment period, it should clarify if this means one calendar year or within the fiscal year of the acquirer following the year of acquisition. I advocate the latter.

33. *[Paragraph omitted from observer note]*

Clarification about Whether Adjustments to Goodwill Should Be Both Increases and Decreases and Whether a Rebuttable Presumption Is Necessary

34. Resource group members also observed that the existing guidance (in paragraph 30 of Statement 109 and in paragraph 68 of IAS 12) is one directional—it only requires *reductions* of goodwill for subsequent recognition of acquired deferred tax benefits. In the BC ED, the requirements were carried forward from existing guidance in both IAS 12 and Statement 109 and are also one directional. Some resource group members view the one-directional adjustment as an anti-abuse provision that should be removed from GAAP.

35. Under the improvement notion in this project, the staff agrees with the suggestion that the one-directional adjustment bias should be removed and believes that *all* changes in the amount of acquired deferred tax benefits should be accounted for consistently. Under that approach, the acquirer would consider facts and circumstances that exist at the acquisition date to determine a provisional value for the portion of deferred tax assets that are more likely than not to be realized. Then, if within the measurement period, as defined by the BC ED, the acquirer discovers additional information about facts and circumstances that existed *at* the acquisition date and those facts substantiate additional acquired deferred tax benefits that have a similar pattern of realizability, increases in the valuation allowance would be offset by adjustments to goodwill. Another example that might result in an increase in the expectation of the realizability of the acquired deferred tax benefits is a

change in judgment. Contrary to the first example, changes in judgment about the realizability would likely stem from subsequent events (as opposed to facts and circumstances that exist at the acquisition date). In those circumstances, adjustments should be recognized in income, rather than as a measurement period adjustment.

36. As with the analysis of Issue 2, changes in circumstances could cause a change that either increases or decreases the amount needed for a valuation allowance (or the amount that meets the recognition criteria). Therefore, to eliminate the directional bias, the staff suggests that the measurement period guidance be applied to both increases and decreases in acquired deferred tax benefits.

37. A rebuttable presumption was included in the BC ED that required that recognition of acquired deferred tax benefits within one year should be applied to goodwill. Basically, that presumption would be overcome if the recognition of those benefits related to subsequent and unforeseeable events. If the rebuttable presumption was overcome, the recognition of acquired deferred tax benefits recognized within one year from the acquisition date would be recognized as income.

38. The rebuttable presumption reduces the complexity of application because it establishes a higher threshold for analysis. It also could be viewed as a mechanism to prevent abuses (e.g., establishing an inflated valuation allowance (or not recognizing all acquired deferred tax benefits so that subsequent income can be reported). However, requiring a rebuttable presumption would make the requirements for adjustments to deferred tax assets and liabilities different from any other acquired asset or liability. In other words, if there was no rebuttable presumption, the acquirer would be required to assess whether any change was a result of facts and circumstances that exist at the acquisition date. There is no rebuttable presumption for other assets and liabilities for which the measurement period applies.

39. The identified alternatives for addressing whether there should be a rebuttable presumption are: (a) remove the rebuttable presumption and

require that the measurement period guidance apply to all acquired assets and liabilities, (b) retain the rebuttable presumption that recognized acquired deferred tax benefits and decreases in the recognized acquired deferred tax benefits should be adjustments to goodwill, or (c) retain the rebuttable presumption that recognized acquired deferred tax benefits should be adjustments to goodwill and add a rebuttable presumption that decreases in the recognized acquired deferred tax benefits (that is, increases in the valuation allowance) should be adjustments to income. Alternative A is consistent with the established requirements for all other subsequent adjustments to acquired assets and liabilities in a business combination. Alternatives B and C are operationally easier to implement because analysis would only be required to rebut the presumption. Within the measurement period, Alternative C is consistent with the abuse prevention notion that is currently in Statement 109 and IAS 12—preventing the recognition of income in future periods by reversing inflated valuation allowances.

Issue 3 Staff Recommendation

40. The staff recommends that the Boards affirm the guidance in the BC ED, with slight modification (shown below), to amend paragraph 68 of IAS 12 and paragraph 30 of Statement 109 to:

a. ~~Include a rebuttable presumption~~ Require that qualifying measurement period adjustments (both increases and decreases) in the acquired deferred tax benefits recognized within ~~one year from the acquisition date~~ the measurement period be recognized as ~~an~~ adjustments to goodwill (~~until~~ increases in the acquired deferred tax benefits recognized would be limited to reducing goodwill ~~is reduced~~ to zero).

b. Require that other changes in the acquired deferred tax benefits ~~one year from the acquisition date~~ be recognized in income, rather than as an adjustment to goodwill.

ISSUE 4: CHANGES TO TAX UNCERTAINTIES AFTER THE BUSINESS COMBINATION

Similarity between Adjustments to Valuation Allowances and Tax Contingencies

41. Based on the feedback from resource group members, subsequent adjustments to the amounts recognized for acquired deferred tax benefits are

similar to adjustments for other types of tax uncertainties. That assertion is further supported in the context of U.S. GAAP by the EITF's conclusion in Issue 93-7 to use the same model for tax uncertainties as is required for acquired deferred tax benefits.

42. Even respondents that disagreed about the Boards' proposal for the subsequent recognition of acquired deferred tax benefits seem to agree that the same accounting should apply to other types of tax uncertainties. For example, Mindthegaap (CL #57), who recommended adjusting goodwill indefinitely, stated that:

> In our view, valuation allowances for deferred tax assets are of the same ilk as provisions for other types of tax contingencies. Consequently, the same accounting should apply in both cases.

43. Feedback from some resource group members also dubbed income tax uncertainties for acquired temporary differences as a "close cousin" to the subsequent recognition of acquired deferred tax benefits. Those members believe that the model for subsequent adjustments to income tax uncertainties should be approached the same way as changes in the assessment about the realizability of acquired deferred tax assets—goodwill should only be adjusted for information that relates to the assets acquired and liabilities assumed as of the acquisition date. Other resource group members supported retaining indefinite adjustments to goodwill for both changes in the assessment about the realizability of acquired deferred tax assets and changes in income tax uncertainties.

44. Some resource group members believe that some constituents will be concerned that this approach will permit entities to over-accrue tax reserves in the acquisition accounting. Those padded reserves could then be reduced in later years to generate "income." However, those resource group members rejected retaining the current approach to prevent that abuse. Those members suggested that for U.S. GAAP purposes, the Interpretation 48 disclosure requirements will serve as a strong counterbalance to this potential area of abuse. The Boards considered this abuse potential because it relates to the subsequent recognition of acquired deferred tax benefits, but rejected

establishing a different accounting approach in an attempt to prevent potential abuses.

Accounting for Tax Uncertainties

45. The FASB issued Interpretation 48 in June 2006. That Interpretation describes recognition and measurement requirements that are different from those that the IASB plans to propose as part of the Convergence Income Taxes project. Therefore, the discussion of the current requirements and staff recommendation is divided into two parts—one for the FASB (paragraphs 46–52) and the other for the IASB (paragraphs 53–59).

[Paragraphs 46-52 omitted from observer note because they address matters relevant only to the FASB.]

Issue 4 for IASB Members

Current Requirements (IASB)

53. IAS 12 requires that an entity recognize a deferred tax asset in a business combination "to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized." IAS 12 does not address how to account for uncertainty that could exist in the amount of the underlying deferred tax balances.

Proposed Requirements in the BC ED and Convergence Income Taxes (IASB)

54. Paragraphs 35 and 36 of the BC ED would require the acquirer to recognize assets and liabilities arising from contingencies at their acquisition date fair value. After initial recognition, assets arising from contingencies would be accounted for in accordance with IAS 38, *Intangible Assets,* or IAS 39, as appropriate, and liabilities arising from contingencies would be accounted for in accordance with IAS 37 or other IFRSs, as appropriate. Assets and liabilities arising from contingencies would be subject to the measurement period requirements proposed in the BC ED, such that qualifying adjustments to those assets and liabilities within the measurement period would be recognized as adjustments to the acquisition accounting (generally an offset to goodwill). If not addressed by the IASB, some might interpret those contingency requirements to apply to tax contingencies.

55. The IASB also made the following decisions about uncertain tax positions, which it plans to include in its forthcoming Exposure Draft on Convergence Income Taxes:

Current Tax:

a. The entity has a stand-ready liability to pay, but the amount is uncertain.

b. Consistent with the approach in the proposed amendments to IAS 37 on recognition, no probability threshold should be applied to the recognition of the stand-ready liability.

c. Rather than adopting an IAS 37 settlement value measurement objective within the constraints of the objectives of IAS 12, the IASB decided on an expected outcome measure (i.e., the probability weighted average of the possible outcomes).

Deferred Tax:

a. Uncertainty could exist in both the amount of the underlying deferred tax balances and the tax rates expected to apply.

b. As with current tax, no probability threshold should be applied to the recognition of additional (or reduced) deferred tax.

c. An expected outcome measure determined by the probability-weighted average of the possible amounts and possible rates should be used.

d. The expected rates should be based on rates substantively enacted at the balance sheet date. Only adjustments related to the level of income (e.g., graduated tax rates) and to the type of income (e.g., the use of different rates depending on the entity's activities should be anticipated). Other possible deductions or rate differences should not be anticipated.

56. The IASB's deliberations in Convergence Income Taxes focused on developing an overall approach for the accounting for tax uncertainties. The IASB has not considered whether changes in uncertain tax positions acquired in a business combination should be reflected as adjustments to goodwill or income as part of those deliberations.

Alternatives and Questions for the Board (IASB)

57. The first question for the IASB is what guidance should be provided. While the Board's decisions for the uncertain tax positions has not been exposed for comment, the underlying principle in both the existing guidance

for contingencies, as well as the proposed guidance for acquired deferred tax benefits subsequent to the acquisition date is the same. That principle explains that adjustments to acquired tax contingencies:

a. That relate to the recognition and measurement as of the acquisition date should be accounted for as adjustments to goodwill

b. That relate to subsequent changes in judgment or to discrete events and circumstances that occurred after the acquisition date should *not be included in the acquisition accounting,* but rather should be accounted for in accordance with other GAAP.

58. *[Paragraph omitted from observer note]*

Issue 4 Staff Recommendation (IASB)

59. The staff recommends that for the purposes of the BC project that no modifications be made to IAS 12 to address the accounting for changes in income tax uncertainties in a business combination.

ISSUE 5: EXEMPTION FOR INDEFINITE LIVED INTANGIBLE ASSETS

60. Both Statement 109 and IAS 12 require recognition of deferred tax assets and liabilities for taxable and deductible temporary differences related to identifiable intangible assets, including those that are indefinite lived. The BC ED proposed no changes to that requirement and carried forward the existing guidance in Statement 109 and IAS 12 for intangible assets without reconsideration.

61. Comment letters from two constituents (Altria and Pepsico) urged the FASB to consider amending Statement 109 to eliminate the current requirement to recognize deferred taxes related to intangible assets that are expected to be held indefinitely. Pepsico (CL #282) provided the following reasons for the Boards' consideration:

> Recognition of deferred taxes on indefinite lived intangibles results in incremental goodwill and a balance sheet gross up in the financial statements which does not reflect the underlying economics of the transaction. Further, it does not seem appropriate to recognize deferred taxes related to indefinite lived intangibles when the taxes will be realized only in the unlikely event that the business is sold.

Altria (CL #240) also suggested that “if an intangible asset were to change and have a definite life, the deferred tax could be recorded at that time.”

62. The FASB has considered this issue in the past—most recently in the redeliberations of the revised Exposure Draft, *Business Combinations and Intangible Assets—Accounting for Goodwill*, in 2001. At that time, the FASB decided not to amortize goodwill and intangible assets with indefinite lives. The lack of expected settlement in the foreseeable future caused nine respondents to view the deferred tax liability as a less-than-legitimate liability that *should not* be recognized until such time as the asset is sold, impaired, or otherwise disposed of—all of which are future events that those respondents believe are unlikely to occur. Respondents also suggested that the nonrecognition of deferred taxes related to intangible assets with indefinite lives were analogous to exceptions in Statement 109 for foreign unremitted earnings and nondeductible goodwill. The Board considered those comments, but rejected the suggestion to provide more exceptions to comprehensive recognition of deferred taxes, noting the following:

a. Statement 109 requires comprehensive recognition of deferred taxes. The only exceptions to that requirement are identified in paragraph 9.
b. Similar issues arose during the development of Statement 109 and other situations currently exist that are similar for which Statement 109 does not provide exceptions. For example, constituents requested that the FASB permit nonrecognition of deferred tax liabilities for taxable temporary differences related to inventory under the last-in-first-out method and land. The Board has denied those requests.
c. Indefinite-lived intangible assets are not analogous to nondeductible goodwill because goodwill is measured as a residual. There is no reason to exempt other types of intangible assets because they are separately identifiable and measured apart from goodwill.

63. The theory in the analysis from Statement 109 also would apply to IAS 12. Additionally, recent IASB efforts to simplify IAS 12 have focused on eliminating exceptions to the principles of IAS 12, wherever possible. Adding a new recognition exception would be counter to those initiatives.

Staff Recommendation

64. The comments received on this issue raise the same concerns that the FASB has received and considered in the past. Requests for an exception for indefinite-lived intangible assets have been considered and previously rejected leading to the issuance of FASB Statements 141 and 142 and would conflict with the IASB's initiatives to improve IAS 12 by eliminating unnecessary exceptions. The staff recommends the Boards affirm the requirements of Statement 109 and IAS 12 and not provide an exception to comprehensive recognition of deferred taxes for indefinite-lived intangible assets.

SUMMARY OF THE STAFF RECOMMENDATIONS

Issue 1: Whether to provide an exception to the fair value measurement principle for assets and liabilities for income taxes. *(Paragraphs 7–9)*

The staff recommends that the Boards affirm their decision to require that income taxes be accounted for in accordance with the guidance in Statement 109 (and related interpretive guidance) and IAS 12, as amended by the final BC Statement.

Issue 2: Whether changes in the **acquirer's** deferred tax assets and liabilities that occur because of the acquisition should be accounted for separate from the acquisition accounting. *(Paragraphs 10–23)*

The staff recommends that the Boards affirm their decision to require that the acquirer recognize separately from the business combination accounting any changes in its deferred tax assets because of the business combination. Such changes would be recognized in postcombination profit and loss or equity.

Issue 3: Whether the recognition of acquired deferred tax benefits subsequent to the acquisition should be accounted for as adjustments to goodwill or recognized in income. *(Paragraphs 24–40)*

The staff recommends that the Boards affirm the guidance in the BC ED, with slight modification (shown below), to amend paragraph 68 of IAS 12 and paragraph 30 of Statement 109 to:

a. ~~Include a rebuttable presumption~~ Require that qualifying measurement period adjustments (both increases and decreases) in the acquired deferred tax benefits recognized within ~~one year from the acquisition date~~ the measurement period be recognized as ~~an~~ adjustments to goodwill (~~until~~ increases in the acquired deferred tax benefits recognized would be limited to reducing goodwill ~~is reduced~~ to zero).

b. Require that other changes in the acquired deferred tax benefits ~~one year from the acquisition date~~ be recognized in income, rather than as an adjustment to goodwill.

Issue 4: Whether changes to acquired tax uncertainties subsequent to an acquisition should be accounted for as adjustments to goodwill or recognized in income. *(Paragraphs 41–59)*

(FASB: Paragraphs 46–52) The staff recommends that the proposed requirements for the reversal of the valuation allowance also apply to changes in acquired tax uncertainties subsequent to the acquisition date. To effect this change for acquired tax uncertainties, Issue 93-7 and Question 17 would be amended to require that:

a. Qualifying measurement period adjustments (both increases and decreases) to the amount recognized for an acquired tax position within

the measurement period be recognized as an adjustment to goodwill (limited to reducing goodwill to zero).

b. *Other changes that result in subsequent recognition, derecognition, or change in measurement of an acquired tax position subsequent to the measurement period be recognized in accordance with Interpretation 48.*

(IASB: Paragraphs 53–59) The staff recommends that for the purposes of the BC project that no modifications be made to IAS 12 to address the accounting for changes in income tax uncertainties in a business combination.

Issue 5: Whether indefinite-lived intangible assets should receive the same deferred tax exemption as goodwill. *(Paragraphs 61–64)*

The staff recommends the Boards affirm the requirements of Statement 109 and IAS 12 and not provide an exception to comprehensive recognition of deferred taxes for indefinite-lived intangible assets.