STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 12—*Income Taxes***
Paper topic	How should current tax assets and liabilities be measured when tax position is uncertain

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify the recognition of a tax asset in the particular situation in which an entity makes a payment to tax authorities in respect of an uncertain tax position (hereafter 'UTP') .

2. The Interpretations Committee was asked to clarify whether IAS 12 *Income Taxes* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be applied to determine whether to recognise an asset in such a situation.

3. The Interpretations Committee discussed the issue in January, May and July 2014 and decided that it should consider separately the question of recognition, and the question of measurement, of income tax on UTPs.

Recognition

4. At the July meeting, the Interpretations Committee decided to remove from its agenda the issue of how current income tax, the amount of which is uncertain, is recognised.

5. The Interpretations Committee understood that the reference to IAS 37 in paragraph 88 of IAS 12 in respect of tax-related contingent liabilities and

contingent assets may have been understood by some to mean that IAS 37 applied to the recognition of such items. However, the Interpretations Committee noted that paragraph 88 of IAS 12 provides guidance only on disclosures required for such items, and that IAS 12, not IAS 37, provides the relevant guidance on recognition, as described above.

6. On the basis of this analysis, the Interpretations Committee noted that sufficient guidance exists on the question of recognition.

Measurement

7. At its July meeting, the Interpretations Committee asked the staff to analyse the question of how to measure assets and liabilities in the situation in which a tax position is uncertain. In particular, the Interpretations Committee asked the staff to analyse how detection risk and probability should be reflected in the measurement of tax assets and liabilities in such situations.

8. At its September meeting, the Interpretations Committee discussed several aspects of measurement of assets and liabilities on UTPs. The Interpretations Committee thought that the approach taken by the IASB and the FASB, when they had developed IFRS 15 *Revenue from Contracts with Customers*, could be relevant when developing the proposal on measurement method(s).

9. The Interpretations Committee also discussed whether detection risk should be reflected in the measurement of tax assets and liabilities arising from UTPs. It concluded that an entity should assume that the tax authorities will examine the amounts reported to them and have full knowledge of all relevant information (ie it should assume a 100 per cent detection risk). It tentatively decided to proceed with this project on measurement of UTPs, subject to further analysis and deliberations. [1]

[1] For further details of the past discussion on measurement of current income tax on UTP, refer to the IFRIC Update for September 2014 (Agenda Paper 4).

Purpose of this paper

10. The purpose of this paper is to present the additional analysis to prepare a proposal. In particular, at its September meeting, the Interpretations Committee requested us to prepare a proposal with respect to:

    (a) the scope of the project;

    (b) the unit of account; and

    (c) possible approaches for the measurement method(s).

Paper structure

11. This Agenda Paper is structured as follows:

    (a) staff analysis on:

        (i) the scope of the project;

        (ii) the unit of account; and

        (iii) possible approaches for the measurement method(s).

            1. Modified IFRS 15 approach
            2. More-likely-than-not estimate

    (b) staff recommendation;

    (c) questions for the Interpretations Committee; and

    (d) Appendix A—Extracted paragraph from "Background Information and Basis for Conclusion" for FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* (hereafter 'FIN 48')

Staff analysis

Scope of the project

12. Some might be concerned that every income tax rule or its enforcement has some kind of uncertainty and that such a broad issue does not meet our agenda criteria. However, we think that setting a scope for specific situations, for example when an entity has unsolved disputes with a tax authority, would be an arbitrary

bright line, because it could exclude other situations that should also be within scope. Such an excluded situation could be, for example, when an entity has a high expectation that a tax authority will challenge or review the entity's view or tax position.

13. When the FASB developed FIN 48, it decided that all tax positions should be subject to the provisions of its interpretation, because it was difficult to define 'uncertainty' and such a scope could be an arbitrary bright line. The FASB thought that such a rule was not necessary because for many routine business transactions it will be clear that the tax positions meet the recognition criteria. (For details, see paragraph B12 of FIN48 in Appendix A.)

14. We think that this approach by the FASB would also be appropriate for our project, if a 'probable' threshold is applied for recognition, because this approach can avoid an arbitrary bright line and an entity would avoid the costs associated with such measurement, if this threshold is applied.

15. When the Interpretations Committee finalised at the July 2014 meeting its agenda decision on recognition of an asset in the situation in which the tax position is uncertain, the Interpretations Committee noted that paragraph 12 of IAS 12 provides guidance on the recognition of current tax assets and current tax liabilities.[2] Paragraph 12 of IAS 12 states that:

> 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.

16. Paragraph 14 of IAS 12 states that (emphasis added):

> 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**

[2] For further details of the finalised decision and the past discussions on recognition of an asset in the situation in which the tax position is uncertain, visit:

http://www.ifrs.org/Current-Projects/IASB-Projects/IAS-12-Threshold-of-recognition-tax-position-is-uncertain/Pages/Home.aspx

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

17. Because paragraph 14 of IAS 12 uses the word 'probable' to explain why a tax asset exists under a particular fact pattern, we think that it would be consistent to apply a probable threshold of recognition to a current tax asset.

18. IAS 12 does not explicitly explain a threshold of recognition of a current tax liability. However, with regard to deferred tax, the Objective of IAS 12 states that (emphasis added):

> It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. **If it is probable that recovery or settlement** of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, **this Standard requires an entity to recognise a deferred tax liability (deferred tax asset)**, with certain limited exceptions.

19. Paragraphs 4.44 and 4.46 of the current *Conceptual Framework* explain that **an entity recognises an asset or liability:**

    (a) if it is probable that any future economic benefit associated with the asset or liability will flow to or from the entity; and

    (b) if the asset or liability can be reliably measured. [3]

20. Consequently, we think that a recognition threshold of current tax assets and liabilities arising from UTPs could be clarified as a 'probable' threshold, to be consistent with the guidance in IAS 12 related to a current tax assets and deferred tax and the *Conceptual Framework*.

[3] In its *Conceptual Framework* project, the IASB has tentatively decided that the revised *Conceptual Framework* should not establish recognition criteria that would apply in all circumstances: it should instead describe factors to consider when developing recognition criteria for particular assets and liabilities. At its July 2014 meeting, the IASB tentatively decided that the Interpretations Committee should start applying the revised *Conceptual Framework* immediately after its publication. We think that the Interpretations Committee should apply the current *Conceptual Framework*, because the revised *Conceptual Framework* has not yet published. Refer to September 2014 IFRIC Update (*Conceptual Framework*—transition and effective date - Agenda Paper 6).

21. If the ‘probable’ threshold to recognise a current tax asset or liability were to be applied to this issue, setting the scope to exclude a tax position that contains a low level of uncertainty (for example, excluding the situation in which the risk is remote) would be unnecessary.

22. Consequently, we suggest that all income tax positions should be included within the scope of the project, but an entity should only recognise a current tax asset or liability if it is probable that the entity will pay to, or recover from, a tax authority some amount.

Unit of account

23. Neither IAS 12 nor the *Conceptual Framework* specifies a unit of account.

24. In some jurisdictions, we think that a dispute with a tax authority does not frequently occur and is case-specific. In such a case, we expect that an entity should use the individual tax position or dispute as a unit of account.

25. In other jurisdictions, similar disputes with the tax authority might be more common. We think that a unit of account should depend on whether uncertainty of a specific UTP is expected to be resolved collectively or separately by the tax authority and on whether the decision on one UTP relates to others. If the decision on one UTP relates to the decisions on others or is expected to be resolved by the tax authority on a collective basis, the group of UTPs should be viewed as a single unit of account. For example, if deductions of a specific type are subject to the tax authority’s specific view on a provision in one tax law, all deductions of that type should form a unit of account.

26. We are concerned that an entity would not provide useful information, if an entity accounts for similar UTPs as separate units of account.

27. Consequently, we think that an entity should make judgements about at what level the unit of account should be used. If a decision on a specific case is expected to affect, or be affected by, other UTPs, those UTPs should be accounted for as a single unit of account. Conversely, UTPs that are independent from each other and are expected to be resolved separately by the tax authority should be accounted for as separate units of account.

28. To provide useful information, we also think that an entity should recognise and measure an asset or liability consistently with its unit of account.

Possible approach for measurement

Modified IFRS 15 approach—approach with specific requirements when an entity makes a judgement about which method should be used between the expected value and the most likely amount

29. Paragraph 53 of IFRS 15 states:

> An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:
>
> (a) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
>
> (b) The most likely amount—the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

30. The measurement of current tax assets or liabilities is explained in paragraph 46 of IAS 12, which states (emphasis added):

> 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.

31. If we develop a similar guidance to paragraph 53 of IFRS 15, we think that we could develop the following guidance as an interpretation of paragraph 46 of IAS 12.

An entity shall estimate an amount expected to be paid to (recovered from) the taxation authorities by using either of the following methods, depending on which method the entity expects to better predict the amount which it will pay to (or recover from) the taxation authorities:

(a) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible amounts. An expected value may be an appropriate estimate of the amount to be paid or recovered if an entity has a large number of positions with similar characteristics.

(b) The most likely amount—the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the position). The most likely amount may be an appropriate estimate of the amount to be paid or recovered if the position has only two possible outcomes.

Provision of specific direction on selection of measurement method

32. In our proposal, we do not think that we should permit an entity to have a free choice, because such guidance does not improve financial reporting or support comparability among entities. Instead, we think that an entity should make judgements on which kind of measurement method should be used that will present the most useful information to predict future cash flows.

33. The interpretative guidance proposed above in paragraph 31 is based closely on the guidance in IFRS 15. We think that the Interpretations Committee should additionally consider whether this issue relating to UTP is sufficiently narrow, such that more specific guidance could be given to support the judgement that needs to be made in identifying which of the two measurement approaches should be applied.

34. If the Interpretations Committee agrees that the guidance should be made more specific in respect of the judgement to be made in identifying which of the two measurement approaches should be applied, we recommend that the guidance be given as follows:

An entity shall estimate an amount expected to be paid to (recovered from) the taxation authorities by using one of the following methods, depending on which method the entity expects to better predict the amount which it will pay to (or recover from) the taxation authorities:

(a) The most likely amount—the most likely amount is the single most likely amount in a range of possible outcomes. The most likely amount would be used if possible outcomes are binary or are concentrated to one value (for example, a dispute to determine a specific expense will be either deductible or non-deductible for tax purposes, forming an individual unit of account as a case-specific dispute).

(b) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible amounts. The expected value would be used, if possible outcomes are widely dispersed with lower probabilities (for example, a number of tax deductions that might be challenged by a taxation authority, and which form a single unit of account).

More-likely-than-not approach

35. The more-likely-than-not approach is not used in any other Standards[4].

36. We understand that it is used in FIN 48 and its value could be more useful than a 'most likely amount' when the possible estimated outcomes are widely dispersed and each shows a low probability. However, we note that the expected value is useful in such a case when a most likely amount is not useful to predict the amount to be paid to or recovered. In analysing this issue we did not identify sufficient reasons to require an entity to use a 'more-likely-than-not estimate'

[4] For details of more-likely-than- not approach and other measurement, refer to Agenda Paper 4 discussed by the Interpretations Committee at its September 2014 meeting.

instead of expected value, given the objective to avoid a free choice as discussed above.

37. In addition, we are concerned that costs of measuring UTPs would be increased if we were to prescribe a more-likely-than-not estimate as a new mandatory method. This is because an entity may need more information about the less probable outcomes and cumulative probabilities than is required for a most likely amount. We are concerned that the additional benefits from this measurement method may not justify the costs of requiring its use.

38. Consequently we do not recommend permitting or requiring the use of a more-likely-than-not measurement approach; to do so would introduce a new measurement method that is not used in other Standards and could be costly for some entities. Additionally we do not think that this approach would significantly improve financial reporting as compared with our modified IFRS 15 approach.

Staff conclusions

Scope

39. We suggest that all income tax positions should be included within the scope of the project, but an entity should recognise a current tax asset or liability only if it is probable that it will pay the amount to, or recover the amount from, a tax authority. This would be consistent with other guidance in IAS 12 and with the current *Conceptual Framework*.

Unit of account

40. We think that an entity should make judgements about the unit of account that should be used, because we think that such an approach would provide more relevant information for each case. If a decision on a specific case is expected to affect, or be affected by, other UTPs, we think that those UTPs should be accounted for as a unit of account.

41. To provide useful information, we think that the same unit of account should be applied for both the recognition and measurement of the asset or liability arising from UTPs.

Approach for measurement

42. We think that an entity should make a judgement between the expected value and most likely amount on the basis of which method it expects to better predict the amount, because this approach would provide more useful information to predict future cash flows for each case. We also think that this measurement approach is operational and understandable because it is consistent with IFRS 15.

43. We think that this approach should prohibit an entity's free choice, to increase comparability. As stated in paragraph 34 of this paper, we recommend that the guidance be given as follows:

An entity shall estimate an amount expected to be paid to (recovered from) the taxation authorities by using one of the following methods, depending on which method the entity expects to better predict the amount which it will pay to (or recover from) the taxation authorities:

(a) The most likely amount—the most likely amount is the single most likely amount in a range of possible outcomes. The most likely amount would be used if possible outcomes are binary or are concentrated to one value (for example, a dispute to determine a specific expense will be either deductible or non-deductible for tax purposes, forming an individual unit of account as a case-specific dispute).

(b) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible amounts. The expected value would be used, if possible outcomes are widely dispersed with lower probabilities (for example, a number of tax deductions that might be challenged by a taxation authority, and which form a single unit of account).

Staff recommendation

44. We recommend providing guidance on consistent determination of unit of account, on a recognition threshold and on measurement, as presented in the *Staff Conclusions* section.

45. As the Interpretations Committee concluded in its September meeting, we also recommend clarifying that an entity should assume that the tax authorities will examine the amounts reported to them and have full knowledge of all relevant information.

46. We recommend developing guidance on UTPs, as an interpretation of paragraphs 12 and 14 of IAS 12 on recognition and paragraph 46 of IAS 12 on measurement. We think that the draft interpretation should include some illustrative examples, to facilitate consistent judgements among entities.

Questions for the Interpretations Committee

Questions
1. Does the Interpretations Committee agree with the staff's analysis in paragraphs 12–43? 2. Does the Interpretations Committee agree with the staff's recommendation to develop guidance in the form of an interpretation?

Appendix A— Extracted paragraph from "Background Information and Basis for Conclusion" for FIN 48

B12 In its redeliberations, the Board considered whether to apply the provisions of this Interpretation to all income tax positions or some subset of income tax positions, specifically, uncertain tax positions. The Board concluded that limiting the application to only uncertain tax positions, or tax positions with specified attributes, would create a rules-based standard that would result in inconsistent application and would add complexity to the accounting guidance for income taxes. The Board does not anticipate that this Interpretation will have a significant effect on how enterprises account for tax positions that are routine business transactions that are clearly more likely than not of being sustained at their full amounts upon examination (see the example in paragraphs A19 and A20). Accordingly, the Board decided that this Interpretation should broadly apply to all tax positions.