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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: **The use of the undistributed or distributed rate (Agenda paper 8B)**

Introduction

1. In March, the IASB and FASB Board advisors on the income taxes project met to discuss how to resolve the remaining issues in the project in a timely manner. The topics that remained to be discussed are outlined in agenda paper 8A (IASB) or memorandum 19 (FASB). This agenda paper / memorandum contains an analysis of the remaining issue that both Boards have left to consider: the requirement to measure tax assets and liabilities using the tax rate applicable to earnings that are retained by the entity (the undistributed rate), until the entity has an obligation to distribute those earnings.

2. As summarized below, the Boards had originally agreed to require the undistributed rate unless an entity has an obligation to distribute those earnings but had concerns with this decision's impact on entities that are structured to avoid double taxation and receive deductions for dividends paid to owners. The Boards asked the staff to consider four alternatives and return with a recommendation so that these types of

entities are not required to recognize tax liabilities in excess of what they will ultimately be liable. [Not reproduced in observer notes.] Accordingly, the staff recommends the Boards' reconsider their original decision to require the undistributed rate; and instead require an entity to use the rate that it expects will apply when measuring a current or deferred tax asset or liability. In determining the rate that an entity expects will apply, the staff recommends that the assumption regarding the distributions that an entity can anticipate be limited to those distributions that the entity has the ability and intent to make for the foreseeable future. This alternative is presented below as Alternative E.

3. The staff's analysis of the four alternatives suggested during the October 2005 Board meeting is also included below. All four alternatives were developed under the assumptions that the undistributed rate would be required. The staff's recommendation – Alternative E – would require the Boards to change their previous decisions to require the undistributed rate. If the Boards reject the staff's recommendation and decide to retain their decision to require the undistributed rate then the staff suggests Alternative D.

Background

4. In some tax jurisdictions, corporate income is sometimes taxed at different rates depending on whether that income is distributed to shareholders. An entity's tax rate for income that is distributed to shareholders (the distributed rate) may be higher or lower than the undistributed rate. For most corporations in the United States, there is no incremental tax (or tax credit) paid (or received) by the corporation when current or retained earnings are distributed to shareholders. Thus, distributed earnings are taxed at the same rate as undistributed earnings. However, the question of which rate to use (distributed or undistributed) arises for entities in many other tax jurisdictions because some governments require different tax rates to be used depending on whether taxable income is distributed to owners or not (dual rate jurisdictions).
5. In addition to dual rate jurisdictions, some jurisdictions allow for a deduction from otherwise taxable income for certain types of entities. Examples of organizations that receive a deduction for dividends include, Real Estate Investment Trusts (REIT), Registered Investment Companies (RIC), and Cooperatives (Co-op). Generally these

organizations must meet certain requirements to receive the dividend deduction; most commonly they must distribute a significant portion of taxable income (90 percent for REIT or RIC).

6. Given that a jurisdiction can either tax income at different rates or provide for a deduction for dividends paid to achieve the same economic result; that is either to motivate distributions to owners or further tax those distributions, the staff is analyzing both dual tax rate jurisdictions and jurisdictions that provide a dividend deduction allowance together for purposes of this issue.

Current Guidance

7. IAS 12 currently requires deferred tax assets and liabilities to be measured using the tax rate applicable to <u>undistributed profits,</u> unless a liability to distribute those earnings has been recognized.
8. Statement 109 is silent on distributed and undistributed rate issues. The impact of dual rate structures outside of the United States is addressed in two EITF Abstracts:
    (a) No. 95-10, "Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109"
    (b) No. 95-20, "Measurement in the Consolidated Financial Statements by a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments."
9. That guidance requires the use of the undistributed rate in a subsidiary's separate financial statements and a rate consistent with the entity's application of the indefinite reversal criteria of APB Opinion No. 23, *Accounting for Income Taxes—Special Areas,* (that is, they require use of the distributed rate if earnings are remitted to parent or undistributed if they are not) in an entity's consolidated financial statements. As discussed in previous Board memorandums (Memorandum #9/January 2005 Agenda Paper 7A), practice has developed under U.S. GAAP using the <u>higher of the distributed or undistributed rate</u>. As indicated through recent discussions with the SEC staff, the SEC would not object to the use of either rate, pending clarification from either the FASB or EITF.[1]

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[1] As indicated in the status section of the EITF Issues, there was no further EITF discussion of Issues 95-10 and 95-20 subsequent to the issuance of the consensuses.

Previous Board Decisions

10. At the October 2005 Joint Board meeting, the Boards decided to require the tax rate applicable to <u>undistributed profits</u>. However, if there was an obligation to distribute a portion of those profits, any deferred taxes on that portion would be measured at the distributed rate. Certain FASB Board members continued to express a view that the tax rate applicable to distributed profits is the appropriate rate to use. However, the FASB decided to converge with the IASB's decision.
11. Certain Board members' rationale for requiring the use of the undistributed rate is that there is no obligation to distribute earnings and, therefore, the undistributed rate should be used until an obligation to distribute earnings exists (when a dividend is declared). At that point, there would be a remeasurement of the tax balances using the distributed rate, but only to the extent of the obligation (the declared dividend). In contrast, supporters of the distributed rate argue that the ultimate distribution to shareholders, in some form, is presumed in the financial statements and, therefore, the measurement of the deferred tax assets and liabilities should reflect that concept. Another reason for the use of the distributed rate is that current and deferred tax assets and liabilities are recognized when they are incurred and should be measured at the rate that is indefinitely expected to apply. This approach is viewed as providing a better depiction of the amount of retained earnings available for distribution to shareholders.
12. The IASB supported the argument for the undistributed rate. Some FASB Board members found merit in each of the arguments above, seem to prefer the distributed rate, but decided for the sake of convergence to support the use of the undistributed rate.
13. The Boards directed the staff to consider the impact of this decision on organizations that receive a dividends paid deduction (for example, REITs, RICs, and Co-ops) that render them essentially tax-exempt upon adequate distribution of dividends. Appendix A to this memorandum is a copy of Memorandum 15, which summarizes this topic. At the October 2005 meeting, the Boards directed the staff to explore the following alternatives for such entities:

a. Keep the proposed requirements, noting that entities that did commit themselves to making a distribution would recognize the distributions and the available deductions.

b. Create a definition of an "in-substance tax-exempt entity" that would cover entities whose tax structure is set up to avoid shareholders suffering double taxation and involves tax deductions being available if the entity distributes all or almost all of its total income

c. Require a point-in-time analysis of whether an entity has the ability to be effectively tax exempt, in which case they would be treated as tax exempt. Disclosure would be required of why they qualify and what they have to do in the future to continue to qualify

d. Allow the effects of a distribution outside the entity to be included as a tax planning strategy in determining whether or not the recovery of an asset or settlement of a liability has taxable consequences and, hence, whether a temporary difference exists.

Analysis of Alternatives Suggested at the Joint October 2005 Meeting

Alternative A: No Special Treatment for REITs, RICs, and Co-ops

14. The first option is to keep the proposed requirement and give no special treatment for entities such as REITs, RICs, and Co-ops. Entities that are obliged to distribute all or almost all of their earnings will recognize a liability for the distribution and the related tax deduction/refund when the distribution is declared. Consistent with the principle agreed to by the Boards, if there is no obligation to distribute, the tax consequences of the distribution should not be anticipated. This approach has the advantage of requiring no exception from a general principle. The Boards have the opportunity to receive feedback on this decision during the comment letter process and could specifically request that feedback.

Alternative B: Define In-substance Tax-exempt Entity

15. The second option is to define an "in-substance tax-exempt entity" as an entity whose structure is established so that the entity is entitled to deductions for dividends paid or to apply a lower tax rate if the entity distributes some or all of its taxable income. If an entity meets the "in-substance tax-exempt" criteria, it would use the distributed rate. This option would resolve concerns with the types of entities identified. Since the Boards decided to require an undistributed rate, the staff considers this option an exception to that requirement. The staff is concerned with the unintended consequence of providing an exception that can be applied too broadly, thereby allowing an entity that should be recognizing deferred taxes (or a portion thereof) the ability to avoid doing so.

16. The staff has developed the following suggested wording for discussion purposes:

X1 In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the taxable income is paid as a dividend or allocated to shareholders of the entity. In other jurisdictions, income taxes may be refundable or payable if part or all of the taxable income is paid as a dividend or allocated to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities shall be measured at the tax rate applicable to undistributed profits except if the entity is regarded as in-substance tax exempt.

X2 Entities can be regarded as in-substance tax exempt when the following conditions have been met:

a. An entity is provided a deduction for payment (or allocation) of dividends to shareholders if all, or substantially all, of the taxable income is distributed or for a rate of zero or a minimal percent to be applied to otherwise taxable earnings that is distributed or allocated to shareholders by the laws or tax codes of the relevant jurisdiction.

b. All of the requirements of the laws and tax codes of the jurisdiction have been met at the reporting date to enable the entity to take the dividend deduction or apply the lower rate.

c. The entity expects to and has the ability to continue to distribute all or substantially all of its future taxable earnings to shareholders.

If the entity meets these requirements, it shall measure current or deferred tax assets or liabilities at the tax rate applicable to distributable profits.

17. The staff has developed the suggested wording for this alternative but has concerns with this option. This option raises questions on whether the distributed rate must be zero, or whether an entity that pays a minimal rate of tax if income is distributed should also be eligible to use the distributed rate. How would minimal be defined? Another question is to what extent an entity must avail itself of the deduction or lower rate for the exception, in other words, what level of income needs to be distributed? Should the Boards specify a bright-line, for example, 90 percent (the current requirement of the IRS for REITs and RICs to continue to qualify for their special tax status) or some other amount? Further, is the intention of such levels of distribution enough or is a past history required? If the latter, what happens if the level of distribution is not met on a particular occasion? Consideration should be given to whether this option should be limited to rates and deductions that render an entity in-substance tax exempt or if credits should also be considered.

Alternative C: Point-In-Time Analysis

18. The staff has considered and has significant concerns with the third option for a number of reasons. First the staff does not see a substantial difference between Alternative B and Alternative C in that both alternatives are an exception to the principle of requiring the undistributed rate and both seem to require an analysis of an entity's compliance with the relevant tax jurisdiction's laws that allow for a lower rate or a special deduction for dividends paid to owners. In addition, the point-in-time analysis would seem to resolve concerns with the measurement of current tax payable and expense but not deferred tax assets or liabilities. Accordingly, the staff does not see this alternative as a viable option.

Alternative D: Distribution outside the entity to be included as a tax planning strategy in determining whether or not the recovery of an asset or settlement of a liability has taxable consequences

19. The last option raised at the joint meeting in October 2005 was to allow the effects of a distribution outside the entity to be included as a tax planning strategy for determining current taxes payable or refundable or in determining whether the recovery of an asset or settlement of a liability has future taxable consequences. If there are no taxable consequences, then the temporary difference is not considered taxable or deductible and, therefore, no deferred tax assets or liabilities are recorded. In addition, as the current tax payable or receivable would be calculating assuming deductions that are available in the current year's tax return, the entity would incorporate the deductions that it anticipates including on that year's tax return as long as it has the intent and ability to distribute the taxable earnings to owners.

20. Although the minutes from that meeting refer to this alternative as a "tax planning strategy" the staff believes that the term "tax planning strategy" might be misleading. Accordingly, the staff would rather refer to this alternative as an exception to the requirement to use the undistributed rate for entities that receive dividend deductions. Paragraph 22 of Statement 109 provides examples of tax planning strategies that an entity ordinarily might not use but would exercise to prevent an operating loss or tax credit carryforward from expiring unused. This analysis also applies to "tax planning opportunities" as described in paragraph 30 of IAS 12.

21. This alternative is an extension of the application of the temporary difference approach to organizations that receive deductions for distributions rather than a tax planning strategy/opportunity. In other words, this alternative allows an entity to anticipate deductions that are received for deductions that are received for earnings that is distributed to owners. Accordingly, the deduction for distributions can be included in the entity's analysis of whether temporary differences will be taxable or deductible in future periods and in calculating current taxes payable or receivable.

22. The staff notes that Statement 109 already requires entities to consider the intended method of recovery under certain circumstances. Paragraph 14 states that certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore,

may not be temporary differences for which a deferred tax asset or liability is recognized. One example in Statement 109 addresses a situation in which the intended method of recovery dictates the income tax accounting. This example concerns the excess of cash surrender value of life insurance over premiums paid that is expected to be recovered without tax consequence upon the death of the insured. If the policy is expected to be surrendered, then any income generated by the policy would be taxable, and any basis difference is recorded as a temporary difference. If the policy is expected to be kept until death of the insured, then no basis difference is recognized. Paragraph 52 of IAS 12 also provides for intent when considering at what amount to measure current and deferred taxes if different rates apply.

23. In addition to the concepts referenced in the previous paragraph, paragraph 145 of Statement 109 states:

> The Board believes that a tax deduction received for the payment of dividends (exclusive of dividends paid on unallocated shares held by an ESOP) represents, in substance, an exemption from taxation of an equivalent amount of earnings. For that reason, the Board concluded that the tax benefit should be recognized as a reduction of tax expense and should not be allocated directly to shareholders' equity. [Emphasis added.]

24. Accordingly, the staff considers Alternative D as a logical extension of some of the underlying concepts that are already contained in Statement 109 and IAS 12. The staff would not characterize this alternative as a tax planning strategy/opportunity, as described in Statement 109/IAS 12, but more akin to an extension of the temporary difference approach in situations when an entity is structured to receive a deduction for dividends paid to owners under the tax code of the relevant jurisdictions and fully anticipates that deduction being received in the future periods.

25. The challenge with this alternative is that it treats deductions for distributions differently than dual tax rate jurisdictions. This alternative allows the current tax payable/receivable or temporary differences to be measured including consideration of a deduction for dividends paid or allocated. In contrast, in jurisdictions where two different rates apply the undistributed would be used to measure current and deferred taxes. This alternative provides different accounting for entities that receive a deduction for distributions to owners compared to those that apply a different tax rate to earnings when they are distributed.

26. Accordingly this alternative is an exception to the requirement of measuring income taxes at the undistributed rate and is **limited** to only those situations when an entity **anticipates** receiving a deduction for dividends or earnings that are paid or allocated to owners. The staff believes that, under Alternative D, if the entity is required to meet certain requirements under the tax law to receive the dividend deductions, those requirements must be met at the reporting date and the entity must anticipate continuing to meet those requirements in future periods. In addition to meeting the legal requirement to anticipate the deduction, the entity must have the intent and ability to make the distribution or allocation in order to anticipate receiving the dividend deduction. This alternative retains the requirement to use the undistributed rate but provides an exception to the types of entities that the Boards' had concerns with and asked the staff to consider.

Resource Group Input

27. [Not reproduced in observer notes.]
28. [Not reproduced in observer notes.].
29. [Not reproduced in observer notes.].

Alternative E – Require the Rate that an Entity Expects will Apply to Measure Current or Deferred Tax Assets or Liabilities

30. [Not reproduced in observer notes.]As a result the staff is proposing and recommending a new alternative, which is to require an entity to use the rate that it expects will applying when measuring current or deferred tax assets or liabilities. The staff acknowledges that this is a change in the Boards' previous decisions but the concept of requiring the rate that is expected to apply is a concept already contained in both Statement 109 and IAS 12.

31. Paragraph 18 of Statement 109 states:

> The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) <u>expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.</u> Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by entities for which graduated tax rates are not a significant factor. Entities for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). <u>Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains).</u> If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

32. Paragraph 49 of IAS 12 states:

> When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are <u>expected to apply to the taxable profit (tax loss) of the periods</u> in which the temporary differences are expected to reverse.

33. Paragraphs 51, 52 and 52A of IAS 12 also state:

> The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities.
>
> In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
>
> (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
>
> (b) the tax base of the asset (liability).
>
> In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.
>
> In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out

as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.

34. As noted in the paragraphs listed above, both standards take an expectation approach to measuring most current or deferred tax assets or liabilities. With that said, given the EITF guidance (Issues 95-10 and 95-20) described in paragraph 8 above and the requirement to use the undistributed rate in IAS 12, the staff acknowledges that some boundaries are necessary to ensure that this recommendation is workable. For example, given the conclusion in IAS 12 and the rationale of the IASB Board members that favored the undistributed rate in all circumstances, the staff argues that it would not be appropriate to allow an entity to reflect a tax receivable (this would arise in a situation when the distributed rate is lower then the undistributed and no dividends were declared) when an entity could not assert that it had the intent and ability to distribute earnings in the foreseeable future. In contrast, supporters of the distributed rate find requiring the undistributed rate not representational when an entity is structured to take advantage of a particular tax structure to avoid corporate taxation; that entity has the intent and ability to make such distributions and it anticipates continuing to make such distributions for the foreseeable future.

35. The staff proposes the following principle to address concerns with requiring the distributed rate in all circumstances and allow an entity the ability to incorporate assumptions about future distributions when measuring current or deferred taxes:

> When measuring current or deferred tax assets or liabilities, including the amount that is currently payable or refundable from a particular jurisdiction, an entity shall use the enacted or substantially enacted tax rate(s) expected to apply to all or a portion of taxable income for the current period or for the periods in which deferred tax assets or liabilities are expected to be realized or settled.
>
> In jurisdictions that have a different tax rate depending on whether taxable earnings are distributed to owners, the entity shall use the rate(s) that it expects will apply to the item being measured incorporating the entity's past practices and future expectations of distributions. When determining future expectations of distributions, the entity must have the intent and ability to continue to make distributions for the foreseeable future. If the entity does not anticipate

distributing earnings or can not demonstrate the ability continue to distribute earnings for the foreseeable future, then the entity shall use the undistributed rate to measure current or deferred tax assets or liabilities.

In jurisdictions that provide the entity with a deduction from taxable earnings for amounts that are distributed to owners, the entity shall include assumptions about future deductions when measuring current or deferred tax assets or liabilities incorporating the entity's past practices and future expectations of distributions. When determining future expectations of distributions, the entity must have the intent and ability to continue to make distributions for the foreseeable future. If the entity does not anticipate distributing earnings or can not demonstrate the ability continue to distribute earnings for the foreseeable future, then the entity shall not anticipate deductions for distributions to owners when measuring current or deferred tax assets or liabilities.

36. The principle expressed in the previous paragraph addresses jurisdictions that have a different rate that would apply to taxable income depending on whether that income is distributed owners and those jurisdictions that allow for a deduction from taxable income if that income is distributed. As noted in the background section, organizations such as REITs, RICs, and Co-ops must meet certain requirements to be able to deduct distributions to owners from taxable income to determine taxes payable. Given that a jurisdiction can either tax income at a different rate or provide a deduction for distributions to owners and achieve the same economic result (i.e. either to motivate distributions to owners or further tax those distributions), the staff is proposing that Alternative E treat both dual tax rate jurisdictions and jurisdictions that provide a dividend deduction similarly. This is in contrast to Alternative D which allows for consideration of only deductions for distributions to owners when measuring current or deferred tax assets or liabilities but requires the undistributed rate in all other circumstances.

37. This alternative has a number of advantages over those listed above (A-D):

(a) This alternative contains a principle that is already contained in both Statement 109 and IAS 12. This alternative expands on the expectation approach to rates contained in both Statement 109 and IAS 12 and would not require any sort of exception to that approach.

(b) This alternative uses terms that are familiar and are principles based rather then establishing bright-lines and introducing thresholds that need to be established and clarified. The notion of foreseeable future is a concept that is contained in Statement 109 and IAS 12 in the discussion on recognizing a deferred tax liability for earnings of a foreign subsidiary (paragraph 31 of Statement 109 and 39 of IAS 12).

(c) This alternative should result in an entity applying a rate that better reflects the economics of its tax situation rather than requiring a rate to apply in all circumstances.

38. There may be some challenges with this alternative as it will require judgment to determine what rate to apply in a dual rate tax jurisdiction. Additionally, some may argue, particularly those that support the undistributed rate, that this alternative would result in recording the tax benefit for an obligation that the entity has not incurred. The staff acknowledges that conceptually this recommendation would allow for the tax affects of a distribution to be recorded before the liability for the distribution is recorded, but as articulated above, anticipating intended actions of the entity is a concept already contemplated and included in Statement 109 and IAS 12.

Staff Analysis and Recommendation

39. The staff supports Alternative E. Alternative E contains a principle that could be incorporated into the concepts already contained in both Statement 109 and IAS 12. Alternative E also treats economically similar items, different tax rates for distributions and deductions for distributions, similarly. That is, the principle contained in Alternative E would allow for an entity to apply the rate that is expected to apply or a deduction that is expected to be received for distributions when measuring current or deferred tax assets or liabilities. Alternative E also resolves the concerns that the Boards' expressed with requiring the undistributed rate but does so by eliminating that requirement.

40. If the Board were to reject the staff's recommendation then the staff would recommend Alternative D. Alternative D does not eliminate the requirement to use

the undistributed rate but it does establish an exception to that requirement for the types of entities that the Boards' asked the staff to address. This alternative would resolve concerns with requiring the undistributed rate for REITs, RICs, Co-ops but provides a different accounting answer based on form rather than substance. That is Alternative D allows an entity to consider deductions that it expects to receive in the future in the measurement of current or deferred tax assets or liabilities but does not allow an entity to anticipate a different rate that would apply if distributions are made to owners. [Not reproduced in observer notes.].

Question 1: Does the Board wish to change its previous decision to require the undistributed rate in all circumstances and require the use of rate that the entity expects will apply (Alternative E)?

Question 2: If the Board does not wish to change its previous decision, does the Board agree with the staff's recommendation for an exception to that decision, Alternative D?