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International
Accounting Standards
Board

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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: **19 July 2007, London**

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

Subject: **Investment tax credits, special deductions and expected rates (Agenda paper 8A)**

Introduction

1. In March, the Board advisors on the income taxes project met with some FASB Board members to discuss how to resolve the remaining issues in the project in a timely manner. The topics that remained to be discussed by one or both Boards were:

   (a) The use of the distributed or undistributed rate to measure tax assets and liabilities

   (b) The definition and treatment of tax credits and investment tax credits

   (c) The definition of tax basis (base)

   (d) Special deductions

   (e) The use of a probability weighted average to determine the rate used to measured tax assets and liabilities

(f) wording changes to Statement 109 for the requirements on the realizability of deferred tax assets and changes in tax status

(g) the exception to recognising a deferred tax liability on the initial recognition of goodwill and

(h) the recognition of assets with acquired temporary differences at fair value.

2. (a) is the subject of Agenda Paper 8B. (c) and (f) are matters for the FASB only and are being considered by the FASB this month. The IASB discussed (g) and (h) in April and made decisions that converged with the FASB decisions. This paper covers topics (b), (d) and (e).

3. The staff recommends that:

(a) tax credits are defined as a benefit granted by the tax authorities that takes the form of a deduction against tax payable

(b) investment tax credits are defined as tax credits that are directly related to the acquisition of depreciable assets.

(c) the Board reverses its previous decision on special deductions and that instead IAS 12 should remain silent on the issue.

(d) the Board reverses its previous decision that the tax rate used to measure deferred tax assets and liabilities should be the probability weighted average of the possible rates that might apply and reverts to the existing wording of the rate ‘expected’ to apply.

Tax credits and investment tax credits

4. In January, the IASB discussed the treatment of an investment allowance. That discussion highlighted the fact that different forms of tax incentives are treated differently under IAS 12 even though their economic substance may be the same or very similar. Tax incentives can come in the following forms, with the following treatment under IAS 12:

(a) Tax deductions. These may be part of the tax base of an asset or liability. If so, they will be included in the calculation of any temporary differences. If not, IAS 12 is silent on their treatment but they could be argued to fall into the determination of the effective tax rate used to measure deferred tax assets and liabilities (see paragraphs 16-26).

(b) Reductions in tax rate. These fall into the determination of the tax rate used to measure deferred tax assets and liabilities.

(c) Tax credits. Unused tax credits are recognised as deferred tax assets, subject to specified recognition criteria.

(d) Investment tax credits. These are scoped out of IAS 12.

A particular problem is that neither tax credits nor investment tax credits are defined in IAS 12, leading to arguments that incentives that take the form of tax deductions are in fact in-substance tax credits.

5. Agenda Paper 6 of the January meeting illustrates the different results given depending on how a tax incentive is classified.

6. The IASB asked a small group of Board members to determine:

(a) how to classify a tax incentive and

(b) whether it is possible to resolve the differences in treatment of tax incentives without delaying the publication of an ED.

7. At the joint meeting in March, the small group considered the following possibilities:

(a) Do nothing in relation to investment tax credits and tax credits. IAS 12 and Statement 109 are converged on their treatment. Do not try to align their treatment with the treatment of tax deductions and tax rate reductions, which should be considered separately.

(b) Define investment tax credits and tax credits and leave their accounting unchanged. From the IASB's constituents' point of view, this would at least mean that they knew how to classify such tax benefits. As with (a), treatment of tax deductions and tax rate reductions should be considered separately.

(c) Consider the accounting for investment tax credits and tax credits together with the accounting for tax deductions or tax rate reductions, with the objective of a consistent treatment for items with similar economic benefits.

8. The small group concluded that approach (c) was outside the scope of a short-term convergence project and could delay publication of an Exposure Draft for a substantial time. They also concluded that it was inappropriate to continue with different treatments for different tax incentives without clear definitions of the different types of incentives (approach (a)). To do so would simply lead to a large number of queries to the IFRIC. The staff was, therefore, instructed to develop definitions for investment tax credits and tax credits but not to try to align their treatment with that of tax deductions and tax rate reductions. Tax deductions and tax rate reductions are discussed further in the section of the paper on special deductions.

9. The objective of the definitions for investment tax credits and tax credits is to achieve convergence with practice under US GAAP. SFAS 109 does not define either investment tax credits or tax credits. In practice, the staff understands that the distinction between tax credits and tax deductions is the amount from which they are deducted. Tax credits are amounts that are deducted from *tax payable*. Tax deductions are amounts deducted to arrive at *taxable profit*. For example:

Income	100
Tax deduction	30
Taxable profit	70

Tax payable at 30%	21
Tax credit	(5)
Tax payable	16

10. The staff acknowledges that the same economic incentive could be provided in either form. However, as noted above, it is beyond the scope of this project to change the accounting for tax credits and tax deductions to make them the same.

11. The staff therefore proposes that tax credits are defined as a benefit granted by the tax authorities that takes the form of a deduction against tax payable.

12. SFAS 109 also does not define investment tax credits. It refers to APB Opinions 2 and 4 for acceptable methods of accounting for the US federal investment tax credit. APB Opinion 2 describes the investment tax credit as follows:

> The Revenue Act of 1962 provides for an "investment credit" which, in general, is equal to a specified percentage of the cost of certain depreciable assets acquired and placed in service after 1961. It is subject to certain statutory limitations and the amount available in any one year is used to reduce the amount of income tax payable for that year. The full amount of the investment credit is treated for income tax purposes as a reduction in the basis of the property. An investment credit once allowed is subject to recapture under certain circumstances set forth in the statute.

13. The staff thinks that the main feature of the US federal investment tax credit that can be used to distinguish it from other tax credits is that it arises on the acquisition of depreciable assets. While the tax law that gave rise to the US federal investment tax credit was repealed in 1986, the staff is aware that tax credits are currently provided by some jurisdictions and follow the accounting prescribed by APB 2 and 4. APB Opinion 2 originally concluded that the investment tax credit should be recognised in profit or loss over the productive

life of the acquired asset.[1] That conclusion can only apply to investment tax credits that arise on depreciable assets.

14. For clarity, the staff notes that depreciable assets include intangible assets. The staff understands that under US GAAP, some tax credits relating to intangible assets are treated as investment tax credits, so for consistency with US practice they should be included in the definition. Further, under IFRS terminology, depreciable assets include intangible assets. In particular, IAS 38 refers to the depreciable amount of intangible assets.

15. To be consistent with the scope exclusion in SFAS 109, the staff therefore recommends that investment tax credits should be defined as tax credits that are directly related to the acquisition of depreciable assets.

Special deductions

16. Special deductions are specific tax deductions that SFAS 109 requires to be recognised no earlier than the period in which they are deductible. Paragraph 232 of SFAS 109 states that, "The tax benefit of statutory depletion and other types of special deductions such as those for Blue Cross-Blue Shield and small life insurance companies in future years should not be anticipated for purposes of offsetting a deferred tax liability for taxable temporary differences at the end of the current year."

17. IAS 12 discusses the treatment of tax deductions that form part of the tax base of an asset or liability. It does not explicitly discuss the treatment of any other tax deductions that an entity might expect to get. This lack of discussion means that such tax deductions may be regarded as affecting the effective tax rate to be applied to the measurement of deferred tax assets and liabilities. An example comparing such an approach and the approach under SFAS 109 to special deductions is given in Appendix A.

18. When the IASB considered the SFAS 109 requirements, it noted that it could not adopt an approach that listed specific deductions as special deductions

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[1] APB Opinion 2 was subsequently amended by APB Opinion 4 which allowed an alternative treatment of recognizing the investment tax credit as a reduction in tax in the period in which the credit arises.

because of the global application of IFRSs. Further, the IASB noted that, as illustrated in Appendix A, the question of tax deductions and tax rate reductions were related. Given this, the Board decided that only deductions and tax rate reductions related to an entity's level of income or type of income should be anticipated in the determination of the tax rate. Any other deductions or tax rate reductions would not. Examples of the type of deductions that would be anticipated in the determination of the tax rate under this proposal are the Canadian small business allowance and the Canadian manufacturing and processing profits deduction.

19. The problem is that, on comparing this decision to the list of special deductions in US GAAP, differences emerge. The special deductions noted in US GAAP are:

(a) the qualified production activities deduction provided by the American Jobs Creation Act of 2004. In FSP 109-1, the FASB staff concluded that it is a special deduction because it is contingent upon the future performance of specific activities, including the level of wages. It is therefore not recognised until the period in which it is deductible. But under the IASB proposals, it might be regarded as a deduction related to a type of income, and therefore could effectively be recognised in part or in full in determining the rate to apply to measure any deferred tax assets or liabilities.

(b) the small life insurance companies deduction is available to entities that generate income below a certain level in a taxable period and holds assets below a certain level. The deduction is calculated as a percentage of taxable income. The deduction is contingent upon the future performance of the business. Because it is a special deduction, it is not recognised until the period in which it is deductible. But under the IASB proposals, it might be regarded as a deduction related to a type of income or a level of income, and therefore could effectively be recognised in part or in full in determining the rate to apply to measure any deferred tax assets or liabilities.

(c) The statutory depletion deduction available to certain extractive industries is calculated for a taxable period based on the cost of reserves or as a percentage of gross income, subject to certain limitations. The deduction is contingent upon future generation of reserves or income. Because it is a special deduction, it is not recognised until the period in which it is deductible. But under the IASB proposals, it might be regarded as a deduction related to a type of income, and therefore could effectively be recognised in part or in full in determining the rate to apply to measure any deferred tax assets or liabilities.

(d) The Blue Cross-Blue Shield deduction is provided by the tax code for qualifying entities that provide health insurance and is based on a percentage of the sum of administrative costs and claims incurred for a specific type of contracts (referred to as cost plus contracts) subject to certain limitations and requirements. Because this is a special deduction, it is not recognised until the period in which it is deductible. It also does not seem to fall under the IASB proposals, as a deduction related to level or type of income.

20. The FASB has not considered the IASB proposals. At the small group meeting, FASB Board members and staff expressed concern with the IASB proposal because it does not converge with the application of special deductions in Statement 109 as amended by the FSP 109-1. In addition, re-opening the discussion of special deductions would add a significant amount of time to the project. Accordingly, the small group meeting participants asked the staff to find some general wording that the IASB could use that would cause as little divergence with the SFAS 109 requirements as possible.

21. On reconsidering the issue, the staff noted the following:

(a) A deduction that relates to the amount that would be realised on the sale of an asset or on the settlement of a liability is part of the tax base of the asset or liability. Special deductions are additional deductions that do not form part of a tax base.

(b) Special deductions could be unrelated to specific assets or liabilities and could have similar economic effects to tax rate reductions. For example, a deduction of 10% of taxable profit is economically the same as a tax rate reduction of 10% of the normal rate.

(c) Under both IAS 12 and SFAS 109, the tax rate used to measure deferred tax assets and liabilities is the rate expected to apply in the period the asset is realised or the liability is settled. For example, if different tax rates apply to different levels of taxable income (graduated rates), the expected average graduated rate is used. If different rates apply depending on how an asset or liability is recovered or settled, the rate that reflects the expected manner of recovery or settlement is used.

22. The staff thinks that the Board has three choices:

(a) define special deductions as deductions that do not form part of a current tax base. Require an entity not to anticipate special deductions.

(b) define special deductions as deductions that do not form part of a tax base. Require an entity to include expected special deductions in the determination of the effective tax rate used to measure deferred tax assets and liabilities.

(c) stay silent on the issue of special deductions.

23. There are problems with all three approaches. Approach (a) would achieve consistency with the treatment of the special deductions listed in US GAAP. But there are other deductions that would fall under the proposed definition the effect of which is recognised in practice in the US. Approach (a) would not achieve convergence on those deductions. Further, it would be inconsistent with the treatment of tax rate reductions under both IAS 12 and SFAS 109.

24. Approach (b) achieves consistency with the treatment of tax rate reductions. As noted above, some special deduction may be very similar to tax rate reductions. But treating all special deductions as tax rate reductions would be a substantial change in practice. The FASB staff has strong reservations about such an approach.

25. The basic problem is that SFAS 109 lists some deductions that do not form part of a tax base as special deductions and requires them not to be anticipated. But SFAS 109 is silent on the treatment of other deductions that do not form part of a tax base. In practice, some are anticipated and others are not. The IASB and FASB staff do not think it is possible in a short period of time to establish general principles on which type of deduction should be anticipated and which should not.

26. Given this, the staff recommends (c). Existing IAS 12 is silent on special deductions and the staff is not aware of any problems in practice arising. The staff acknowledges that does not mean that there is consistent treatment in practice or that problems will not arise in the future. However, if IAS 12 is silent, entities have the choice of being consistent with practice under US GAAP. Any other approach will either take considerable time or will cause divergence in some cases from US GAAP.

Weighted Probability Approach to Determine the Applicable Rate

27. To measure deferred tax assets and liabilities, IAS 12 requires the use of the tax rate that is expected to apply in the period the asset or liability will be recovered or settled. IAS 12 gives no guidance on how ‘expected’ should be interpreted when there is uncertainty over what the rate might be. The IASB discussed this issue at the same time as it considered uncertainty over the amounts underlying tax assets and liabilities. The IASB concluded that, consistent with its thinking in the proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the measurement of tax assets and liabilities should be the expected outcome, ie the probability weighted average of the possible amounts and rates.

28. That proposal diverges from the requirements of FIN 48 *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, which covers the treatment of uncertainty over the amounts underlying tax assets and liabilities. It also diverges from current interpretations of the requirement in SFAS 109 to use the tax rates expected to apply in the period the deferred tax asset or liability is expected to be realised or settled. At the small group meeting, participants noted that, in respect of the use of an expected rate, the IAS 12 and SFAS 109 are currently converged. Participants suggested that now was not the time to specify a particular meaning for expected, given that doing so would introduce divergence in practice under the two standards.

29. The staff therefore recommends that the rate used to measure deferred tax assets and liabilities should continue to be simply the rate expected to apply. (No change is proposed to the proposals relating to uncertainty over the amounts underlying tax assets and liabilities. Participants at the small group meeting accepted that was a matter on which the IASB will issue proposals that diverge from the requirements of FIN 48.)

Appendix A: illustrative example

Facts

A taxable temporary difference of 1000 arises that is expected to reverse in two years time. At that time the statutory tax rate is expected to be 30%. In that future period, the entity expects to have other taxable profit of 2000 and to qualify for a deduction of 600 unrelated to a specific asset or liability. When the period arrives, everything happens in line with the entity's expectations.

Treatment of the deduction as a special deduction

When the taxable temporary difference arises:

Dr income tax expense	300	
Cr deferred tax liability		300

being the recognition of a deferred tax liability of 300 (1000x30%) for the taxable temporary difference.

When the taxable temporary difference reverses:

Dr deferred tax liability	300	
Dr income tax expense	420 ((2000-600)x30%)	
Cr cash		720 (2400x30%)

being the payment of tax on the taxable profit and the reversal of the temporary difference.

The tax benefit of the deduction of 180 (600x30%) is recognised in the period the deduction is available.

Treatment of the deduction as a reduction in the effective tax rate

In the period the deduction is available, tax of 720 ((2000+1000-6000)x30%) is payable. If the deduction of 600 is thought of as a rate reduction, rather than a deduction, the tax of 720 is expressed as taxable profit of 3000 at an effective tax rate of 24%.

Under this view, the journal entries would be as follows.

When the taxable temporary difference arises:

Dr income tax expense	240	
Cr deferred tax liability		240

being the recognition of a deferred tax liability of 240 (1000x24%) for the taxable temporary difference.

When the taxable temporary difference reverses:

Dr deferred tax liability	240	
Dr income tax expense	480	
Cr cash/tax payable		720 (2400x30%)

being the payment of tax on the taxable profit and the reversal of the temporary difference.

Under this approach, 60 of the tax benefit of the deduction is recognised in the measurement of the deferred tax liability when the taxable temporary difference arises.

The amount of the total benefit from the deduction that is recognised in the measurement of the deferred tax liability depends on the amount of the taxable temporary difference compared to the other taxable profit arising in the period that the temporary difference reverses. In this case, the reversal of the taxable temporary difference gives rise to 33% of the total taxable profit, so the benefit that is recognised when the taxable temporary difference arises is 33% of the total benefit.