IASB Meeting | Agenda reference **4A**

Staff Paper | Date **Week beginning 15 March 2010**

Project **Income Tax**

Topic **Scope – Practice issues**

Purpose of this paper

1. This paper discusses which practice issues the Board should consider in a limited scope project to amend IAS 12.
2. At the end of this paper, the staff has provided its recommendation which forms part of the staff recommendation in Agenda Paper 4.

Approach

3. In Agenda Paper 8 for the November Board meeting, the staff identified six issues as being significant practice issues. Given their significance, the staff has assessed whether the Board should include those issues in the scope of the project.
4. In making that assessment, the staff has considered whether the Board can resolve the issues without diverging from US GAAP and without changing the fundamental approach under IAS 12. For those issues that do not meet these criteria, the staff thinks that they should be resolved through the fundamental review of the accounting for income tax which the Board and the FASB will undertake in the future. The six issues are discussed in Appendix A.
5. In the November Board meeting, the staff also presented in Agenda Paper 8B a list of other practice issues that consists of:

   (a) Issues that the IFRIC previously rejected from its agenda

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(b) Convergence issues that respondents to the ED raised in their comment letters

(c) Other issues which respondents to the ED raised in their comment letters

6. The staff has applied the IFRIC agenda criteria in the IFRIC due process handbook to those practice issues and assessed whether the Board should consider them further. They are discussed in Appendix B.

7. Some of those practice issues were already rejected by IFRIC for a reason other than the Board's project on income tax. The staff omitted those issues from the assessment because there is no reason to suppose that the Board would come to a different conclusion from the IFRIC. The issues which IFRIC rejected for a reason other than the Board's project are listed in Appendix C.

Staff recommendation

8. As a result of the assessments in Appendices A and B, the staff thinks that the Board should consider the following issues in a limited scope project to amend IAS 12:

(a) Uncertain tax positions, but only after the revision of IAS 37 is finalised.

(b) Deferred tax on property revaluation.

Appendix A

Assessment of significant practice issues

Uncertain tax positions

Description of the issue There is diversity in practice as to how to account for uncertainty over whether the tax authority will accept tax positions taken in the entity's tax return.
Example An entity claimed a tax credit of CU100 based on a position that the entire R&D expenses of CU1,000 qualified for tax purposes. However, the entity is uncertain whether, and to what extent, the tax authorities will accept the R&D expenses as a qualified expense for tax purposes.
Why is this issue significant? IAS 12 is silent on this issue, whereas the FASB issued FIN 48 in 2006, now included in ASC Topic 740-10, and extended its application to non-public entities in 2009. Because of the differences between IFRSs and US GAAP in the treatment of uncertain liabilities in general, the Board's exposure draft *Income Tax* proposed requirements for uncertain tax positions that differed from those under US GAAP. A similar difference might result if the Board addresses this issue now. However, leaving IFRSs silent on this matter could lead to a question on the quality/completeness of IFRSs.
Staff Recommendation The staff thinks that the Board should consider dealing with this issue. However, the staff also thinks that should be done only after the amendment to IAS 37 is finalised. Responses to the ED indicated different views on whether new requirements for uncertain tax positions should be based on current IAS 37, future IAS 37 or US GAAP Topic 740. The staff thinks that the new requirements for uncertain tax positions should be consistent with the general requirements for uncertainties under the revised IAS 37. The Board should justify any inconsistency with the revised IAS 37 if any exceptions to the general requirements are necessary. In order to do so, the Board should finalise the revision of IAS 37 first and then should start discussion of uncertain tax positions.

Property revaluations

Description of the issue IAS 12 requires an entity to recognise and measure deferred tax on a basis that reflects the manner in which the entity expects to recover the underlying asset that generates the deferred tax. In some jurisdictions, an entity will pay income tax if it expects to recover an asset through use, but will pay no income tax if it recovers the asset through sale. Therefore, in those jurisdictions: (a) if an entity has a taxable temporary difference and expects to recover the asset through use, it recognises a deferred tax liability. (b) If it expects to recover the asset through sale, it recognises no deferred tax liability.

Many jurisdictions with no capital gains tax argue that they should not have to recognise deferred tax on property revaluations, even when an entity expects to recover the asset through use that will generate taxable cash inflows.
Example In Hong Kong, all properties are situated on leasehold land with lease periods that range from 50 to 999 years. There is no capital gain tax in Hong Kong (except claw-back tax on past tax depreciation for buildings on the leasehold land) but rental income from the leasehold properties is subject to ordinary income tax. When an entity re-values the leasehold property together with the buildings, it is required to provide a deferred tax liability on the revaluation gain because the leasehold property is treated as a depreciable asset and the entity expects to recover it through use.
Why significant? The issue arises not only in Hong Kong but also other jurisdictions where there is no capital gain tax. According to respondents to the ED, users in those jurisdictions ignore the deferred tax liabilities on revaluation surplus. Although US GAAP does not allow re-measurement of property, plant and equipment or a leasehold property, US GAAP requires a measurement of those properties at fair value upon business combinations. We have heard conflicting views on whether US GAAP practice results in the recognition of deferred tax in those circumstances.
Staff recommendation The staff thinks that the Board should consider dealing with this issue. As discussed in Agenda Paper 4C, the staff thinks that entities in some jurisdictions have legitimate cause for concern over the application of IAS 12. This is an issue that can be considered without reconsidering the basic approach in IAS 12 and its resolution may improve IAS 12 in a way that eases other issues.

Recovery of asset partly through use followed by sale (dual recovery)

Description of the issue There is diversity in practice as to whether separate tax bases need to be determined for the part of an asset expected to be recovered through use and the part expected to be recovered through sale, with any resulting temporary differences assessed and measured separately.
Example In some jurisdictions tax deductions are not available for the use of an asset but a deduction at the cost is available when the asset is sold. Under the basic 'expected' model under IAS 12 paragraph 52, an entity has to determine a manner in which it expects to recover the carrying amount of the asset, and then it determines a tax base and an applicable tax rate based on that expectation. When the entity expects to recover the carrying amount of an asset partially by use and partially by sale, there is a question on how the entity should determine a tax base. Some argue that the entity should determine two tax bases, one for use and one for sale, and calculate deferred taxes separately for both scenarios.

Why significant? We were told that there was significant diversity in practice.
Staff recommendation The staff thinks that this issue could lead to a more fundamental issue of what the tax base means and whether there can be two or more tax bases for one asset. It could create further divergence from US GAAP. Therefore, it should be dealt with in a future project. The staff thinks that, in some cases, the problem occurs upon a revaluation of a property for temporary differences that are common to market participants. The staff thinks that the number of cases that create the problem could therefore possibly be reduced or eliminated by dealing with the issue of the property revaluation.

Single asset entities

Description of the issue In some jurisdictions, some types of assets are often acquired in shell companies because there are tax and other advantages in selling the shares in shell companies instead of selling the underlying asset. There is considerable debate about whether deferred tax should be recognised for temporary differences arising on the asset within the shell company.
Example Real estate investment company A owns real estate. The real estate is held in single-asset entities for tax or legal purposes. A accounts for the acquisition of the single-asset entities as asset acquisitions, not as business combinations. Company A accounts for the real estate for using the fair value model of IAS 40. Any unrealised gains and losses are recorded in income. Subsidiary B is one of those single-asset entities. The local tax rate applicable to B is 40% on any profit (capital gain or rental income), regardless of whether it sells or rents out the asset. If A were to sell the shares of B, then a tax rate of 0% would be applied to the difference between the tax base of the shares and the sales price. Does A have to account for the temporary taxable difference between the carrying amount of the real estate and its tax base in the books of B if it intends to sell the asset by selling the shares?
Why significant? The staff thinks that the required treatment under IAS 12 is clear but other views appear to be also accepted in specific limited circumstances in practice. Further, the issue has become wide spread and many constituents think the current treatment under IAS 12 is counter-intuitive.
Staff recommendation The staff thinks that the Board should not deal with this issue independently but consider it together with the property revaluation issue. The staff thinks that this issue contains a more difficult question on how to determine the fair value of an asset held by

a shell company when there is no market to trade the asset itself but a market to trade shares of the shell company. The situations in which constituents feel the answer given by IAS 12 is counter-intuitive could possibly be reduced or eliminated by dealing with the issue of the property revaluation.

Initial temporary differences arising when the same transaction gives rise to both a liability and asset (or an increase in the cost of an asset)

Description of the issue

Initial temporary differences arise on both a liability and asset as a result of an entity entering into a finance lease transaction. There is divergence in practice over whether an entity should recognise the resulting deferred taxes initially and, in particular, subsequently. The same issue occurs as a result of recording a decommissioning liability and corresponding adjustment to the related asset.

Example

When an entity enters into a finance lease transaction, it recognises a lease asset and a lease obligation for the same amount. In many jurisdictions, tax law does not recognise a lease asset and a lease obligation for tax purposes. As a result, there are two equal and opposite initial temporary differences. There is diversity in practice as to whether the initial recognition exception should apply to the initial temporary differences. If the exception applies, deferred tax will not be recognised even if the amounts of those temporary differences subsequently change at different times.

Why significant?

We were told that there was significant diversity in practice.

Staff recommendation

The staff thinks that the Board should not deal with this issue. Firstly, depending on the Board's decision on the issue of the property revaluation, this issue may become less significant. Secondly, if the issue is not so resolved, the staff thinks that the IFRIC could resolve it were it re-submitted.

Tax consequence of distributions by entities such as real estate investment trusts and co-operative societies

Description of the issue

In some jurisdictions, some entities are in effect tax exempt because of tax rate reductions or tax deductions relating to distributions and a policy of distributing all or almost all of their available reserves. Those entities find it counter-intuitive to recognise tax liabilities at an undistributed tax rate despite their effective tax exempt status

Example

A real estate investment trust is effectively exempt from tax or bears significantly small amount of tax as it is allowed to deduct dividends declared and is generally expected to distribute most of its taxable income.

Why significant? Many find it counter-intuitive that entities such as the real estate investment trust would have to recognise current tax and deferred tax on their temporary differences at the ordinary tax rate even if the entities are effectively exempt from income tax by distributing most of the profit to investors.
Staff recommendation The staff does not think that the Board should deal with this issue in the limited scope project. The staff thinks that the best way to deal with this issue is to finalise a proposal in the ED regarding the use of a distributed rate and an undistributed rate. However, although the proposal was generally supported, there were also strong concerns on practicability of the proposed method among some respondents. If the Board wants to finalise the proposal, the Board will have to spend some time in outreach to our constituents and assessing the practicability of the proposals.

Appendix B

Assessment of other practice issues in light of IFRIC agenda criteria

IFRIC Agenda Criteria

The staff has applied the IFRIC agenda criteria in the IFRIC due process handbook to other practice issues and assessed whether the Board should consider them further. The IFRIC agenda criteria in paragraph 24 of the IFRIC due process handbook are cited below:

> The IFRIC assesses proposed agenda items against the following criteria. An issue does not have to satisfy all the criteria to qualify for the agenda.
>
> (a) The issue is widespread and has practical relevance.
>
> (b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.
>
> (c) Financial reporting would be improved through elimination of the diverse reporting methods.
>
> (d) The issue can be resolved efficiently within the confines of existing IFRSs and the *Framework,* and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.
>
> (e) It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.
>
> (f) If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.

Note: The criterion in (f) is omitted in our assessment because it does not apply in this case.

Conclusion

In the below section "Analysis", the staff has applied the above criteria to the other practice issues and has concluded that no further consideration is necessary for those issues.

Analysis

IFRIC rejected issues

Initial basis difference arising in both a liability and asset (February 2003, #13, June 2005, IAS 12-2)

Issue not assessed here because the staff already identified it as a significant practice issue. See Appendix A for further consideration.

Initial basis difference relating to deductions in excess of cost being available for an asset (February 2003, #13)

Description of the issue Initial temporary differences arise when a tax law in a jurisdiction provides supplemental tax deductions on fixed asset investment in certain plant and equipment (for example, 130% of the cost is deducted). There is divergence in practice over whether an entity should recognise the resulting deferred taxes initially and, in particular, subsequently.
(a): The issue is wide spread and has practical relevance. Yes
(b): There are significant divergent interpretations (either emerging or already existing in practice). Yes
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. No. This issue would require developing a definition of investment tax credits (as in the ED) and developing guidance on what deductions form part of the tax base. Further, dealing with this issue may lead to a more fundamental question regarding the definition of tax base and interaction with the government grant etc.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not

so narrow that is not cost effective. Maybe not. Resolution of the issue depends on the definitions of tax base. It may also relate to accounting for investment tax credits.
(e): The Board will be able to reach a timely consensus. Maybe not. The issue related to the definitions of tax base is fundamental to the temporary difference approach. The accounting for investment tax credits and its interaction with the government grant is something that the Board should consider in future projects.
Conclusion The staff thinks that it maybe possible to resolve this issue by developing a definition of investment tax credits (as in the ED) and developing guidance on what deductions form part of the tax base. But it could take some time to fully understand the implications of any proposals across different tax jurisdictions and to arrive at a Board consensus. Further, dealing with this issue may lead to a more fundamental question regarding the definition of tax base and interaction with the government grant. The staff thinks that the Board should defer this issue to a future project.

Deferred tax accounting for an equity instrument issued by the entity (February 2003, #13)

Description of the issue An entity purchases an option on its own shares and classifies it as an equity instrument. For tax purposes, the cost of the option will be deductible against future taxable profits at some point in the future. Should an entity recognize a deferred tax asset on the income tax benefit from future deduction of the cost of the option?
(a): The issue is wide spread and has practical relevance. Yes. There are several questions relating to tax on equity instruments generally.
(b): There are significant divergent interpretations (either emerging or already existing in practice). Yes, on tax on equity instruments generally.
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. No. This issue would require amendment to the existing standard because IAS 12 does not require accounting for tax consequence of the recovery of the equity items.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective.

Maybe not. Dealing with this issue could lead to a bigger issue as to deferred tax consequence of own equity items.
(e): The Board will be able to reach a timely consensus. Maybe not. Dealing with this issue could lead to a bigger issue as to deferred tax consequence of own equity items as a whole.
Conclusion Questions on tax on equity instruments often arise. Both IAS 12 and ASC Topic 740 are silent on the matter. Dealing with this issue will likely lead to a more fundamental issue as to what is meant by recovery of the carrying amount of own equity item. It could possibly increase divergence too. The staff thinks that it is an issue that the Board should consider in a future project.

Deferred tax accounting for un-remitted foreign branch profits where the entity is subject to tax on territorial income rather than worldwide income (February 2003, #13, July 2007, IAS 12-6)

Description of the issue Certain tax jurisdictions compute tax liabilities on a territorial basis rather than world wide basis, so that overseas income is not taxable unless it is repatriated. If an entity does not have a foreign branch and does not intend to remit the overseas income to the home jurisdiction and therefore does not expect to be liable to domestic taxation, should it recognize a deferred tax liability? The issue relates to the definition of 'branches' under IAS 12 paragraph 39.
(a): The issue is wide spread and has practical relevance. Yes.
(b): There are significant divergent interpretations (either emerging or already existing in practice). Yes.
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes if we just clarify the definition of 'branches' under IAS 12.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. Maybe not. This issue could lead to a more fundamental question on what the outside basis difference and its recovery mean and why the standard gives an exception from recognising deferred tax on some of them.

(e): The Board will be able to reach a timely consensus. Maybe not. This issue could lead to a more fundamental question of what the outside basis difference and its recovery mean and why the standard gives an exception from recognising deferred tax on some of them.
Conclusion The staff does not think that the Board should deal with this issue in the limited scope project. Although unremitted foreign earnings in a foreign bank account appear to be similar to those in foreign subsidiaries or foreign branches, IAS 12 does not provide distinctive criteria for outside basis differences or for the exception from recognising deferred tax. Since there are diverse views on the basis for any exception (as indicated in the responses to the ED), it could take some times for the Board to deliberate the issue and arrive at a consensus. The Board should defer this issue to a future project.

Discount current tax payable if the entity agreed with the tax authorities to pay tax over a period greater than 12 months (June 2004, #14)

Description of the issue Is it appropriate to discount current taxes payable when an agreement with the taxing authorities has been reached to permit the entity to pay such taxes over a period greater than twelve months?
(a): The issue is wide spread and has practical relevance. Not certain
(b): There are significant divergent interpretations (either emerging or already existing in practice). Not certain.
(c): Financial reporting would be improved through elimination of the diverse reporting method. Not certain.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. No
(e): The Board will be able to reach a timely consensus. Yes

Conclusion IFRIC previously rejected on a ground that a conflict between IAS 12 and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* would be removed because the Board had tentatively decided to withdraw IAS 20. However, after the IFRIC decision, the Board changed that tentative decision. In the January 2009 Board meeting, when developing the income tax ED, the Board tentatively decided that the ED should be silent on this matter. Consistent with this decision, the limited scope project to amend IAS 12 should not deal with this issue.

Non-amortisable intangible assets including consideration of relevance of SIC 21 (August 2005, IAS 12-3)

Description of the issue What tax rate should be applied to calculate deferred tax on intangible assets that are no longer to be amortised because of changes to accounting standards. *Example* An entity purchases a brand through a business combination. The carrying amount of the brand is recognised initially at its fair value, is considered to have an indefinite life, and is not tax deductible. Thus there is a taxable temporary differences arising from the brand. The cash flows associated with the brand will result from the sale of branded products in various jurisdictions. Those sales will form part of the taxable profit or loss generated in each of those jurisdictions, which will be subject to normal tax rates applicable to operations ('use rate'). The entity does not intend to sell the brand. If the entity were to sell the brand, this would generate a gain to which the tax rate applicable on capital gains would apply (referred herein as 'sale rate'). The issue is which tax rate should be used to measure the deferred tax liability in such situation, the sale rate or the use rate.
(a): The issue is wide spread and has practical relevance. Yes.
(b): There are significant divergent interpretations (either emerging or already existing in practice). No
(c): Financial reporting would be improved through elimination of the diverse reporting method. N/A
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective.

Yes
(e): The Board will be able to reach a timely consensus. Yes
Conclusion IAS 38 was revised in 2004. IAS 12 was clear and there was no diversity in practice. Some constituents just did not like the answer. There is no reason for the Board to address it.

Single asset entities (November 2005, IAS 12-4)

Issue not assessed here because the staff already identified it as a significant practice issue. See Appendix A for further discussion.

Other convergence issues

Uncertain tax positions

Issue not assessed here because the staff already picked it up as a significant practice issue. See Appendix A for further consideration.

Intra-group transfer of a non-monetary asset or liability

Description of the issue In the US GAAP, there is an exception to the temporary difference approach for an intra-group transfer of a non-monetary asset or liability. IAS 12 does not provide such an exception nor did the ED propose adding one. However, many respondents noted the difference between IAS 12 and US GAAP and requested such an exception be made. *Example* Company A sells a product for CU300 to its overseas subsidiary B. Company A reports taxable profit of CU100 (Sale CU300 less cost of the product CU200) from the sale of the product to B and pays income tax of CU40 (CU100 * ordinary tax rate 40%) to the tax authorities in A's tax jurisdiction. When A consolidates B, it eliminates the profit of CU100 as it is a profit from the sale within a consolidated group. As a result, there is a temporary difference of CU100 between the carrying amount of CU200 and a tax base of CU300 in B's tax jurisdiction. Ordinary tax rate applicable to B is 30% in B's tax jurisdiction. IAS 12 requires the entity to recognise a deferred tax asset of CU30 (CU100 * 30%, ie the buyer's rate) whereas US GAAP requires to carry the current tax of CU40 (using the seller's rate) on the balance sheet until B sells the product.
(a): The issue is wide spread and has practical relevance. Yes

(b): There are significant divergent interpretations (either emerging or already existing in practice). Under IFRS, no. But there is a divergence between IFRS and US GAAP.
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes in terms of comparability between US GAAP and IFRSs but no in terms of providing an additional exception to the temporary difference approach.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Only if we provide an additional exception to IAS 12.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. Yes
(e): The Board will be able to reach a timely consensus. Yes
Conclusion The FASB had previously decided that the exception in US GAAP should be removed. However, the FASB has suspended its project on income tax and hence the exception will not be removed. The staff is aware that many constituents feel strongly that not having an exception leads to counter-intuitive results and some fear the possibility of earnings management. However, the staff can see no conceptual reason for the Board to introduce an exception from the temporary difference approach.

Difference between the functional currency and local currency

Description of the issue Under US GAAP, an exception to the temporary difference approach is provided for some differences between the functional currency and local currency. IAS 12 does not provide such an exception. *Example* Company A operates its business in a country Z but uses CU as a functional currency instead of a local currency (LC) in the country Z. In year X1, A purchases an asset for LC100, which is recorded at CU200 using an exchange rate of 2 CU/LC. The asset is a non-depreciable asset. Therefore, A carries the asset at CU200 unless it is impaired (the fair value model under IAS16 is not used). In year X2, the exchange rate for CU has fallen to 1.5CU/LC. As a result, there is a temporary difference of CU50 between the carrying amount of CU200 and the tax base of CU150 (LC100 * 1.5CU/LC). The ordinary tax rate in country Z is 30%. IAS 12 requires the entity to provide deferred tax liability of CU15 (CU50 * 30%) whereas US GAAP exempts the entity from providing deferred tax.

(a): The issue is wide spread and has practical relevance. Yes
(b): There are significant divergent interpretations (either emerging or already existing in practice). Under IFRS, no. But there is a divergence between IFRS and US GAAP.
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes in terms of comparability between US GAAP and IFRSs but no in terms of providing additional exception to the temporary difference approach.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Only if we provide an additional exception to IAS 12.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. Yes.
(e): The Board will be able to reach a timely consensus. Yes
Conclusion The FASB had previously decided that the exception in US GAAP should be removed. However, the FASB has suspended its project on income tax and hence the exception will not be removed. The issue is similar to intra-group transfers because they both involve an event that changes the tax basis but does not affect the carrying amount. Fewer constituents complain about the lack of this exception and the staff thinks that the result from this lack of exception is less counter intuitive because there is a real exchange loss from the tax base in local currency. The staff does not think there is any conceptual reason to give an exception. .

Other issues raised by constituents

Discounting deferred tax balances

Description of the issue Many constituents argue that deferred tax should be discounted.
(a): The issue is wide spread and has practical relevance. Yes
(b): There are significant divergent interpretations (either emerging or already existing in practice). No

(c): Financial reporting would be improved through elimination of the diverse reporting method. N/A
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. No
(e): The Board will be able to reach a timely consensus. No
Conclusion Whether or not deferred tax should be discounted (or has already effectively been fully discounted) is a difficult question. It depends on the view taken of the objective of deferred tax: for example, is the objective to recognise tax that would arise on immediate recovery of the underlying asset, or is the objective to consider tax that would arise as the entity recovers the asset in the expected manner of recovery? Also, discounting deferred tax would involve practical difficulties and lead to a major divergence with US GAAP. The staff thinks this issue should be dealt with in a fundamental review in the future.

Deferred tax on share based payment (IFRS 2 requirement differs from US GAAP requirement)

Description of the issue This issue is one of the most consistent requests from respondents to the ED (another one is the issue of the intra-group transfer of a non-monetary asset and liability). Those respondents asked the Board to consider changing deferred tax treatment for share base payment in order to converge with US GAAP. *Example* In year X1, Company A grants 100 share options to its employee. The share options vest at and employee can exercise the share options from the beginning of year X3 at an exercise price of CU 9. The market price of company A's share was CU10 at the time the options are granted. Using a valuation model, the fair value of the share options at the time of the grant is computed as CU 70. The price of Company A's share is CU11 at the end of year X1 and CU12 at the end of year X2. In year X3, the employee exercises the share option when the share price is CU15. Corporate tax rate applied to A is 30% throughout the periods. In the above example, Company A recognises the service costs of CU70 over the initial two years. The tax base of the employee services is calculated as CU100 ((11-9)*100*1/2) at the end of year X1 based on the intrinsic value of the options and the

one out of two year service period. A is required to recognise a deferred tax asset of CU30 (100*30%) in at the end of year X1. At the end of year X2, A is required to recognise deferred tax asset of CU90 ((CU12-CU9)*100*2/2*30%) and to recognise the difference between CU30 and CU90 as tax income for the year X2. When the employee exercises the share option in year X3, A recognises current tax income of CU180 ((CU15-CU9)*100*30%) and reversal of deferred tax asset of (CU90) as deferred tax expense. According to IAS 12 paragraph 68C, the tax effect of the excess tax deduction CU600 ((CU15-CU9)*100) over the amount of service costs charged to profit or loss (CU70), ie 159 ((CU600 – CU70)*30%) is charged to equity. If US GAAP were applied, A would recognise a deferred tax asset of CU10.5 (70*1/2 *30%) at the end of year X1 and additional deferred tax asset of CU10.5 (70*1/2*30%) at the end of year X2. Then it would recognize current tax income of CU180 ((15-9)*100*30%) and reversal of deferred tax asset of (CU21) as deferred tax expense. According to paragraph 62 of FAS 123(R), the excess tax benefit CU159 ((600–70)*30%) shall be recognised as equity (however, the excess tax benefit shall be recognised in profit or loss to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes).
(a): The issue is wide spread and has practical relevance. Yes
(b): There are significant divergent interpretations (either emerging or already existing in practice). Under IFRS, no. There is a divergence between IFRS and US GAAP.
(c): Financial reporting would be improved through elimination of the diverse reporting method. Not by pure convergence with US GAAP, which the Board rejected when it developed IFRS 2. Some assert that the requirements in IAS 12 could be improved in other ways.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. No. If we converge with the requirement in US GAAP, we would have to amend IAS 12.
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. Yes
(e): The Board will be able to reach a timely consensus. Maybe

Conclusion The staff does not think that the Board should deal with this issue in the limited scope project. FAS 123(R) Basis for Conclusions B220 states that the IASB's conclusion is more consistent with the general approach to accounting for deferred taxes under both ASC Topic 740 and IAS 12. Nonetheless, the US GAAP ASC Topic 718 uses a different method because that method is consistent with the measurement of the related compensation cost (FAS123(R) B219). The requirement in IAS 12 reflected the most update thinking of the Board at the time IFRS 2 was issued. This issue also relates to deferred tax consequence of entity's own equity instruments which could raise more fundamental questions in the temporary difference approach. The Board should consider this issue in a future project: either a project to fundamentally review the accounting for income tax or a project to review IFRS 2 *Share-based Payment*.

Accounting for tax credits, investment tax credits, government grants, special deductions, rebates and tax holidays

Description of the issue The ED included definitions of tax credit and investment tax credit. Many respondents asked the Board also to specify accounting requirements for those tax credits in a manner which is consistent with the accounting treatment for government grant. Some also said that tax credits, investment tax credits, government grants, special deductions, rebates and tax holidays have some similarities in nature and their accounting treatment should be consistent.
(a): The issue is wide spread and has practical relevance. Yes
(b): There are significant divergent interpretations (either emerging or already existing in practice). Yes
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. No
(e): The Board will be able to reach a timely consensus. No

Conclusion The staff agrees that it would be desirable to have consistent accounting for all types of tax benefits and government grants. However, the staff thinks that achieving that is beyond the reasonable scope of limited amendments to IAS 12 and should be considered in a future project.

Accounting for a change in tax status and tax election

Issue not assessed here because it relates to the issue of entities such as real estate investment trusts discussed in Appendix A.

Subsequent tracking of initially unrecognised temporary differences because of the exceptions for non-deductible goodwill and the initial recognition exception

Description of the issue Some respondents to the ED requested guidance on subsequent tracking of initially unrecognized temporary differences.
(a): The issue is wide spread and has practical relevance. Yes
(b): There are significant divergent interpretations (either emerging or already existing in practice). Yes
(c): Financial reporting would be improved through elimination of the diverse reporting method. Yes
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. Yes, too narrow an issue.
(e): The Board will be able to reach a timely consensus. Yes
Conclusion The staff thinks this is too detailed an issue for the Board to address in a limited scope project.

UK life insurance policyholder's tax (a presentation issue)

Description of the issue Some UK life insurers make the following argument: 'in the UK many UK life products provide benefits to policyholders on a net of tax basis (i.e. the insurer bears the income taxes on behalf of the policyholder). Under IAS 12 such taxes meet the definition of an income tax and hence there will be a mixture of pre-tax and post tax items appearing in the income statement within the pre-tax result. This will lead to distorting and non comparable information within the income statements of some UK insurers. They argue that the tax should be treated as a withholding tax.
(a): The issue is wide spread and has practical relevance. No
(b): There are significant divergent interpretations (either emerging or already existing in practice). No
(c): Financial reporting would be improved through elimination of the diverse reporting method. There is no diversity, but financial reporting might be improved by clearer guidance on the distinction between income tax of the entity and withholding tax.
(d)(i): The issue can be resolved within the confines of existing IFRSs and the *Framework*. Yes
(d)(ii): The issue is sufficiently narrow in scope to be capable of interpretation but not so narrow that is not cost effective. No.
(e): The Board will be able to reach a timely consensus. Yes
Conclusion The issue raised is industry specific and too detailed for the Board to consider in this project. It also involves issues of the definition of income tax, which the IFRIC previously rejected as being difficult to develop guidance within a reasonable period of time given the variety of taxes existing world-wide and judgment required in determining whether some taxes are income taxes. Arguably, it is a symptom of a wider issue: how best to present an expense (in this case policyholder benefits) that is determined on an after-tax basis.

Appendix C

Practice issues which IFRIC previously rejected for a reason other than the Board's project on income tax

Issue	Description of issue	Reason for Rejection
Income tax accounting under the tax consolidation system – Subsidiary leaving the group (April 2003, #9)	The issue concerns the recognition and measurement of tax assets and tax liabilities under the consolidation tax system where a wholly owned subsidiary leaves, or is expected to leave, the tax consolidated group.	This issue was relevant only to separate financial statements and it would be difficult to provide guidance that could be applied consistently by entities, given that tax laws in each jurisdiction are different. cf: The related issue is discussed in Agenda Paper 4B.
Deferred tax accounting for the asset revaluation (February 2002, #10)	Do changes in the fair value of assets give rise to taxable temporary differences and deferred tax liabilities under IAS 12?	IAS 12 provides sufficient guidance. cf: The related issue is discussed in Appendix A.
Effective tax rate when the effective tax rate is reduced because certain revenue is exempt from income tax (February 2002, #11)	Which tax rate should be used to measure deferred tax assets and liabilities for entities that have low effective tax rates, eg because some income is exempt from tax.	IAS 12 provides sufficient guidance.
Deferred tax accounting for properties held under a finance lease contract which is accounted for using the fair value model under IAS 40	Is the whole of an investment property held under a finance lease consisting of land and buildings that is accounted for using the fair value model in IAS 40 a "non-depreciable asset" under paragraph 4 of SIC-21 (with the consequence that any deferred tax asset or liability on it	SIC 21, IAS 16 and IAS 12 provide adequate guidance. cf: The related issue is also discussed in Appendix A.

(August 2002, #12)	should be measured at the tax rate applicable on a sale of the property)?	
Deferred tax accounting for tax deductible dividends (February 2003, #13)	When an entity issues an equity instrument, any payment under which will be deductible against taxable profits, should the entity recognize a deferred tax asset on the income tax benefit arising on any payments under the instrument in income or equity?	Tax consequence of dividends is explicit in IAS 12, paragraph 52B. cf: The related issue is also discussed in Appendix A.
Classification of interests and penalties (June 2004, #15)	How interest and penalties that arise from unpaid tax obligation should be classified?	IAS 12 and IAS 1 provide adequate transparency of these items. cf: The related issue is discussed in Paper 4B.
Tax on dividends under Estonian Income Tax Law (June 2004, #16)	Should the tax on dividends under Estonian Income Tax Law be recognized in profit or loss, or directly in equity.	The features of the Estonian tax system are not particularly widespread or pervasive throughout the world. cf: The related issue is discussed in Paper 4A (use of the distributed rate or undistributed rate)
Guidance on application of “probability” criterion for recognizing deferred tax assets arising from the carryforward of unused tax losses and unused tax credit (June 2005, IAS 12-1)	Whether to provide guidance on how to apply the probability criterion for the recognition of deferred tax assets arising from the carryforward of unused tax losses or unused tax credits taken as a whole or to portions of the total amount.	There is no diversity in practice. cf: The related issue is discussed in Paper 4B.
Scope of the income taxes (March 2006, IAS 12-5)	Is IAS 12 required to be applied to the recognition, measurement and presentation of amounts arising under various taxation and royalty	Variety of taxes exists world-wide and judgment is needed in determining whether

	arrangements that have not typically be considered 'income taxes'? Examples of such taxes and royalties include, but are not limited to, resource rent tax in Australia, petroleum resource tax in UK, production and revenue based royalties, production sharing arrangements or the similar one in various countries.	some taxes are income taxes. Guidance beyond the observation noted in the rejection wording could not be developed in a reasonable period of time.