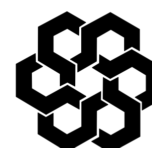

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**International Accounting Standards Board**

*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:** **22 July 2008, London**

**Project:** **Income taxes**

**Subject:** **Sweep Issues (Agenda Paper 5)**

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## Introduction

1. A pre-ballot draft package of the exposure draft of amendments to IAS 12 *Income Taxes* was distributed in May. Comments were sought from Board members and subject matter experts from the international accounting firms and the staff of some national standard setters. This paper discusses matters arising from those comments.[1]

2. The project is a joint project with the FASB. The FASB is considering whether to issue an exposure draft of amendments to SFAS 109 *Accounting for Income Taxes* arising from its decisions in the project or whether to issue the ED of IAS 12 for its constituents to consider. At the time of posting this paper, the FASB had not made a decision on this matter. The staff will update the Board on any developments at the Board meeting.

[1] Some comments from subject matter experts were received too late for the staff to include them in this paper. The staff will consider them while developing the second pre-ballot draft and will draw the Board's attention to any major points.

3. The paper is divided into the following sections:

   (a) whether any Board members wish to express an alternative view in the exposure draft

   (b) issues that the staff raised in the cover note to the pre-ballot draft

   (c) other issues that Board members have asked to be discussed at the Board meeting or that the staff wish the Board to discuss.

4. Any other comments, other than drafting comments, are noted in Agenda Paper 5A with the staff response. [Agenda Paper 5A is not reproduced as observer notes.] The staff does not intend to discuss the comments in Agenda Paper 5A at the Board meeting unless requested to do so by a Board member. If Board members wish to discuss any issues in Agenda Paper 5A at the meeting, it would be helpful if they could let the staff know as soon as possible.

## Alternative views from Board members

5. The Board made most of the decisions in this project sometime ago. **Does the current Board wish to publish the exposure draft, subject to the matters discussed in this paper? Do any Board members wish to express an alternative view in the exposure draft?**

## Issues that the staff raised in the cover note to the pre-ballot draft

6. The staff raised the following issues in the cover note to the pre-ballot draft, for discussion at a Board meeting:

   i. the format of the documents

   ii. tax relating to equity instruments

   iii. the exception brought in from SFAS 109 for foreign subsidiaries and joint ventures

   iv. guidance on substantive enactment

v. the wording of the requirements on tax allocation

vi. disclosures arising from the financial statement presentation project

vii. disclosures on the effects of distributions

viii. disclosures on tax uncertainties.

**Format of the exposure draft package**

*Amendments to IAS 12 or IFRS X*

**7.** One Board member asked whether it would be more appropriate for the new standard to be a new IFRS rather than a revision of IAS 12, given the extensive redrafting of the standard. The staff notes that although the standard has been rewritten, the basic approach to deferred tax, the temporary difference approach, has not been reconsidered. Some Board members may not be comfortable issuing an IFRS without reconsidering that approach. The staff therefore recommends that the ED continue to be described as amendments to IAS 12 rather than as the exposure draft of a new IFRS. **Does the Board agree?**

*Invitation to comment*

8. The IASB invitation to comment includes questions on exceptions from the temporary difference approach that are not in IAS 12 and that are proposed to be removed from SFAS 109. Some Board members did not think that the invitation to comment should include a question on these exceptions, because the Board has no plans to add the exceptions to IAS 12. The staff agrees and recommends that the questions be removed. If the FASB decides to issue an exposure draft of amendments to SFAS 109, the staff will make it clear in the introduction to the IASB exposure draft that SFAS 109 is proposed to be amended to remove these exceptions. **Does the Board agree?**

*Standard and application guidance*

9. The pre-ballot draft included in the proposed standard only the main requirements that are applicable to most entities. Detailed requirements applying only in specific circumstances were included in the application guidance with a cross reference in the proposed standard. No Board members disagreed with the split of the material between the standard and the application guidance.

10. Most of the comments from the subject matter experts were also supportive of the proposed structure, but some raised questions about what material should go where. For example, one questioned whether it was appropriate to have for some issues just a cross-reference to application guidance in the standard without any statement of the basic principle or requirement. Others argued that the requirements applying to investments in subsidiaries and the determination of a valuation allowance would apply to many entities and hence should be included in the standard.

11. The staff notes that the application guidance will be described as an integral part of the standard, so that the status of its requirements as equal to that of the requirements in the standard will be clear. On reviewing the requirements in the application guidance the staff would describe them as follows:

    (a) detailed requirements that take many paragraphs to set out or

    (b) requirements that apply only to a minority of entities.

12. The staff is reluctant to add the longer sections in the application guidance into the standard. One objective of the rewrite of IAS 12 was to make IAS 12 easier to follow for readers who are not experts in tax accounting. The staff thinks that the current balance between the material in the standard and the material in the application guidance means that the standard gives a broad overview of how to account for income tax, leaving those that need to know the details on specific issues able to turn to the relevant paragraphs in the application guidance.

13. The staff therefore proposes no change in the split between the standard and the application guidance. **Does the Board agree?**

*Implementation Guidance*

14. In the cover note to the pre-ballot draft, the staff noted that it did not intend the Implementation Guidance to be issued by the Board with the final standard. Instead the staff thought that at that time the guidance would be educational in nature and should be handled by the education staff.

15. Some of the Board and some of the subject matter experts thought that the examples were necessary to understand the requirements and, hence, should be issued as implementation guidance with the final standard. Some thought some of the examples should be added to the application guidance, others thought that the application guidance should include in the relevant paragraphs cross-references to the relevant examples. There were many requests for examples on tax allocation and one request for an example on tax uncertainties.

**16.** The staff notes that the examples should only illustrate the requirements in the standard and application guidance. They should not include additional requirements. Because of this, they are not an integral part of the standard. The staff therefore continues to think that when the final standard is issued, the examples should become educational material to be handled by the education staff. **Does the Board agree?**

17. The staff agrees that cross-references in the relevant paragraphs of the standard and application guidance to examples could be helpful to readers of the exposure draft. But the standard and application guidance are intended to be documents that together stand alone and can be used without reference to other documents. It would be against IFRS policy to date to include cross-references to illustrative examples. **Does the Board agree that the standard and application guidance should not include such cross-references?**

18. The staff agrees that an examples on tax allocation and tax uncertainties would be useful and will develop such examples.

**Tax relating to equity instruments**

19. The cover note to the pre-ballot draft explained that the staff proposed that equity instruments should not be regarded as having a tax basis that is compared with the carrying amount of the equity instrument to assess the tax consequences of repurchasing instrument or derecognising the carrying amount in some other way. Rather tax consequences related to equity instruments that will occur without any change to the carrying amount in equity should be regarded as the tax basis of items with no asset or liability carrying amount.

20. No commentator disagreed with this approach. **Does the Board agree that this approach should be included in the ED?**

**The exception brought in from SFAS 109 for foreign subsidiaries and joint ventures**

21. The cover note to the pre-ballot draft discussed three issues relating to the exception brought in from SFAS 109 for foreign subsidiaries and joint ventures. The first was whether the words 'an investment that is essentially permanent in duration' and 'a temporary difference that is not expected to reverse in the forseeable future' are intended to result in the same threshold.

22. The exceptions in SFAS 109 for foreign subsidiaries and joint ventures apply as follows:
    (a) for deferred tax liabilities, to investments that are essentially permanent in duration and
    (b) for deferred tax assets, when the temporary difference is not expected to reverse in the foreseeable future.

23. Further, if circumstances change, deferred tax liabilities are recognised if it becomes apparent that unremitted earnings will be remitted in the foreseeable future.

24. [Not reproduced in observer notes.]

25. [Not reproduced in observer notes.]

26. The staff notes that the Board's rationale for the exception is that the calculation of the amount of deferred taxes for permanently reinvested unremitted earnings of foreign subsidiaries and joint ventures is so complex that the costs of doing so outweigh the benefits. Given this rationale, the staff thinks it is difficult to justify the different thresholds for the exception for deferred tax assets and deferred tax liabilities. However, the staff acknowledges that convergence with the requirements of SFAS 109 was also a factor in the Board's decision. On the assumption that the FASB issues an exposure draft amendments to SFAS 109 and the role of convergence in the project remains the same as when the decisions were originally made, the staff recommends no change to the substance of the thresholds required by SFAS 109.

27. In terms of the wording of the thresholds, the staff does not think that the application guidance can use the term 'foreseeable future' in different paragraphs to mean different periods. In addition, editorial director asked whether 'essentially permanent in duration' could be changed to 'in effect permanent in duration'. He thinks that 'essentially' is used to emphasise the basic, fundamental or intrinsic nature of a thing or situation, while 'in effect' is used to convey that something is in practice the case, even if it is not formally acknowledged to be so. He also notes:

> Paragraph AG5 refers to an investment that is 'essentially' permanent. If that is so, there seems no need to use the word: the investment is either permanent or it is not. Yet paragraph AG7 discusses an investment that becomes 'no longer essentially permanent'. This seems like a nonsense: a permanent thing is either permanent or it is not. If it is not, we should not have used the word 'essentially' in the first place. That is why I have suggested 'in effect', which does not imply intrinsic permanence, merely the practical appearance of permanence.

28. [Not reproduced in observer notes.]

29. The staff therefore recommends:

(a) drafting the exception for deferred tax liabilities in terms of 'investments essentially permanent in duration' both for initial application of the exception and for subsequent changes in circumstances and

(b) drafting the exception for deferred tax assets in terms of 'temporary differences that are not expected to reduce in the near future'.

**Does the Board agree?**

30. The other issues raised in the cover note to the pre-ballot draft related to foreign subsidiaries ceasing to be subsidiaries or investments becoming subsidiaries. In the cover note the staff proposed that specific requirements in SFAS 109 should be replaced by requirements consistent with the treatment of disposals and step-acquisitions in IFRS 3. [Not reproduced in observer notes.] **Does the Board agree that the requirements should be consistent with the treatment of disposals and step-acquisitions in IFRS 3**?

**The wording of the requirements on tax allocation**

31. The Board decided to adopt the SFAS 109 requirements on tax allocation. The combined IASB and FASB staff has reworded the requirements to try to bring out the general principles more clearly. However, many Board members and most of the subject matter experts found the requirements unclear.

32. [Not reproduced in observer notes.]

33. When the Board decided to adopt the allocation requirements in SFAS 109, it did so because it acknowledged that:

(a) the allocation requirements in IAS 12 are incomplete and can be subjective

(b) developing a new set of allocation requirements would take more time than was considered appropriate for this project

(c) any set of requirements would include some arbitrary elements in some cases

(d) the SFAS 109 requirements were an existing complete set of requirements, adoption of which would ensure convergence.

34. On the assumption that the FASB issues an exposure draft of amendments to SFAS 109 and the role of convergence in the project remains the same as when the decision was originally made, the staff continues to recommend adopting the allocation requirements in SFAS 109. The staff will discuss with those concerned the problems with the wording in the current draft and will try to develop clearer wording and illustrative examples.

35. **Does the Board agree that the ED should adopt the SFAS 109 allocation requirements**?

**Guidance on substantive enactment**

36. The Board decided that substantive enactment occurred when future events required by the enactment process will not change the outcome. In the cover note to the pre-ballot draft, the staff proposed to explain in the Basis that 'will not' does not mean the same as 'cannot' and to note that this is a matter on which national standard setters may wish to give jurisdictional guidance.

37. Some subject matter experts noted that the explanation that 'will not' does not mean 'cannot' should be in the application guidance not the Basis. Others found the distinction between 'will not' and 'cannot' confusing, noting that the way 'will not' is described implies a probabilistic threshold.

38. The Board originally decided on the phrase 'will not' because it wanted to move away from a probabilistic threshold. However, the staff agrees that, in fact, the threshold is probabilistic. The staff has amended the application guidance as follows:

> An entity shall regard tax rates as substantively enacted when future events required by the enactment process historically have not affected the outcome and are highly unlikely to do so.

**Does the Board agree**?

39. Some Board members disagreed that the Basis should note that this is a matter on which national standard setters may wish to give jurisdictional guidance. The staff notes that the point of substantive enactment under any jurisdiction may be a matter of judgement but that it is something on which a consensus should be reached. The staff therefore continues to think it is a matter on which national standard setters could give guidance and it might be helpful to say so in the Basis. **Does the Board agree?**

**Disclosures arising from the financial statement presentation project**

40. In response to suggestions arising in the financial statements presentation project, the cover note to the pre-ballot draft proposed that the following disclosures currently required for total deferred tax expense should be analysed for each type of temporary difference, unused tax loss and tax credit.

    (a) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;

    (b) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

    (c) the effect on deferred tax of any change in amount determined in accordance with paragraph 27 of the standard [ie the effects of changes in uncertain tax amounts];

    (d) any change in a valuation allowance;

    (e) the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8 or specific transitional requirements in another standard;

    (f) adjustments to deferred tax arising from a change in the tax status of an entity or its shareholders.

41. The aim was to give the same information as would be provided by a reconciliation of total tax expense to current tax expense, and the intention of

the income tax staff was to do this by requiring a balance sheet to balance sheet numerical reconciliation for the deferred tax arising from each type of temporary difference, unused tax loss and tax credit, identifying which amounts are allocated to profit or loss, other comprehensive income or equity.

42. Staff on the financial statements presentation project noted that the words in the pre-ballot draft did not convey to them the notion of a balance sheet to balance sheet numerical reconciliation, and that if such a numerical reconciliation was required, that might be regarded as requiring too much detailed information. No Board members disagreed with the proposed requirements.

43. The income tax staff understood that the Board wished to provide more analysis of the deferred tax expense than is currently provided. That is achieved by a balance sheet to balance sheet numerical analysis for each type of temporary difference, unused tax loss and tax credit. The staff proposes clarifying the requirement so that such a numerical reconciliation is required. **Does the Board agree?**

**Disclosures related to the effect of distributions**

44. The cover note to the pre-ballot draft proposed the following disclosure requirement relating to the tax effects of distributions:

    (a) the entity's assumptions about future distributions and their effect on the tax rate used to measure deferred tax assets and liabilities.

45. No Board member disagreed. **Can the Board confirm that the ED should include this requirement?**

**Disclosures on tax uncertainties**

46. The cover note to the pre-ballot draft discussed the disclosures relating to tax uncertainties and compared those required by FIN 48 *Accounting for Uncertainty in Income Taxes* with those proposed in the ED. Some Board members thought that further disclosures should be proposed in the ED, in

particular an analysis of the difference between the amounts claimed in the tax return and the amounts recognised in the financial statements.

47. In this regard, FIN 48 requires the following disclosures:

(a) A tabular reconciliation of the total amounts of unrecognised tax benefits at the beginning and end of the period, which shall include at a minimum:

i. The gross amounts of the increases and decreases in unrecognised tax benefits as a result of tax positions taken during a prior period

ii. The gross amounts of increases and decreases in unrecognised tax benefits as a result of tax positions taken during the current period

iii. The amounts of decreases in the unrecognised tax benefits relating to settlements with taxing authorities

iv. Reductions to unrecognised tax benefits as a result of a lapse of the applicable statute of limitations

(b) The total amount of unrecognised tax benefits that, if recognised, would affect the effective tax rate

48. The requirements proposed in the ED were:

(a) any adjustments recognised in current tax for the period relating to current tax of prior periods, including the effect of any change in amount determined in accordance with paragraph 27 of the standard [ie any change in the probability weighted average of all possible outcomes];

(b) for each type of temporary difference, and for each type of unused tax losses and unused tax credits, the effect of any change in amount determined in accordance with paragraph 27 of the standard;

49. Both standards require similar qualitative descriptions of key uncertainties.

50. The disclosures in the ED focus on changes in the amounts recognised, whereas those in FIN 48 focus on the unrecognised amounts. The staff notes that the disclosures in the ED are consistent with the approach to the recognition and measurement of uncertain tax assets and liabilities. There is no recognition threshold and all uncertainty is reflected in the measurement of the recognised amount. The disclosures are also consistent with those proposed in the amendments to IAS 37 for uncertain liabilities

51. The staff continues to think that the proposed disclosures are appropriate given the proposed approach to tax uncertainties and that there is no need for additional disclosures. **Does the Board agree?**

## Other issues that the Board members or staff wish to raise

52. Other issues raised by Board members or that the staff wish Board members to discuss are:

    (a) wording of the core principles

    (b) the treatment of temporary differences that arise on the initial recognition of assets and liabilities

    (c) the role of expectation in accounting for deferred tax

    (d) the analysis between recognition and measurement for deferred tax assets

    (e) discounting deferred tax assets arising from unused tax losses and tax credits

    (f) the allocation of the effects of changes in uncertain tax positions

    (g) the classification of interest and penalties payable to tax authorities

    (h) the transition requirements for first-time adopters of IFRSs

**The wording of the core principles**

53. Some Board members expressed concern that the core principles seemed more like a description of the method than a set of principles. The staff is working with Board members to develop a short paragraph that sets out a principle without discussing the methodology. So far, the paragraph is as follows:

> An entity shall recognise the tax effects of changes in its assets and liabilities and of its equity transactions in the current period, and changes in the tax effects of such changes and transactions arising in previous periods. These recognised amounts comprise current tax and deferred tax. Current tax is tax due on taxable profit for the current period. Deferred tax is tax payable or recoverable in future periods, generally as a result of the entity recovering or settling its assets and liabilities for their current carrying amount, and the tax effect of the carryforward of currently unused tax losses and tax credits.

54. **The staff does not wish to discuss the drafting of the paragraph at the Board meeting, but would welcome views on whether there are any other concepts that should be included in the core principle.**

**The treatment of temporary differences that arise on the initial recognition of assets and liabilities**

55. The pre-ballot draft application guidance included requirements for the treatment of temporary differences that arise on the initial recognition of assets and liabilities. Some Board members and subject matter experts expressed concern that the requirements were complex and confusing.

56. The application guidance first requires an entity to separate the asset or liability that resulted in an initial temporary difference into two items:

    (a) an asset or liability with a tax basis available to market participants in a transaction for the individual asset or liability in that tax jurisdiction and

(b) a tax advantage or disadvantage arising from any difference between the tax basis described in (a) and the tax basis available to the entity.

57. The objective of this first step is to recognise an asset or liability in accordance with applicable IFRSs at a carrying amount that is consistent with that recognised for other assets and liabilities and that is not affected by any entity-specific tax effects.

58. Next, a deferred tax asset or liability is recognised for the temporary difference that arises because of the difference between the carrying amount of the asset or liability and the tax basis available to the entity. This establishes a deferred tax asset or liability that is consistent with the other deferred tax assets or liabilities under IAS 12.

59. A problem then arises if the sum of the carrying amounts of the recognised asset or liability and the deferred tax asset or liability does not equal an externally established price for a transaction. This problem *does not* arise if the asset or liability is recognised as a result of a transaction that affects comprehensive income or equity, for example internally-generated assets or liabilities. In those cases, there is no externally established price and the sum of the carrying amounts of the asset or liability and the deferred tax asset or liability is recognised in comprehensive income or equity. There is also not a problem to the extent that the initial temporary difference arises because of deductions that affect taxable profit, because the effect of the temporary difference will be offset by an effect on current profit. And finally there is not a problem if the transaction is a business combination, because any difference between the transaction price and the sum of the recognised amounts affects goodwill.

60. But if the transaction affects does not affect comprehensive income, equity or taxable profit at the time of the transaction and is not a business combination, there can be a difference between the amounts recognised as described in paragraphs 57 and 58 and the transaction price. This is the group of temporary

differences that falls under the initial recognition exception currently in IAS 12.

61. In such cases, the application guidance then requires a premium or allowance to be recognised to make the sum of the recognised amounts equal the transaction price. That premium or allowance is an anomaly that arises because the methodology in IAS 12 does not measure deferred tax assets and liabilities at fair value or at a price established by an exchange transaction for the tax asset or tax liability. Because that premium or allowance relates to the measurement of the tax assets and liabilities under IAS 12, the Board decided to recognise it as part of the deferred tax balance.

62. The impact of these requirements can be analysed across two groups of assets or liabilities that give rise to the temporary differences in question:

    (a) those for which the same tax basis is available to the entity and to market participants. In other words, such a temporary difference would arise for any market participant. Examples arise when a tax authority wishes to encourage investment in certain assets and gives tax deductions in excess of cost to any entity acquiring those assets. For these assets, there is no entity-specific tax effect that the entity needs to split out before recognising the asset or liability in accordance with applicable IFRSs. The entity then recognises a deferred tax asset or liability for any resulting temporary difference and an allowance or premium that will always on initial recognition exactly offset the amount of the deferred tax asset or liability. For example, suppose an entity acquired an asset for its fair value of 100. The asset has a tax basis of 150, available to all market participants and the tax rate is 30%. The entity recognises an asset of 100, a deferred tax asset of 15 and an allowance of 15.

    (b) those for which the tax basis available to the entity is different to the tax basis available to market participants. In other words, such a temporary difference arises because of the entity's specific tax situation. Examples arise when the entity acquires the shares in a

shell company that holds a single asset. The transaction is accounted for as an asset acquisition under IFRSs and the change in ownership of the shares does not affect the tax basis of the underlying asset that is available to the acquiring entity. For these assets, the acquirer is required to separate the cost of the asset into the elements described in paragraph 56. This may be a difficult judgement to make. For example, if an asset is required to be measured at cost on initial recognition under IFRSs, it may not be clear what the cost of an asset with a tax basis equal to that assumed by the market in a transaction for the individual asset or liability in that tax jurisdiction would have been. In other words it may not be clear what impact the entity's relative tax advantage or disadvantage had on the purchase price. When the entity recognises the asset in accordance with applicable IFRSs, a deferred tax asset or liability for any resulting temporary difference and an allowance or premium, the allowance or premium may not exactly offset the deferred tax asset or liability. For example, suppose an entity acquires shares in a shell company that holds an asset with a tax basis of nil. A market participant acquiring the individual asset would get a tax basis equal to cost. The entity pays 90 for the shares. The entity accounts for the acquisition as an asset acquisition because there is no business associated with the asset. The entity has to assess what the cost of the asset would have been had it been acquired as an individual asset. In some cases that may be difficult to assess. Suppose in this example the entity assesses that cost would have been 100. The entity would recognise an asset of 100, a deferred tax liability of 30 and a premium of 20.[2]

63. A number of questions arise:

(a) the total population of assets affected by the initial recognition exception (ie those in both 62(a) and (b)) is small. Why add

[2] The example assumes that there is no difference on initial recognition between the carrying amount and tax basis of the investment in the shares (ie no outside basis difference).

complex requirements to the standard for such a small population? Is this an issue on which a principled-based standard should just be silent?

(b) for assets in 62(a), the requirements in the application guidance give exactly the same results in practice on initial recognition as the existing initial recognition exemption. Does the change for the assets in 62(b) justify the change to the standard?

(c) are the requirements workable in practice for assets in 62(b)?

64. The staff agrees that the population of items currently affected by the initial recognition exception is small, and that the changes to the definition of tax basis will reduce the population further. But the staff notes that the FASB thought it necessary to issue EITF 98-ll to resolve issues that arise even when the definition of tax basis is clear. The staff thinks that removing the initial recognition exception and not replacing it with a specified treatment would lead to confusion and many issues being raised with the IFRIC.

65. The staff also agrees that for the cases in 62(a) the effect of the requirements in practice on initial recognition is the same as the existing initial recognition exception. But many of the problems that arise in practice with the initial recognition exception relate to difficulties in distinguishing between subsequent changes in an unrecognised initial difference (the effect if which is not recognised) and the creation of new temporary differences (that effect of which is recognised). Recognising the effect of the original temporary difference and an offsetting premium or allowance makes tracking subsequent changes easier.

66. The staff agrees that there may be difficulties assessing what the amount recognised in accordance with applicable IFRSs would have been if the same tax basis were available to the entity as to a market participant. Originally, the Board had decided the carrying amount on initial recognition should be fair value. But the Board changed that decision to the amount recognised in accordance with applicable IFRSs because this project is not the place in which to introduce new fair value measurements. The staff thinks that entities

should be able to form some view as to whether or not the transaction or entity specific tax effects have affected the transaction price.

67. On the other hand, the staff acknowledges that the effect of the premium or allowance can also pose some problems. For example, some Board members are troubled by the different treatment of the tax effects of a deep discounted bond with non-deductible imputed interest and the tax effects of a convertible bond. Say an entity issued a deep discount bond for 70, to be redeemed for 100 in five years' time. The imputed interest of 30 is not deductible for tax purposes for any market participant. The tax basis of the liability is 100.[3] The entity recognises a liability of 70, a deferred tax liability of 9 (assuming a tax rate of 30%) and purchase premium of 9. As the interest accrues on the liability, the temporary difference reduces and the deferred tax liability is released. At the same time, the purchase premium is also released, resulting in no deferred tax effect in profit or loss. Also, no current tax benefit arises from the interest.

68. In contrast, consider a convertible bond that is split into a liability of 70 and an equity component of 30. In this case the tax basis of the liability is also 100.[4] The entity recognises a liability of 70 and a deferred tax liability of 9. The effect of the deferred tax liability is recognised in equity because the transaction affects equity. There is no purchase premium. So in this case, as the imputed interest on the liability component accrues the deferred tax liability is released, resulting in a reduced tax charge.

69. In both cases the liabilities and the deferred tax liabilities are recognised at a consistent amount. But, for the deep discount bond, the release of the purchase premium could be regarded as distorting the tax expense in the periods in which the interest accrues.

70. Others are troubled by the requirement in the application guidance that the premium or allowance does not affect the assessment of the need for a

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[3] In stating that the tax basis of the liability is 100, the staff has assumed that if the entity settled the liability for 70 a taxable gain of 30 would arise. This is consistent with the tax authority not giving deductions for the imputed interest of 30.

[4] The staff has again assumed that if the liability were settled for 70 a taxable gain of 100 would arise. This is consistent with the tax authority not giving deductions for the imputed interest of 30.

valuation allowance. This means that the need for a valuation allowance is always assessed on deferred tax assets that are measured consistently under IAS 12. But suppose an entity bought an asset for its fair value of 100. Market participants get a tax basis equal to cost, but the entity gets deductions of 150 on sale or use of the asset. The entity would recognise an asset of 100, a deferred tax asset of 15 and an allowance of 15, assuming a tax rate of 30%. Suppose the entity does not expect to be able to benefit from the additional deductions because it does not expect to have sufficient taxable profit in the future. But it does expect to have sufficient taxable profit to benefit from the 'normal' deductions of 100 so it would still have paid 100 for the asset. If the need for a valuation allowance is assed on the deferred tax asset of 15, the entity would recognise a deferred tax asset of 15, a valuation allowance of 15 and a purchase allowance of 15, resulting in an initial loss of 15.

71. As noted above, the staff regards the purchase premium or allowance as an anomaly under the IAS 12 methodology. So it is not surprising that its subsequent accounting gives rise to anomalous results. But the staff thinks it is easier to understand how these results arise under a method that maintains a consistent approach to the carrying amounts of assets and liabilities and deferred tax assets and liabilities, with an extra item that is clearly acknowledged to be a plug needed on initial recognition, compared to an exception to the basic temporary difference approach.

72. It could be argued that immediate release of the purchase premium or allowance to comprehensive income would result in the most consistent approach, because the anomaly is removed as quickly as possible without effects in subsequent periods. The IASB and FASB considered that approach at the time the IASB decided to remove the initial recognition exception, but rejected it on the grounds that the recognition of gains or losses on the initial recognition of assets and liabilities in arm's length transactions was inappropriate.

73. The FASB also decided to change from the current requirements in US GAAP (set out in EITF 98-11) to the approach set out in the ED. Any change to that

approach would need to be discussed by the FASB if the Boards are to keep a converged approach on this.

74. The staff therefore recommends no change to the substance of the requirements in the application guidance on temporary differences arising on the initial recognition of assets and liabilities. The staff will discuss the drafting with those concerned about its clarity and try to improve the wording. **Does the Board agree?**

**The role of expectation in the recognition and measurement of deferred tax assets and liabilities**

75. Under existing IAS 12, the entity's expectations about the way in which the carrying amount of an asset or liability will be recovered or settled affects the tax basis, whether the difference between the carrying amount and the tax basis is a temporary difference and the rate used to measure any temporary difference.

76. Under the proposed amendments, the entity's expectations *do not* affect the tax basis. That is determined by the deductions that will be available on sale of the asset or settlement of the liability. But the entity's expectations about the way in which the asset or liability will be recovered or settled *do* affect whether any difference between the carrying amount and the tax basis is a temporary difference and the rate used to measure any temporary difference.

77. Some Board members thought this approach seemed inconsistent. Some of the subject matter experts found the approach confusing.

78. The approach is illustrated in example 16 as follows:

An entity acquires an asset for CU100. Deductions of 150 per cent are available over ten years if the asset is used. If the asset is sold, deductions of 100 per cent of cost are available but all previous deductions received for use must be repaid. The entity expects to recover the carrying amount of the asset through use over ten years.

The tax basis of the asset is determined by the consequences of recovery through sale. After two years the carrying amount of the asset is CU80 and the tax basis is CU70 (CU100 less the deductions of CU30 already received). There is a basis difference of CU10. But if the asset is used, that basis difference will have no tax consequences. The entity expects to recover the asset through use, so the basis difference is not a temporary difference.

79. The problem is that if the entity recovers the carrying amount of 80 through sale it will pay tax on net proceeds of 10. If it recovers the carrying amount of 80 through use it will receive deductions of 120. Assuming a tax rate of 40%, under the first assumption, it would seem to make sense to recognise a deferred tax liability of 4, and under the second assumption a deferred tax asset of 16. But in fact, the proposals result in no deferred tax asset or liability.

80. [Not reproduced in observer notes.]

81. The objective of the approach proposed in the ED is to converge as closely to practice under US GAAP on as many occasions as possible. The approach can be justified on the grounds that the tax basis is a matter of fact that determines whether or not a deferred tax asset or liability *exists*. That is not affected by the entity's expectations about the manner of recovery or settlement of an asset or liability. In contrast, determining whether any difference between the carrying amount of an asset or liability and its tax basis has any tax effect (ie whether it is a temporary difference) and what rate to use to measure the tax effect is a matter of *measurement*, and that can be affected by the entity's expected manner or recovery or settlement of the asset or liability.

82. The staff acknowledges that convergence with the requirements of SFAS 109 was a factor in the Board's decisions on these issues. On the assumption that the FASB issues an exposure draft of amendments to SFAS 109 and the role of convergence in the project remains the same as when the decisions were originally made, the staff recommends keeping the approach currently set out in the ED. The staff will add the reasoning set out in paragraph 81 to the Basis and will discuss the drafting of the requirements on this issue in the ED,

application guidance and implementation guidance with those that found them confusing to find ways of improving them. **Does the Board agree?**

**The analysis between the recognition and measurement of deferred tax assets**

83. Several responses from the subject matter experts noted that the introduction of the requirements relating to tax uncertainties and the valuation allowance approach created some confusion between the recognition and measurement aspects of deferred tax assets.

84. The approach in the ED is that:

    (a) a deferred tax asset is *recognised* for the tax effect of the full amount that an entity is entitled to receive in deductions in the future, *measured* at an amount that includes the effect of any uncertainty over what deductions the tax authority may allow

    (b) a valuation allowance is *recognised* so that it is more likely than not that there will be sufficient future taxable profit to utilise the net amount of the deferred tax asset and the valuation allowance.

85. The amount of both the deferred tax asset and valuation allowance are required to be disclosed, for each type of temporary difference and unused tax credit and tax loss.

86. The response from one subject matter expert noted that it might be regarded as a lot of work to go through to calculate the deferred tax asset and the valuation allowance when an entity knows that the net amount it can recognise is nil because it is more likely than not to have insufficient taxable profits in the future. Another response thought the two step approach confusing.

87. The staff notes that under existing IAS 12 there is a one step approach to recognising and measuring the deferred tax asset at the amount that is probable of being realised. But there is also a requirement to disclose the amount of any temporary differences, unused tax losses and tax credits for which no deferred tax asset is recognised. So the equivalent of both the deferred tax asset and valuation allowance amounts described in paragraph 84 need to be

calculated under existing IAS 12. The only added complication is the impact of tax uncertainty.

88. The staff agrees that the proposals on tax uncertainty add complexity to the calculation of the deferred tax assets, but thinks that is inevitable consequence of those proposals. Unless the Board is prepared to loose the information currently given by the disclosure of any temporary differences, unused tax losses and tax credits for which no deferred tax asset is recognised, both amounts in paragraph 84 need to be calculated. The staff therefore recommends no change in the approach, but will try to improve the drafting so that the two-step process is clearer. **Does the Board agree?**

**Discounting deferred tax assets arising from unused tax losses and tax credits**

89. In the cover note to the pre-ballot draft, the staff noted that some constituents had asked the staff to raise with the Board the question of discounting deferred tax arising from unused tax losses and tax credits. Those constituents accepted that discounting deferred tax arising from temporary differences was too complex to be addressed in this project. But they argued that discounting the tax effects of unused tax losses and tax credits is more straightforward. All that needs to be done is to make an estimate of when the deferred tax will be realised and to apply a discount rate.

90. The staff agreed that discounting deferred tax related to unused tax losses and tax credits is more straightforward than discounting deferred tax related to temporary differences. But the staff noted that there are still issues that would need to be resolved, for example what discount rate should be used and how should the effect of risk be treated?

91. Some Board members thought that the ED should propose that such deferred tax assets should be discounted. They noted that requiring the amounts to be discounted at a rate that captures only the time value of money and no effects of risk would be an improvement on not including the time value of money. Such a requirement would improve the measurement of such deferred tax assets and would not be overly complex.

92. The staff continues to think that this issue is outside the scope of this project. Even if a risk-free discount rate were specified, there are still questions over whether the unwinding of the discount would be regarded as a tax amount or a financing amount, and how a valuation allowance would be assessed. And deferred tax assets arising from unused tax losses and tax credits would be measured on a different basis from deferred tax assets arising from temporary differences. Some temporary differences arise from a comparison of future tax deductions with an item with a carrying amount of nil. It is not clear why a deferred tax asset arising from such a temporary difference should be measured at an amount different from deferred tax assets arising from unused tax losses and tax credits.

93. Further, these amounts are not discounted under US GAAP. If we want to continue with a converged approach, we would need to ask the FASB to discuss this issue.

94. The staff recommends not taking on this issue in this project. **Does the Board agree?**

**Allocation of the effect of changes in uncertain tax positions**

95. The allocation requirements in the ED are intended to be the same as the requirements in SFAS 109 (see discussion in paragraphs 31-35 above). The requirements in SFAS 109 are silent on the question of how to allocate the effect of changes in uncertain tax positions. FIN 48, which sets out the accounting for uncertainties that affect tax assets and liabilities, states that it does not change the allocation requirements in SFAS 109. [Not reproduced in observer notes.] But the combined staff agreed that it would consistent with the general principle, that changes in tax assets and liabilities are not tracked back to the component in which the tax asset or liability originally was recognised, to also not track back these changes.

96. The staff therefore recommends that the ED proposes that the effects of changes in uncertain tax positions should be recognised in continuing operations, regardless of the component of comprehensive income or equity in

which the related tax assets and liabilities were originally recognised. **Does the Board agree?**

**Interest and penalties**

97. The ED proposes that an entity shall make an accounting policy decision on how to classify interest and penalties payable to tax authorities. One Board member disagrees. That Board member thinks that interest should be classified as interest and that penalties are not tax.

98. The staff notes that this decision converges with the requirements of FIN 48. If the Board wishes to remain change the decision and remain converged, it would need to ask the FASB to reconsider the decision. The staff recommends no change to the approach in the ED. **Does the Board agree?**

**Transition for first-time adopters**

99. The Board decided that first-time adopters whose date of transition to IFRSs is *before* the revised standard is issued should be required to apply the existing IAS 12 requirements for any periods presented that start before the date of issue. The revised standard should be applied to the assets and liabilities in the opening statement of financial position for the first period starting after the standard is issued and to all events and transactions thereafter.

100. The Canadian Accounting Standards Board (AcSB) has pointed out that this could require some first-time adopters to perform two tax accounting conversions in consecutive years (with one being required only for comparative purposes). Assuming the revised standard is issued in 2010, countries adopting IFRSs effective from January 2011 would:

(a) report years prior to 2011 using local GAAP

(b) report the 2010 comparative data in the 2011 financial statements using the existing version of IAS 12 and

(c) report 2011 and onwards using the revised version of IAS 12.

Requiring preparers to use existing IAS 12 for one comparative period only seems unduly burdensome.

101. The staff agrees. The problem is that it was thought not to be reasonable to expect preparers to gather information needed for the requirements in the revised standard before that standard is issued. So for existing IFRSs users, the amendments are required to be applied to the assets and liabilities in the opening statement of financial position for the first period beginning *after the revised standard is issued* and to all events and transactions thereafter. Any adjustment arising on the application to that first statement of financial position would be recognised in retained earnings. The proposal for first-time adopters mirrored that treatment.

102. The AcSB notes that a possible solution is to *allow* first-time adopters to apply the revised standard to comparative periods presented with periods to which the revised standard applies. It would be possible for preparers to do that limited amount of retrospective application, unless the requirements of the revised standard need contemporaneous information that the entities did not collect during the comparative periods. Examples of such information needed under the current proposals are:

   (a) the assessment of the probability-weighted average amounts for uncertain tax assets and liabilities

   (b) the assessment of valuation allowances for deferred tax assets that under existing IAS 12 are not recognised because of the initial recognition exception.

103. Of course, based on the proposals in the exposure draft, an entity could start to collect the information that may be necessary for the final revised standard. But if the proposals in the exposure draft change before the final standard is issued, there may still be some missing information.

104. Nonetheless, the staff thinks that the AcSB proposed solution is the best way forward. It would allow entities that preferred not to use the existing IAS 12 for just one comparative period the option of collecting the information

necessary (based on the proposals in the exposure draft) to apply the revised version to that period. Those entities that did not collect the necessary information would instead have to apply the existing IAS 12 to that period.

105. So the staff recommends that first-time adopters with a transition date before the date of issue of the revised standard should have the option to apply the revised standard to all periods presented in the financial statements to which the revised standard first applies. **Does the Board agree?**