

# IAS Plus Update.

## Changes proposed for income tax accounting

On 31 March 2009, the International Accounting Standards Board (IASB) issued an exposure draft (ED) ED/2009/2 *Income Tax* containing proposals for an International Financial Reporting Standard (IFRS) to replace the current IAS 12 *Income Taxes* and related Interpretations.

Under the proposals, the 'temporary difference' approach to accounting for income taxes would be retained. However, the ED proposes to eliminate a number of exceptions regarding the recognition of deferred taxes, to clarify other aspects of IAS 12, and to reduce some (but not all) of the differences between IFRSs and US Generally Accepted Accounting Principles (US GAAP) in this area.

Comments on the ED are requested by 31 July 2009.

### Significant changes

The key features of the ED are summarised in the Appendix to this newsletter. The most significant changes proposed, compared with the requirements of IAS 12, include:

- a revised calculation methodology for deferred taxes;
- elimination of recognition exceptions on initial recognition of assets and liabilities and for many investments;
- changes to the allocation of taxes between the various components of the financial statements; and
- new measurement and disclosure requirements for 'uncertain tax positions'.

### Revised calculation methodology

The following steps would be required for the calculation of deferred taxes under the proposals in the ED.

1. Identify which assets and liabilities are expected to affect taxable profit if they are recovered or settled for their carrying amounts. In assessing the potential effect on taxable profit, consider the expected manner of recovery or settlement.
2. Determine the tax basis at the end of the reporting period of all those assets and liabilities, and of other items that have a tax basis. The tax basis is determined by the consequences arising from the sale of the assets or settlement of the liabilities for their carrying amounts at the end of the reporting period.
3. Compute any temporary differences (difference between the carrying amount and the tax basis), unused tax losses and unused tax credits.
4. Recognise deferred tax assets and liabilities arising from the temporary differences, unused tax losses and unused tax credits.
5. Measure deferred tax assets and liabilities based on the tax rates and tax laws that have been substantively enacted at the end of the reporting period and that are expected to apply when the deferred tax liability is settled or the deferred tax asset is realised.

Deferred tax assets arising from unused tax losses and unused tax credits are also recognised, based on their gross amounts (with an appropriate valuation allowance as necessary) and the relevant tax rate.

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The following points regarding the proposed methodology are noteworthy.

**Step 1 is new.** The idea is that it is only necessary to consider deferred tax in respect of assets and liabilities for which the entity expects the recovery or settlement of the carrying amount to affect taxable profit (and for other items that have a tax basis – see below). The ED lists the circumstances in which there will be no effect on taxable profit when the entity recovers the carrying amount of an asset or settles the carrying amount of a liability – i.e. when:

- a) no taxable income or amounts deductible from taxable income arise on the recovery or settlement of the carrying amount; or
- b) equal taxable income and amounts deductible from taxable income arise, having a nil net effect; or
- c) a nil tax rate applies to any taxable or deductible amounts. (In this case, although the recovery or settlement of the carrying amount may affect taxable profit, in practice the effect is the same as the situation described in (a).)

Where the expected method of recovery is not expected to give rise to a future tax consequence, no further deferred tax calculation is required for that item (i.e. no further steps in the calculation process are required).

**There is a new definition for ‘tax basis’ (‘tax base’ under IAS 12).** The proposed definition for tax basis is “the measurement, under applicable substantively enacted tax law, of an asset, liability or other item”. Although the words in the proposed definition are not very different from those in IAS 12’s definition of tax base (“the amount attributed to the asset or the liability for tax purposes”), a key difference arises as a result of the expanded guidance proposed in the ED which would require the tax basis of an asset to be determined on the assumption that the asset is recovered through sale, and the tax basis of a liability to be determined on the assumption that it is settled for its carrying amount at the end of the reporting period.

As under IAS 12, the proposals envisage that some items will have a tax basis that are not recognised as assets/liabilities (e.g. research costs recognised as an expense for accounting purposes when they are incurred but for which a future tax deduction is available).

**All deferred tax assets would be recognised – but, where appropriate, they would be reduced by a valuation allowance to bring the net balance to the amount that is more likely than not to be recovered.** This contrasts with the current approach under IAS 12 where a deferred tax asset is recognised only if its realisation is ‘probable’. This change is not expected to affect the net amount recognised in the statement of financial position.

**A number of changes are proposed regarding the measurement of deferred tax assets and liabilities, including:**

- the tax rate used must be consistent with the tax basis – but, for assets, this will not necessarily be the rate payable on sale of the asset. As discussed above, the tax basis of an asset would be determined based on the deductions that are available on sale of the asset. If those deductions are only available on sale, the deferred tax asset/liability would be measured at the tax rate applicable to the sale. However, if the same deductions are available whether the asset is recovered through use or sale, and the entity expects to recover the asset through use, then the deferred tax asset/liability would be measured using the rate applicable to recovery through use; and
- the tax effects of the entity’s expectations of future distributions would be taken into account in measuring deferred tax assets and liabilities. This is in contrast to the position under IAS 12 which requires the use of the tax rate applicable to undistributed profits until a liability to make the distribution is recognised.

#### **Elimination of the ‘initial recognition exception’**

The ED proposes to eliminate the so-called ‘initial recognition exception’ available under IAS 12. The current exception prohibits the recognition of deferred tax liabilities and assets in relation to temporary differences arising on the initial recognition of an asset or liability other than in a business combination where the asset or liability does not impact accounting profit or taxable profit at the time of recognition.

The IASB has developed an approach that proposes to measure the asset or liability separately from the related tax effects. This approach would require that where a temporary difference arises on the initial recognition of an asset or liability, the entity should disaggregate the asset or liability into two components:

- the fair value of the asset or liability excluding any entity-specific tax effects, i.e. the asset or liability with a tax basis available to market participants in a transaction for the individual asset or liability (outside a business combination); and
- any entity-specific tax effects, i.e. the tax advantage or disadvantage arising from any difference between the tax basis available to market participants and that available to the entity itself.

Deferred taxes would be recognised for any temporary differences arising between the initial carrying amount of the asset or liability and the tax basis available to the entity, even though the asset or liability may have been initially recognised outside of a business combination without impacting accounting profit or taxable profits.

Where a difference arises between the amount paid and the aggregate of the asset or liability and the deferred taxes recognised in these circumstances, this difference would be recognised as an allowance against, or premium in addition to, the deferred tax asset or liability. The allowance or premium would be presented within deferred tax in the statement of financial position and would be reduced pro-rata with changes in the related deferred tax asset or liability.

Examples of the application of this revised approach have been developed by IASB staff, and these have been published in implementation guidance accompanying the ED.

### Allocation of taxes between the components of the financial statements

For initial recognition of deferred taxes, the ED is consistent with IAS 12: entities would recognise the tax expense arising at the time of a transaction in the same component of comprehensive income (i.e. continuing operations, discontinued operations or other comprehensive income) or equity in which it recognises the transaction.

In respect of subsequent changes in tax balances (except as regards valuation allowances for deferred tax assets for which specific principles are proposed) the ED proposes a new approach, which would result in all subsequent changes in balances (including changes arising from the changes to tax laws and rules currently accounted for under SIC-25 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders*) being recognised in profit or loss, within continuing operations.

If, during the initial and subsequent recognition, the sum of the individual tax expenses allocated to each component does not equal the total tax expense, the ED provides guidance on how to allocate this difference between different components of comprehensive income.

### Uncertain tax positions

It is common for uncertainties to arise regarding the tax treatment of items and whether the treatment adopted will ultimately be sustained on investigation by the relevant tax authority. These types of uncertainties are referred to as 'uncertain tax positions'. IAS 12 does not provide any explicit guidance on how to account for uncertain tax positions, and divergent practice has developed.

The ED proposes that current and deferred tax assets and liabilities should be measured using a probability-weighted average amount of all possible outcomes, assuming that the tax authorities will review the amounts submitted and have full knowledge of all relevant information. This approach is illustrated in the example below.

The measurement of uncertain tax positions is a mechanical but very subjective process. Although the ED indicates that the IASB does not intend entities to seek out additional information to determine their uncertain tax position assessments, in practice some entities need to do so where the probabilities of possible outcomes have not previously been determined. In some jurisdictions, determining the range of possible outcomes for each uncertain tax position and the probability of each of those outcomes occurring may prove to be a very difficult task which may require expert tax advice.

#### Example – uncertain tax positions

An entity intends to claim a tax deduction for expenditure of CU100,000 (CU30,000 tax-effected at a 30% tax rate) in its 20X1 tax return. In consultation with its tax advisers, the entity develops the following estimates of the amount of the deduction that will ultimately be allowed and associated probabilities of each outcome. The outcomes and probabilities are based on the assumption that the tax position is the subject of a review by the tax authority and that the entity ultimately negotiates a settlement with that tax authority to pay an additional tax amount (because it has claimed the full amount of CU100,000 in its tax return).

Possible amount of deduction ultimately allowed (CU)	Individual probability	Weighted probability outcome (CU)
30,000	30%	9,000
25,000	25%	6,250
20,000	20%	4,000
15,000	15%	2,250
10,000	10%	1,000
		<b>Total 22,500</b>

On the basis of the probability analysis above, the entity would conclude that the tax deduction represents an expected benefit of CU22,500 (tax-effected).

## Appendix

### ED/2009/2 Income Tax – key features

Topic	Overview
<b>Calculation methodology</b> <i>(changed)</i>	Deferred tax accounting is only performed where the entity expects an effect on taxable profit from recovering assets or settling liabilities.  The 'tax basis' of an asset/liability is determined by reference to the tax consequences that would arise if the asset was sold or the liability settled at the end of the reporting period.
<b>Uncertain tax positions</b> <i>(new)</i>	Introduces guidance on how uncertainty, if any, is to be taken into account in the measurement of income taxes. 'Uncertain tax positions' must be measured using a probability-weighted average of all possible outcomes.
<b>Investments</b> <i>(changed)</i>	Recognition exception eliminated for temporary differences relating to investments in subsidiaries, associates, branches, and joint ventures other than those that are related to foreign subsidiaries and foreign joint ventures that are essentially permanent in duration.
<b>Tax allocation</b> <i>(changed)</i>	Elimination of 'backwards tracing' concept in favour of a more mechanical approach allowing pro-rata allocation in some cases. Deferred tax recognition in equity usually limited to initial equity event.  (An alternative view based on the current 'backwards tracing' approach is presented in the ED but is not supported by the IASB.)
<b>Tax consolidation</b> <i>(clarification)</i>	New allocation and disclosure requirements for the allocation of tax to entities within groups that file a consolidated tax return for those entities' separate financial statements.
<b>Deferred tax assets</b> <i>(changed)</i>	Deferred tax assets recognised on a 'gross' basis together with an associated valuation allowance so that the net carrying amount is the highest amount that is more likely than not to be realisable against taxable profit.
<b>Initial recognition of assets and liabilities</b> <i>(changed)</i>	Recognition exception eliminated in favour of a 'split-accounting' approach, resulting in separate recognition of an asset/liability and any entity-specific tax advantage/disadvantage. The effect may in some cases be similar to the outcome under the initial recognition exemption.
<b>Changes in tax status</b> <i>(clarified)</i>	The ED proposes to incorporate the existing requirements in SIC-25 into the proposed IFRS and further clarify that a change in tax status is only recognised on approval date by the relevant tax authority, or on the filing date if approval is not required.
<b>Classification</b> <i>(changed)</i>	Deferred tax balances will be classified as current (or non-current) assets or liabilities, resulting in symmetry of treatment between the item giving rise to the deferred tax and the deferred tax balance itself.
<b>Tax rates affected by distributions</b> <i>(changed)</i>	Removal of the requirement to use the undistributed rate (for distributions to shareholders) when measuring tax assets and liabilities – moving to an expected rate approach. To determine the appropriate rate (distributed versus undistributed), entities should consider past experiences as well as the intention and ability to make distributions during the period in which the deferred asset or liability is expected to be recovered or settled.
<b>Substantive enactment</b> <i>(clarified)</i>	The notion of 'substantive enactment' has been clarified to mean situations where future steps in the approval process historically have not affected the outcome and are unlikely to do so.
<b>Tax credits</b> <i>(clarified)</i>	New definitions are proposed for 'investment tax credits' and 'tax credits'. However, the ED proposes to retain the scope exclusion for 'investment tax credits' and so does not provide any additional guidance on how these should be accounted for.
<b>New disclosures</b> <i>(changed)</i>	New disclosure requirements include: <ul style="list-style-type: none"> <li>• description and possible financial effects of estimation of uncertainties and their timing (such as uncertain tax positions);</li> <li>• impacts of the effects of the possible outcomes of a review by the tax authorities on current and deferred taxes;</li> <li>• a movement schedule for each type of temporary difference, unused tax loss and unused tax credit;</li> <li>• differences between tax bases and reported amounts of assets and liabilities for 'pass-through entities' (where income is taxed in the hands of owners);</li> <li>• details of transactions between tax jurisdictions with different tax rates;</li> <li>• details of tax-consolidated groups including amounts of current/deferred expenses and payables/receivables from other entities in the group, and the basis of allocation (separate financial statements); and</li> <li>• accounting policies for interest and penalties and exchange differences on foreign tax assets and liabilities.</li> </ul>
<b>Treatments carried over from IAS 12</b>	A number of requirements are carried forward from IAS 12, including: <ul style="list-style-type: none"> <li>• the calculation of current tax;</li> <li>• treatment of deferred taxes arising in relation to business combinations, share-based payments and foreign currency translation;</li> <li>• the prohibition on the discounting of deferred taxes;</li> <li>• offsetting requirements; and</li> <li>• many disclosures.</li> </ul>
<b>Consequential amendments to other Standards</b>	IAS 32 would be amended to remove the reference to income tax consequences of equity transactions.  IAS 34 would be amended to require valuation allowances to be determined in accordance with the new income tax Standard, rather than being spread over the annual reporting period.  IFRS 1 would be amended to provide additional relief to first-time adopters.
<b>Transitional requirements</b>	The revised requirements are generally expected to be applied on a prospective basis from the beginning of the first annual reporting period to which the new IFRS is applied.  Accordingly, comparative information will not be required to be restated.

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