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Heads Up

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# The Taxing Steps Toward Convergence

# IASB Proposes Changes to Income Tax Accounting

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On March 31, 2009, the IASB issued an exposure draft (ED), Income Tax (ED/2009/2), containing proposals for an International Financial Reporting Standard (IFRS) on income taxes that would replace the current guidance under IAS 12, *Income Taxes*, and its related interpretations. The ED seeks to clarify certain aspects of IAS 12 and reduce the income tax accounting differences between IFRSs and U.S. GAAP. The comment deadline is July 31, 2009, with a final standard expected in 2010.

This *Heads Up* highlights the significant changes proposed for income tax accounting under IFRSs and compares the proposals with existing practice under U.S. GAAP. No changes to U.S. GAAP have been proposed yet, but the SEC is considering a wholesale conversion to IFRSs for U.S. issuers pursuant to its proposed roadmap. Accordingly, U.S. constituents should carefully review and consider the proposals in the ED because its proposed income tax guidance may one day be required in the United States or may soon be relevant for entities that currently apply IFRSs (e.g., U.S. subsidiaries of foreign multinational entities). Further, the FASB is considering its approach to short-term convergence projects in light of the SEC's proposed roadmap and will request comments from U.S. constituents to help shape any final decisions (see the "Background" section below). A newsletter discussing the impact of the ED on entities that currently apply IFRSs will be available soon on Deloitte's IAS Plus Web site.

## Background of IASB and FASB Convergence Project on Income Taxes

The income taxes project is one of the short-term convergence projects outlined in the Memorandum of Understanding (MoU) entered into by the IASB and FASB in 2006. IAS 12 and its U.S. GAAP counterpart, FASB Statement No. 109, *Accounting for Income Taxes*, are both based on the temporary-difference approach. Accordingly, the scope of the convergence project did not include evaluating alternatives to the underlying fundamental principles (in IAS 12 and Statement 109), but was limited to addressing the differences between the two standards. Both the IASB and FASB continued to deliberate potential changes to their respective standards through 2008. In September 2008, the IASB and the FASB issued an updated MoU that described the status and next steps of the short-term convergence projects and the priorities and milestones necessary to complete their major joint projects by 2011. As part of that update, the FASB decided to indefinitely defer its income tax project until it had an opportunity to evaluate its strategy on the ongoing short-term convergence projects, citing the possibility that U.S. issuers may be transitioning to IFRSs at some point in the near future.

The FASB plans to issue an invitation to comment that includes the IASB's *Income Tax* ED not only to solicit input on the IASB's proposals, but also to gather feedback on its policy regarding short-term convergence. However, timing on the issuance of the invitation to comment is unknown. Upon its issuance, and after input is considered, the FASB will decide how to proceed with convergence for income taxes. An option the FASB may consider is a wholesale adoption of the IASB's revised standard on income taxes to replace Statement 109 and achieve full convergence. Other options include piecemeal amendments to Statement 109 to eliminate specific differences or the removal of the project from its agenda altogether. The FASB made a number of tentative decisions during the short-term convergence project that may provide a basis for the piecemeal option if the FASB selects that approach. See the FASB's Web site for a summary of decisions reached.

To reduce differences between IFRSs and U.S. GAAP, the ED proposes a number of changes that are based on the guidance in Statement 109. However, many of the proposed changes are principles-oriented (i.e., not as prescriptive as the guidance in U.S. GAAP — e.g., the allocation of taxes discussed in the ED in paragraphs 33 and 34 and BC90–BC99). Accordingly, an entity must carefully consider the ED when assessing whether a proposed change truly converges with its application of Statement 109.

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## Summary of the ED's Significant Changes to Accounting Under IAS 12

The ED proposes significant changes to the accounting for income taxes under IAS 12, including the following:

- *Uncertain Tax Positions* — The ED proposes to address uncertainty as part of the guidance related to the measurement of current and deferred tax assets and liabilities. The measurement guidance will require the use of a probability-weighted average amount of all possible outcomes, assuming there is an examination by the taxing authority with full knowledge of all relevant information. IAS 12 contains no guidance on accounting for uncertainty.
- *Definitions* — Changes to the definition of "tax basis" and the addition of the definition of "tax credit" and "investment tax credit."
- *Initial Recognition Exemption* — Removal of the exception to the recognition of deferred taxes on the initial recognition of an asset or liability when a basis difference exists. The ED's measurement approach addresses this situation.
- *Exceptions for Investments in Subsidiaries and Related Entities* — Changes to the exception "relating to [recognizing] a deferred tax asset or liability arising from investments in subsidiaries, branches and associates, and [interests in] joint ventures." The proposed exception will relate only to foreign subsidiaries, joint ventures, and branches (not associates) that are essentially permanent in duration.
- *Deferred Tax Asset Recognition* — Change to the recognition of deferred tax assets such that deferred tax assets will be recognized in full, less a valuation allowance (if applicable). The ED also includes additional guidance derived from Statement 109 on assessing deferred tax assets for realization (e.g., expenses related to tax planning strategies).
- *Tax Rate: Effect of Distributions* — Replacement of the requirement for entities to use the undistributed rate (for distributions to shareholders) when measuring tax assets and liabilities with an expected-rate approach. To determine the appropriate rate (distributed versus undistributed), entities should consider past experiences as well as the intent and ability to make distributions during the period in which the deferred tax asset or liability is expected to be recovered or settled.
- *Recording Subsequent Changes in Deferred Taxes* — Change in the allocation guidance to replace "backwards tracing" with an approach similar to that required by Statement 109.

- *Classification of Deferred Taxes* — Change from presenting all deferred taxes as noncurrent to classifying deferred tax assets and liabilities as either current or noncurrent.

## Next Steps

The IASB is accepting comments on the proposed changes until July 31, 2009. The FASB has yet to issue its invitation to comment, but when it does, the FASB will probably seek input on its approach to short-term convergence projects as well as the IASB's proposed changes in the ED. In light of the possibility of a mandatory conversion to IFRSs in the United States for U.S. issuers, U.S. constituents are encouraged to review the proposals in the ED and submit comments to the IASB.

## Appendix A — Significant Remaining Differences Between Accounting Under U.S. GAAP and IFRSs

The approach to income tax accounting under IAS 12 is similar to that under Statement 109 (i.e., both use the temporary-difference approach). The ED eliminates several of the differences between the two standards related to exceptions to the temporary-difference approach and to recognition, measurement, and disclosures, but some differences remain, as noted in the table below.

| Area of Difference | U.S. GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| Uncertain tax positions | Interpretation 48[1] requires a two-step approach:<br>• Step 1: Determine whether the tax position is more-likely-than-not to be sustained upon examination by the taxing authority.<br>• Step 2: For tax positions that meet the recognition threshold, measure the benefit at the largest amount over 50 percent likely to be realized in a negotiated settlement.<br>Interpretation 48 includes specific guidance on interest and penalties and allows for a policy election regarding the income statement classification of such amounts. | Entities address uncertainty in measurement of tax amounts by using a one-step approach. There is no recognition threshold, and measurement is based on a probability-weighted average of **all** possible outcomes, assuming the taxing authority will examine the position and has full knowledge of all relevant information.<br>The ED allows for a policy election regarding the income statement classification of interest and penalties but includes no accounting guidance. | Convergence in this area was not reached because the underlying principles for the treatment of uncertainties under U.S. GAAP and IFRSs are not consistent. The proposed IFRS approach may seem onerous because entities would need to address all tax positions by using the probability-weighted-average approach, but paragraph BC63 of the ED's Basis for Conclusions states that the IASB did not intend for entities to seek additional information to apply this proposed change. This proposal is expected to receive significant attention during the comment period. |
| Special deductions | These tax benefits should be recognized for financial reporting purposes no earlier than the year in which they are available to reduce taxable income on the enterprise's tax returns. In addition, the future tax effects of special deductions may nevertheless affect (1) the average graduated tax rate and (2) the need for a valuation allowance for deferred tax assets. | Accounting for special deductions is not specified in the ED. | The IASB decided to remain silent on the matter of tax benefits related to special deductions because the global application of IFRSs involves numerous jurisdictional issues that could not all be mentioned specifically. |
| Exceptions for temporary differences on investments in subsidiaries and related entities | Deferred tax *liabilities* are not recognized on investments in **foreign** subsidiaries or corporate joint ventures that are essentially permanent in duration unless they are expected to reverse in the foreseeable future.<br>Deferred tax *assets* are not recognized on investments in **any** subsidiary or joint venture that is essentially permanent in duration unless they are expected to reverse in the foreseeable future.<br>Deferred tax *liabilities* are not recognized on investments in **domestic** subsidiaries if the tax law provides a means to recover the reported amount tax-free and the enterprise expects to use that means. | Deferred tax liabilities or assets are not recognized on an investment in **foreign** subsidiaries, joint ventures, or branches that are essentially permanent in duration unless they are expected to reverse in the foreseeable future. | The IASB had considered eliminating all exceptions to recording deferred taxes on investments in subsidiaries and related entities but was convinced that the calculations necessary to do so for foreign interests were so complex that the cost would outweigh the benefits. Accordingly, the IASB has proposed an exception for *foreign* subsidiaries, joint ventures, or branches that is similar to the exception under U.S. GAAP. If the proposal is finalized, the exceptions for investments in *domestic* subsidiaries and joint ventures in Statement 109 will not be converged. |
| Intercompany transfer of assets (paragraph 9(e) exception) | Tax expense from intercompany sales is deferred until the related asset is sold or disposed of, and no deferred taxes are recognized for the purchaser's change in tax basis. | No such exception is provided to the temporary-difference approach. | This exception never existed in IAS 12 and the IASB decided not to include it in the ED because the application of the temporary-difference approach reflected the economic events involving a transaction between the enterprise and two outside parties (i.e., the tax authorities in each tax jurisdiction involved). |

[1] FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109.

| Area of Difference | U.S. GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| Foreign nonmonetary assets/liabilities remeasured from local currency to functional currency (paragraph 9(f) exception) | Deferred tax is not recognized on differences related to nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency and that result from (1) changes in exchange rates or (2) indexing for tax purposes. | Deferred tax is recognized on differences related to nonmonetary assets and liabilities that are remeasured from local currency to functional currency. | This exception never existed in IAS 12, and in deciding not to include it in the ED, the IASB noted that one of the objectives of the project was to minimize exceptions to the temporary-difference approach. |
| Tax rate used in measurement | Use enacted tax rates. | Use tax rates and tax laws that have been substantively enacted. The ED's Basis for Conclusions notes that in the United States, substantive enactment occurs only upon enactment. | The IASB observed that the announcement of tax rates or laws by governments in certain jurisdictions has the substantive effect of actual enactment because often the event of enactment is only a formality. |
| Tax rate — tax effects of future distributions | Statement 109 has been clarified by various EITF Issues.[2] Generally, enterprises use the higher of the distributed rate or undistributed rate when measuring tax items. | Entities should use the rate expected to apply when the tax asset or liability is realized or settled. 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. | The proposed IASB approach requires entities to use a significant amount of judgment to determine the tax rate that is expected to apply when the deferred tax asset or liability is expected to reverse. This proposal is also expected to receive significant attention during the comment period. This difference may be significant in jurisdictions that either impose additional income taxes or refund income taxes when distributions are made to owners. |
| Determination of tax basis of assets acquired outside of a business combination | Entities record deferred taxes by adjusting the carrying value of the asset for the related deferred tax asset or liability. Entities calculate both the carrying values of the asset and the deferred tax asset or liability by using simultaneous equations (see Issue 98-11[3]). | Asset or liability that results in a temporary difference should be separated into (1) the asset or liability, excluding any entity-specific tax effects and (2) the deferred tax asset or liability determined when the carrying amount of asset or liability is compared to its tax basis. If the consideration differs from the sum of (1) and (2), an allowance or premium is recorded on the deferred tax amount. | Upon reconsideration of the initial recognition exception in IAS 12, the IASB considered the approach in Issue 98-11 but opted for one that would not result in the carrying amount of the asset being adjusted for entity-specific tax effects (e.g., an asset acquisition structured so that the acquirer receives carry-over tax basis from the seller). Accordingly, the IASB developed the proposed approach to separate the measurement of the asset acquired or liability assumed from the tax effects. |
| Investment tax credits | Opinion 2,[4] as amended by Opinion 4,[5] allows either of the following two recognition methods of such credits: (1) the deferral method (preferred) or (2) the flow-through method. | No specific guidance is provided on the accounting for investment tax credits, however the ED added a definition of "investment tax credit." | Because no specific guidance on investment tax credits exists under IFRSs, users must consider the IFRS Framework or look to other sets of standards with a similar framework (e.g., U.S. GAAP) to determine the appropriate accounting policy. |
| Definition of tax basis | No definition in Statement 109 exists, but Issue 98-11 contains a footnote that states that the "tax basis of an asset [or liability] is a question of fact under the tax law." | Under applicable substantively enacted tax law, the measurement of an asset, liability, or other item is determined by the consequences of the sale of the asset or settlement of the liability for its current carrying value. | The more explicit guidance in the IASB's proposal is not expected to result in significant accounting differences unless the basis of an item *in use* is significantly different from that determined by sale or settlement. |

[2] See, e.g., EITF Issue No. 95-9, "Accounting for Tax Effects of Dividends in France in Accordance With FASB Statement No. 109;" EITF Issue No. 95-10, "Accounting for Tax Credits Related to Dividend Payments in Accordance With FASB Statement No. 109;" and EITF Issue No. 95-20, "Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments."

[3] EITF Issue No. 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations."

[4] APB Opinion No. 2, *Accounting for the "Investment Credit."*

[5] APB Opinion No. 4, *Accounting for the "Investment Credit."*

| Area of Difference | U.S. GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| **Disclosures** | | | |
| Uncertain tax positions | Specific disclosures required by Interpretation 48 include a tabular reconciliation of unrecognized tax benefits, potential impacts of an enterprise's effective tax rate, and amounts for which significant increases or decreases are reasonably possible within 12 months of the report date. | Disclosures regarding uncertainty are much less prescriptive. Entities are required to disclose the effects of any adjustments of current and deferred income taxes included in tax expense as well as the major sources of uncertainty related to income taxes. | Interpretation 48 disclosures have been the subject of much debate in the United States. The proposed significant change regarding information provided to users of financial statements is expected to receive considerable attention during the comment period. |
| Dividend disclosures | No disclosure requirement. | The estimates related to future distributions and their effect on the tax rate used to measure deferred taxes, if any. | Disclosure requirement is the result of the proposed change in the rate an entity uses to measure tax amounts when a different rate applies because an entity makes distributions to owners. This disclosure difference is the result of the accounting difference summarized above. |
| Investments in subsidiaries and related entities | Paragraph 44 of Statement 109 requires, among other things, disclosure of (1) a description of the temporary difference and the events that would cause it to be taxable, (2) the cumulative amount of the temporary difference, and (3) the amount of the unrecognized deferred tax liability if practicable. | Aggregate amount of temporary differences associated with investments in subsidiaries and interests in joint ventures for which deferred tax liabilities have not been recognized. | The ED does not amend the disclosure requirement in IAS 12, which, like U.S. GAAP, emphasizes the aggregate amount of the temporary difference associated with the investment. The IASB concluded that additional disclosures would not be useful or practicable. |
| Disclosure of the expiry date (if any) of deductible temporary differences | The amounts and expiration dates of operating losses and tax credit carryforwards for tax purposes. | The expiry date, if any, of temporary differences, unused tax losses, and tax credits. | The ED expands on the requirement in Statement 109 to disclose temporary differences that expire. Expiring temporary differences are not common. |
| Intragroup transfers of assets between jurisdictions with different tax rates | No disclosure requirement, since recording of tax effects is specifically prohibited under paragraph 9(e). | For transfers between taxing jurisdictions with different tax rates: (1) deferred tax assets and liabilities arising from the transfer, (2) the net effect on tax expense, and (3) tax effect of modifications since end of reporting period. | The IASB added this new disclosure to the IAS 12 requirements because of concerns about the perception of earnings management through intragroup transfers of assets. |

## Appendix B — Differences Between Accounting Under U.S. GAAP and IFRSs That Were Not Considered in the IASB's Income Tax Project

Certain areas outside of income taxes, but in which there may be income tax consequences, were not considered during the scope of the short-term convergence project. Therefore, accounting under U.S. GAAP and IFRSs will continue to differ in these areas, as noted in the table below.

| Area of Difference | U.S. GAAP | IFRSs |
|---|---|---|
| Share-based payments | The tax benefit of the tax deduction in excess of the compensation cost recognized (i.e., the excess tax benefit) must be recorded as a credit to equity. The tax benefit of the shortfall between the tax deduction and the compensation cost recognized (i.e., tax benefit deficiency) is recorded as a debit to equity to the extent that prior excess tax benefits exist (i.e., APIC pool). In the absence of prior excess tax benefits, the tax benefit shortfall is recorded as income tax expense. | The tax benefit of the tax deduction in excess of the compensation cost recognized must be recorded as a credit to equity. The tax benefit of the shortfall between the tax deduction and the compensation cost recognized is recorded as income tax expense. |
| Steamship enterprise and other exceptions | Deferred tax liabilities are not recognized for the following (subject to certain tax years), unless they are expected to reverse in the foreseeable future:<br>• "Bad debt reserves" for tax purposes of U.S. savings and loan associations.<br>• "Policyholders' surplus" of stock life insurance companies.<br>• Statutory Reserve Funds of U.S. steamship enterprises. | No similar exceptions to the temporary-difference approach. |
| Leveraged leases | Statement 13[6] provides an exception to the Statement 109 accounting for recognition of changes in the expected tax rate (i.e., over life of lease rather than immediate recognition). | There are no leveraged leases under IFRSs. |

[6] FASB Statement No. 13, *Accounting for Leases.*

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