STAFF PAPER

IFRS Interpretations Committee Meeting

January 2014

Project	**IAS 12 *Income Taxes*—Threshold of recognition of an asset on uncertain tax position**

CONTACT(S) Leonardo Piombino lpiombino@ifrs.org +44 (0)20 7246 0571

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request for guidance on the recognition of an asset in a situation in which the tax position is uncertain. The Interpretations Committee was asked to clarify whether IAS 12 *Income Taxes* (and a probable threshold) is applied to recognise an asset, where an entity has paid cash to the tax authority but expects to recover some or all of that cash, or whether the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (and a 'virtually certain' threshold) should be applied.
2. We performed outreach on this topic with national accounting standard-setters and regulators. The results of this outreach are included as part of the staff's analysis of this issue.
3. The submission is reproduced in full in Appendix B to this paper.

Objective

4. The objective of this paper is to:

(a) provide background information on the issue raised in the submission;

(b) provide an analysis of the issue, including a summary of the outreach responses received;

(c) present an assessment of the issue against the Interpretations Committee's agenda criteria;

(d) make a recommendation to the Interpretations Committee; and

(e) ask the Interpretations Committee whether it agrees with the staff's recommendation.

Background information

5. IAS 37 provides the following definition of contingent asset:

> A *contingent asset* is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

6. According to paragraph 33 of IAS 37, contingent assets are recognised only if the realisation of income is virtually certain. Paragraph 23 states that [emphasis added]:

> 33 Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is **virtually certain**, then the related asset is not a contingent asset and its recognition is appropriate.

7. Paragraphs 12 and 14 of IAS 12 provide guidance on the recognition of current tax liabilities and current tax assets. They state that [emphasis added]:

> 12 Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.
>
> 14 When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it

> is **probable** that the benefit will flow to the entity and the benefit can be reliably measured.

8. Paragraph 24 of IAS 12 provides guidance on the recognition of deferred tax asset. It states that [emphasis added]:

> 24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is **probable** that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:...

9. Paragraph 46 of IAS 12 provides guidance on the measurement of current tax liabilities and current tax assets [emphasis added]. It states that:

> 46 Current tax liabilities (assets) for the current and prior periods shall be measured at the **amount expected to be paid to (recovered from) the taxation authorities**, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Staff analysis

Description of the issue

10. The submitter notes that:

    (a) in some jurisdictions, tax laws require an entity to make an immediate payment where a tax examination results in an additional charge, even when the entity intends to appeal against the charge; and

    (b) there is diversity in the approach used to determine whether an asset should be recognised for the amount potentially recoverable from the tax authority. Some entities use a 'probable' threshold whereas other entities use a 'virtually certain' threshold.

11. The submitter requested the Interpretations Committee to clarify whether IAS 12 (and a probable threshold) is applied to recognise an asset, where an entity has paid cash to the tax authority but expects to recover some or all of that cash, or whether the guidance in IAS 37 (and a 'virtually certain' threshold) should be applied.

12. The submitter thinks that two views exist in practice:

    (a) **View 1: IAS 12 and the 'probable' recognition threshold should be applied**. IAS 12 is the relevant Standard for the accounting for income taxes. According to IAS 12 tax assets are recognised to the extent it is probable that they will be recovered. According to paragraph 46 of IAS 12, tax assets should be recognised for the amounts an entity 'expects' to recover from the tax authorities.

    (b) **View 2: IAS 37 and the 'virtually certain' recognition threshold should be applied**. IAS 12 does not specifically address the accounting for disputes with tax authorities. Applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Error*, management should refer to guidance in another Standard dealing with similar issues. The guidance in IAS 37 for the recognition of contingent assets is the guidance that most closely matches the situation. Consequently, the tax asset is recognised only when it is virtually certain that an inflow of economic benefit will arise.

13. We will analyse these views in the following paragraphs.

View 1—IAS 12 and the 'probable' recognition threshold should be applied

14. Proponents of this view think that IAS 12 addresses the accounting for income taxes and is therefore the relevant Standard. They note that income taxes are specifically excluded from the scope of IAS 37[1] and so it is not appropriate to apply the guidance in IAS 37 to income taxes.

15. In their view, IAS 12 provides sufficient guidance for recognition and measurement of tax assets and liabilities that can be applied to tax uncertainties, because according to:

---

[1] Paragraph 5 of IAS 37 states that: When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, some types of provisions are addressed in Standards on:

(a) construction contracts (see IAS 11 Construction Contracts);

(b) income taxes (see IAS 12 Income Taxes);…

(a) paragraph 14 of IAS 12, current tax assets are recognised to the extent it is probable that they will be recovered; and

(b) paragraph 46 of IAS 12, current tax assets are measured at the amount 'expected' to be recovered from the tax authorities. In their view, the term 'expected' reflects a 'probable' or 'more likely than not' threshold and does not require a 'virtually certain' threshold.

16. They think that there are often situations in which a tax uncertainty affects both current and deferred tax assets, and that it is counterintuitive and confusing for users of the financial statements to apply different recognition thresholds to current and deferred[2] taxes.

17. In their view, it is also counterintuitive to apply:

(a) a 'probable' threshold to the recognition of a liability for a tax uncertainty, but

(b) a 'virtually certain' threshold to the recognition of an asset for a similar tax uncertainty that differs only because the tax authority required a payment before the uncertainty was resolved.

18. They also think that the probable threshold is consistent with paragraph 4.44 of the *Conceptual Framework*, which requires that an asset is recognised when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. The guidance in IAS 37 that contingent assets are recognised when they are virtually certain is an exception to the general principle in the *Conceptual Framework* and should only be applied to contingent assets within the scope of IAS 37.

View 2—IAS 37 and the 'virtually certain' recognition threshold should be applied

19. Proponents of this view think that IAS 12 does not specifically address the accounting for disputes with taxation authorities. They note that paragraphs 10 and 11 of IAS 8 require management to first refer to guidance in another IFRS

[2] According to paragraphs 24 and 34 of IAS 12, a deferred tax asset shall be recognised to the extent that it is probable that future taxable profit will be available.

dealing with similar and related issues in the absence of an IFRS that specifically applies to a transaction. In their view, the guidance in IAS 37 for the recognition of contingent assets is the guidance that most closely matches this issue (ie the recognition of an asset on uncertain tax position).

20. Consequently, they think that:

    (a) the asset and the related tax benefit are recognised only when it is virtually certain that an inflow of economic benefit will arise; and

    (b) when the inflow of economic benefit is probable, an entity shall disclose the contingent asset (as required by paragraph 35 of IAS 37).

21. They also note that paragraph 88 of IAS 12:

    (a) requires an entity to disclose any tax-related contingent liabilities and contingent assets in accordance with IAS 37; and

    (b) specifies that contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities.

22. They also think that it is not clear whether the entity is entitled to a refund and therefore whether an asset exists. In their view, the guidance for contingent assets is more appropriate when the existence of an asset is not certain.

Staff view

23. Our view is similar to View 1.

24. We think that in this fact pattern (ie an entity is required to pay cash to the tax authority but expects to recover some or all of that cash) the main issue is not the recognition threshold for the tax asset. We think that the issue is the measurement of the liability. Paragraph 12 of IAS 12 provides guidance on the recognition of current tax assets and liabilities and states that:

    > …If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset...

25. In our view, this means that an asset is recognised if the amount of cash paid (which is a certain amount) exceeds the amount of tax expected to be paid (which

is an uncertain amount). We think that an asset related to tax exposure is only a residual amount (ie cash paid minus tax liability) and so it cannot be measured on its own (ie without taking into account the uncertain tax liability).

26. We think that in many cases View 1 and our view should lead to similar results, because using View 1 the recognition threshold for tax assets and tax liabilities is the same.

27. We also think that paragraphs 12 and 14 of IAS 12 provide sufficient guidance on the recognition of current tax assets and liabilities. However, we think that IAS 12 does not provide sufficient guidance on the measurement of the uncertain tax positions. In our view, the term "amount expected to be paid to (recovered from) the tax authorities" as used in paragraph 46 of IAS 12 is not sufficiently clear, because IAS 12 does specify the measurement method. Consequently, we understand that in practice entities use different methods (for example a probability weighted average method or the most likely outcome method) that can give different results.

Outreach requests

28. We asked IOSCO, ESMA and national standard-setters to provide us with information on whether the issues raised in the submission:

    (a) are widespread and have practical relevance; and

    (b) indicate that there are significant divergent interpretations (either emerging or existing in practice).

29. We asked the following two questions:

    (a) *How common is this issue? If it is common, could you provide us with information that the Interpretations Committee could use to assess how widespread the issue is?*

    (b) *In your view, is there diversity in practice in the recognition of an asset on uncertain tax position? Please describe the predominant approach that you observe in your jurisdiction.*

Responses from national standard-setters and regulators

30. We received responses from the following 17 jurisdictions: Europe (6), Asia (6), Americas (2), Oceania (2) and Africa (1).

31. The issue is common in eleven jurisdictions. In seven of them diversity in practice has been noted.

32. We understand that three views have been observed in practice. The third view observed in practice is the staff's view: the cash paid to the tax authority is a certain asset, whereas the tax liability is considered as an uncertain position.

33. We also understand that:

    (a) different measurement methods are used in practice to measure uncertain tax positions. These methods include, for example, the weighted average probability of outcomes and the most likely outcome method; and

    (b) different units of account are used in practice to measure uncertain tax positions. For example it can be an individual uncertain tax position, an entire tax computation, or a group of related uncertain positions.

Agenda criteria assessment

34. Our assessment of the Interpretations Committee's agenda criteria is as follows:

Source of issue	
Issues could include: the identification of divergent practices that have emerged for accounting for particular transactions, cases of doubt about the appropriate accounting treatment for a particular circumstance or concerns expressed by investors about poorly specified disclosure requirements (5.14).	
Criteria	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected; where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual*	Yes. On the basis of our outreach the issue is common and there is diversity in practice.

Source of issue	
Framework for Financial Reporting.	
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (5.17)?	No. We think that in order to address this fact pattern comprehensively, the Interpretations Committee should also provide guidance on the measurement of the uncertain tax liability. We think that developing such guidance would be a project too broad to be addressed in an efficient manner by the Interpretations Committee. Indeed, in the Exposure Draft *Income Taxes* issued in March 2009 ('ED'), the IASB addressed the measurement of uncertain tax positions (ie it proposed using the probability-weighted average amount of all possible outcomes). However, many respondents to the ED disagreed with the IASB proposal. In March 2010, the IASB decided that it should not do further work on uncertain tax positions until it had completed the redeliberations on the project on IAS 37. The project on IAS 37 is now paused and it is not a priority (it is a research project for which the timing of preliminary work has not yet been confirmed).
Will it be effective for a reasonable time period (5.21)? Only take on the topic of a forthcoming Standard if short-term improvements are justified.	Yes, if the Interpretations Committee could address this issue in an efficient manner, the solution developed would be effective for a reasonable period of time.

Staff recommendation

35. We think that in this specific fact pattern (ie an entity is required to pay cash to the tax authority but expects to recover some or all of that cash) an asset is recognised if the amount of cash paid (which is a certain amount) exceeds the amount of tax expected to be paid (which is an uncertain amount). In our view, paragraphs 12

and 14 of IAS 12 provide sufficient guidance on the recognition of current tax assets and liabilities. Consequently, we recommend that the Interpretations Committee should not add the "recognition issue" to its agenda

36. We also think that IAS 12 does not provide sufficient guidance on the measurement of the uncertain tax positions. However, we recommend that the Interpretations Committee should not add the "measurement issue" to its agenda, because we think that developing guidance on the measurement of uncertain tax positions would be a project too broad for it to address in an efficient manner.

37. Our proposed tentative agenda decision is included in Appendix A of this paper.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree that according to IAS 12 (in this specific fact pattern) an asset is recognised if the amount of tax expected to be paid (which is the uncertain amount) is less than the amount of cash already paid? 2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should not add this issue to its agenda? 3. Does the Interpretations Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1 The proposed wording for the tentative agenda decision is presented below.

IAS 12 *Income Taxes*—Threshold of recognition of an asset in the situation in which the tax position is uncertain

The Interpretations Committee received a request for guidance on the recognition of a tax asset if an entity has paid cash to the tax authority and the entity expects, but is not certain, to recover some or all of that cash . The Interpretations Committee was asked to clarify whether IAS 12 *Income Taxes* (and a 'probable' threshold) is applied to determine whether to recognise an asset, or whether the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (and a 'virtually certain' threshold) should be applied.

The question has arisen because in some jurisdictions tax laws require an entity to make an immediate payment where a tax examination results in an additional charge, even when the entity intends to appeal against the charge.

The Interpretations Committee noted that paragraph 12 and 14 of IAS 12 provide guidance on the recognition of current tax assets:

- according to paragraph 12 of IAS 12, current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset; and
- according to paragraph 14 of IAS 12, current tax assets are recognised to the extent that it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

The Interpretations Committee observed that:

- in this specific fact pattern an asset is recognised if the amount of cash paid (which is a certain amount) exceeds the amount of tax expected to be paid (which is an uncertain amount);
- in order to address this fact pattern comprehensively, it should also provide guidance on the measurement of the amount expected to be paid;
- IAS 12 does not provide sufficient guidance on the measurement of the uncertain tax positions, because it does not specify the measurement method. Paragraph 46 of IAS 12 only states that current tax assets and liabilities are measured at the amount expected to be paid to (or recovered from) the tax authorities; and
- developing guidance on the measurement of uncertain tax positions would be too broad for it to address in an efficient manner.

On the basis of the analysis above the Interpretations Committee [decided] not to add these issues to its agenda.

Appendix B—Request

B1 We received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

Potential interpretation:
IAS 12, Income Tax – Threshold of recognition of an asset on uncertain tax position

We suggest in this letter an issue that the IFRS Interpretation Committee might consider clarifying through an interpretation.

The issue

Income tax laws are often not clear or not consistently understood. This can cause a difference of view between an entity and the tax authority and uncertainty about the amount of tax owed. Some jurisdictions require an entity to make an immediate payment where a tax examination results in an additional charge, even when the entity intends to appeal against the charge. There is diversity in the approach used to determine whether an asset should be recognised for the amount potentially recoverable from the tax authority.

Income taxes are excluded from the scope of IAS 37, *Provisions*. Some argue, however, that the 'virtually certain' recognition threshold in IAS 37 paragraph 35 should be applied to the recognition of an asset in connection with an uncertain tax position in the absence of specific guidance in IAS 12. Others argue that the guidance in IAS 12 paragraph 46 that an asset should be recognised for the amounts an entity 'expects' to recover from the tax authorities should be applied, and the reference to 'probable' in IAS 12 paragraph 14 and 24 means that an asset should be recognised to the extent it is probable the tax will be recovered.

Current practice

We understand that current practice is mixed where an entity has paid cash to the tax authority but expects to recover some or all of that cash. Some entities use a 'probable' threshold whereas other entities use a 'virtually certain' threshold.

- <u>Application of a 'probable' threshold</u>

Supporters of this view argue that IAS 12 addresses the accounting for income taxes and is therefore the relevant standard. Income taxes are specifically excluded from the scope of IAS 37 and it is not appropriate to apply the guidance in that standard to income taxes. Entities should apply IAS 12 which provides sufficient guidance for recognition and measurement of tax assets and liabilities that can be applied to tax uncertainties.

The following guidance in IAS 12 specifies that tax assets are recognised to the extent it is probable that they will be recovered.

- IAS 12 paragraph 14 – recognise the benefit as an asset in the period in which it arises because it is probable that a benefit will flow to the entity...

- IAS 12 paragraph 24 and 34 - A deferred tax asset shall be recognised... to the extent that it is probable that future taxable profit will be available....

Supporters of this view also note that IAS 12 paragraph 46 requires that current tax assets are measured at the amount ‘expected’ to be recovered from the tax authorities. An expectation that the asset will be recovered is a 'probable' or 'more likely than not' threshold and does not require that recovery is ‘virtually certain’.

They also note that there are often situations in which a tax uncertainty affects both current and deferred tax assets and that it is counter intuitive and confusing for users of the financial statements to apply a different recognition threshold to current and deferred taxes. This will result in an asset being derecognised when a temporary difference reverses and tax is paid to the tax authority, although there is no change in management’s expectations of recovery.

It is also counter intuitive to apply a probable threshold to the recognition of a liability for a tax uncertainty and a virtually certain threshold to the recognition of an asset. This approach could result in an entity concluding that it should not recognise an expense or a liability for an uncertainty it believed would be resolved in its favour, but then being required to recognise an expense simply because the tax authority required a payment before the uncertainty was resolved.

The probable threshold is also consistent with paragraph 4.44 of the Framework, which requires that an asset is recognised when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. The guidance in IAS 37 that contingent assets are recognised when they are virtually certain is an exception to the general principle in the Framework and should not be applied beyond contingent assets in the scope of IAS 37.

- Application of ‘Virtually certain’ threshold according to IAS 37

Supporters of this view argue that IAS 12 does not specifically address the accounting for dispute with taxation authorities. IAS 8 paragraphs 10 and 11 require management to first refer to guidance in another IFRS dealing with similar and related issues in the absence of an IFRS that specifically applies to a transaction. The guidance in IAS 37 for the recognition of contingent assets is the guidance that most closely matches this situation. The asset and the related tax benefit are recognised only when it is virtually certain that an inflow of economic benefit will arise. Where the inflow of economic benefit is probable, an entity shall disclose the contingent asset (IAS 37 paragraph 35).

Supporters of this view also argue that it is not clear whether the entity is entitled to a refund and therefore whether an asset exists. The guidance for contingent assets is more appropriate when the existence of an asset is not certain. They also point out that there is diversity in practice and that regulators in some jurisdictions require that the guidance in IAS 37 is applied.

Question for the Committee

The Committee is asked to clarify whether IAS 12 and a probable threshold is applied where an entity has paid cash to the tax authority but expects to recover some or all of that cash, or whether the guidance in IAS 37 for contingent assets should be applied.

Reasons for the IFRIC IC to address the issue

We set out below consideration of this issue against the IFRS IC criteria for a potential agenda item.

Criteria	**Assessment**
Is the issue widespread and practical?	Yes. The issue affects all entities.
Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?	Yes. There is diversity in practice and there are some jurisdictions where local regulators require that the guidance in IAS 37 is applied by analogy.
Would financial reporting be improved through elimination of the diversity?	Yes.
Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?	Yes. The issues relate to a specific and narrow application of specific paragraphs in IAS 12.
If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?	Not applicable.