



Board Meeting Handout
Income Tax Convergence Project
January 31, 2007

OVERVIEW

The staff has identified a number of income tax issues related to business combinations in the convergence income tax project and the business combinations project. This handout summarizes the issues raised in the convergence income tax project. Based on decisions reached by the Board, the staff will assess which project should include any changes to current requirements and whether those changes would require exposure in the convergence income tax project.

Issue 1: Whether to clarify the tentative decision to record the acquisition of an asset with a tax basis difference at fair value (assuming full deductibility for tax purposes)?

Issue 2: Whether to retain the guidance in FASB Statement No. 109, *Accounting for Income Taxes*, by continuing to prohibit the recognition of a deferred tax liability for the amount of goodwill that is not deductible for tax purposes?

ISSUE 1: RECORDING ASSETS AND LIABILITIES AT FAIR VALUE
(ASSUMING FULL DEDUCTIBILITY FOR TAX PURPOSES)

The FASB and the IASB reached a joint tentative decision to require that acquired temporary differences in asset acquisitions be recognized at fair value (assuming full deductibility for tax purposes). The staff noted situations in which the amount that would be recorded under the proposed guidance would be different than fair value and, therefore, requests that the Board clarify what it intended for these transactions.

Statement 109 currently requires that an asset or liability should be recorded at the amount required by other U.S. generally accepted accounting principles (GAAP)

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(generally fair value) and not net of any related deferred tax liability or asset that arises when a tax basis difference exists as the result of the assumption of the seller's tax basis (herein referred to as the Fair Value View). The proposed joint decision is to record an asset or liability at *fair value assuming no tax basis difference* in all circumstances (herein referred to as the Other Measurement Attribute View). This measurement attribute is different than fair value in certain circumstances. The application of the two views would result in a different amount being recorded for an asset when an acquired tax basis difference is solely the result of tax attributes of a specific asset in a jurisdiction that either limits or enhances the deductibility of that asset (a basis difference that would transfer to all market participants), rather than when a tax basis difference exists as the result of the assumption of the seller's tax basis by the acquirer (a basis difference that only transfers if a transaction is structured appropriately).

Question 1: In an asset acquisition with an acquired tax basis difference, does the Board wish to clarify that fair value, rather than fair value assuming full deductibility for tax purposes, should be used for the initial recognition of that asset?

Staff Recommendation

The staff recommends that the Board clarify that in requiring that an asset be recorded at *fair value assuming no tax basis difference*, the Board's intention was that the asset should not be recorded net of the deferred tax consequences and that the measurement attribute to be used for the asset is fair value.

If the Board decides in question 1 that assets acquired should be recorded assuming full deductibility for tax purposes, the Board would need to consider whether it would like to extend this measurement attribute to the other transactions as presented in question 2. Question 2 of this issue may or may not be necessary based on the Board's response to question 1.

Question 2: If the Board has chosen fair value assuming full deductibility for tax purposes in question 1, does the Board wish to extend its decision to require a new measurement attribute (fair value, assuming full deductibility for tax purposes) for business combinations, assumptions of liabilities, and remeasurements?

Alternative 1: No. (*Staff recommendation*)

Alternative 2: Yes, the Board wishes to require the measurement attribute—fair value assuming full deductibility for tax purposes—to assumptions of liabilities, business combinations, and remeasurements.

ISSUE 2: RECOGNITION OF A DEFERRED TAX LIABILITY FOR NONDEDUCTIBLE GOODWILL

Statement 109 and IAS 12, *Income Taxes*, both prohibit the recognition of deferred tax liabilities (DTLs) for goodwill that is not deductible for income tax purposes. Specifically, recognition is prohibited both at the acquisition date and subsequently for:

- a. Goodwill that has a tax basis of zero (that is, goodwill does not exist for tax purposes and does exist for financial reporting purposes)
- b. Goodwill for financial reporting that is in excess of tax deductible goodwill.

In its convergence income tax project, the IASB decided to propose a change to IAS 12 that would require DTLs to be recognized for temporary differences arising on the initial recognition of goodwill. The staff considered the relative merits associated with retaining and eliminating the exception for nondeductible goodwill in terms of the relevance to users of financial statements, symmetry between deferred tax assets (DTAs) and DTLs for goodwill, consistency with the principles of Statement 109, complexity of calculation at the acquisition date, and complexity of the accounting post acquisition.

Alternatives

Alternative A: Retain the guidance in Statement 109 by continuing to prohibit the recognition of DTLs for nondeductible goodwill for purposes of the forthcoming Exposure Draft on the convergence income taxes project. (*Staff recommendation*)

Alternative B: Further explore whether the exception for nondeductible goodwill should be eliminated as part of the convergence income taxes project.

Question 3: Does the Board want to retain the guidance in Statement 109 by continuing to prohibit the recognition of DTLs for nondeductible goodwill?



Board Meeting Handout
Business Combinations Project
January 31, 2007

OVERVIEW

The staff has identified a number of income tax issues related to business combinations in the convergence income tax project and the business combinations project. This handout summarizes the issues raised in the business combinations project. Based on decisions reached by the Board, the staff will assess which project should include any changes to current requirements and whether those changes would require exposure in the convergence income tax project.

The basic approach in the business combinations project for income taxes was to retain the existing guidance for accounting for income taxes in a business combination. However, the Boards proposed limited amendments to FASB Statement No. 109, *Accounting for Income Taxes*, and IAS 12, *Income Taxes*, to further converge those standards and to make those standards more consistent with the business combinations principles. Those amendments were exposed for comments in the FASB Exposure Draft, *Business Combinations*. At today's meeting, the Board will discuss whether to affirm or modify those proposed changes.

Issue 1: Whether to affirm an exception to the fair value measurement principle in accounting for a business combination for assets and liabilities for income taxes?

Issue 2: Whether to affirm that changes in the **acquirer's** deferred tax assets that occur because of the business combination should be accounted for separate from the business combination accounting?

Issue 3: Whether the recognition of acquired deferred tax benefits subsequent to the business combination should be accounted for as adjustments to goodwill or recognized in income (in U.S. generally accepted accounting principles (GAAP),

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the recognition of deferred tax benefits are referred to as decreases in the acquiree's valuation allowance)?

Issue 4: Whether changes to uncertainties for acquired tax positions subsequent to a business combination should be accounted for as adjustments to goodwill or recognized in income?

Issue 5: Whether an exception to the recognition requirements for deferred taxes should be added to Statement 109 and IAS 12 for taxable and deductible temporary differences related to indefinite-lived intangible assets acquired in a business combination?

ISSUE 1: INCOME TAX EXCEPTION TO THE FAIR VALUE MEASUREMENT PRINCIPLE

FASB Statement No. 141, *Business Combinations*, and IFRS 3, *Business Combinations*, currently require that income tax assets and liabilities in a business combination be measured in accordance with existing income tax guidance in Statement 109 and IAS 12, respectively, rather than at fair value. The proposal by both Boards in the Exposure Draft on business combinations is to retain that exception, primarily because of the complexities that would arise in periods subsequent to the acquisition under the temporary difference approach for income tax accounting.

Staff Recommendation

The staff recommends that the Board affirm its decision to require that income taxes be accounted for in accordance with the guidance in Statement 109 (and related interpretive guidance), as amended by the forthcoming final Statement on business combinations.

Question 1: Does the Board wish to affirm an exception to the fair value measurement principle for income tax assets and liabilities that are acquired in a business combination, and instead require that they be measured in accordance with existing income tax guidance?

ISSUE 2: CHANGES TO THE ACQUIRER'S DEFERRED TAX ASSETS BECAUSE OF THE BUSINESS COMBINATION

IAS 12 and Statement 109 presently require different accounting for changes to the **acquirer's** deferred tax assets because of a business combination. IAS 12 requires the acquirer to separately recognize from business combination accounting any changes in its

deferred tax assets that become recognizable because of the business combination. Such changes are recognized in post-combination profit and loss or equity. Statement 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's valuation allowance) that results from a business combination to be accounted for as part of the business combination, generally as an adjustment of goodwill.

The Exposure Draft proposes that an acquirer recognize any changes in the *acquirer's* deferred tax benefits as a transaction separately from the business combination. That proposal would amend Statement 109 to require that such changes (that is, changes in the acquirer's previously recognized valuation allowance) be recognized either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances.

The Exposure Draft's basis for conclusions observes that, for practical reasons, the FASB limited its consideration of this issue to the existing alternatives prescribed by Statement 109 and IAS 12, rather than requiring an assessment of whether a change in the acquirer's deferred taxes are part of the business combination. FASB Board members acknowledged that the existing requirements in Statement 109 and IAS 12 are both defensible on conceptual grounds. They also observed that neither alternative is entirely consistent with the requirements in the Exposure Draft because both alternatives (retaining Statement 109 or adopting the approach in IAS 12) remove the judgment that is required in assessing whether other assets or liabilities are part of the business combination.

Alternative A: An acquirer should recognize any changes in *its* deferred tax benefits as a transaction separately from the business combination. (*Staff recommendation*)

Alternative B: An acquirer should recognize any changes in *its* deferred tax benefits as part of business combination accounting.

Proponents of Alternative A state that this view is consistent with the business combinations model of excluding the effects that are not part of the exchange. That is, the change in the acquirer's circumstances upon a business combination should be accounted for as a separate event.

Proponents of Alternative B emphasize consistency with the Statement 109 model. They view the business combination as the triggering event for the recognition of the change. They also believe that an acquirer's tax synergies are factored into the price that the acquirer is willing to pay and, therefore, constitute goodwill.

Question 2: Does the Board wish to affirm its decision to require that the acquirer recognize separately from business combination accounting any changes in its deferred tax assets because of the business combination?

ISSUE 3: CHANGES TO THE ACQUIRED DEFERRED TAX BENEFITS AFTER THE BUSINESS COMBINATION

The Exposure Draft proposes to amend paragraph 30 of Statement 109 to:

- a. Include a rebuttable presumption that acquired deferred tax benefits recognized within one year from the acquisition date be recognized as an adjustment to goodwill until goodwill is reduced to zero.
- b. Require acquired deferred tax benefits recognized after one year from the acquisition date to be recognized in income, rather than as an adjustment to goodwill.

Comments received in response to the amendments to paragraph 30 were mixed. Those that agree with the Boards' proposal do so because:

- a. Changes often relate to post-combination results. Changes in estimates that occur after the business combination often relate more to conditions that emerge after the combination and, therefore, should be correlated with the post-combination operating results.
- b. Goodwill recognized at the acquisition date would not reflect the full undiscounted amount of the tax attribute. While it may be true that the acquirer "paid something" for the acquired tax benefits (such as net operating losses of the acquiree), it is particularly unclear how much the acquirer paid for them in a scenario where it was not more likely than not that the acquirer could use them at the time it made the deal.

Those that disagree do so primarily because they believe that the requirements for income taxes result in a measure that is drastically different than fair value. They view the indefinite adjustment to goodwill as a “true-up” of the estimate, based on what actually comes to fruition. They view income taxes as a significant area of judgment and have concerns that small changes in judgment could have a significant and unrepresentative impact to income in future periods.

Clarification about the Length of the Period of Adjustment

The Exposure Draft includes a rebuttable presumption that acquired deferred tax benefits recognized within one year from the acquisition date (that is, decreases to the valuation allowance within one year from the acquisition date) would be recognized as an adjustment to goodwill. A comment letter suggested that instead of a fixed one-year limit for adjustments, adjustments to the recognized acquired deferred tax benefits should be subject to the measurement period described in the Exposure Draft.

Whether Adjustments to Goodwill Should Be Both Increases and Decreases

Existing guidance (in paragraph 30 of Statement 109) is one-directional—it only requires *reductions* of goodwill for subsequent recognition of acquired deferred tax benefits. In the Exposure Draft, the requirements were carried forward from existing guidance in both IAS 12 and Statement 109 and are also one-directional. Some view the one-directional adjustment as an anti-abuse provision that should be removed from GAAP.

Whether a Rebuttable Presumption Is Necessary

A rebuttable presumption is included in the Exposure Draft that would have required that recognition of acquired deferred tax benefits within one year be applied to goodwill. Basically, that presumption would be overcome if the recognition of those benefits related to subsequent and unforeseeable events. If the rebuttable presumption was overcome, the recognition of acquired deferred tax benefits recognized within one year from the acquisition date would be recognized as income.

The rebuttable presumption would reduce the complexity of application because it establishes a higher threshold for analysis. It also could be viewed as a mechanism to prevent abuses (for example, establishing an inflated valuation allowance [or not

recognizing all acquired deferred tax benefits so that subsequent income can be reported]). However, requiring a rebuttable presumption would make the requirements for adjustments to deferred tax assets and liabilities different from any other acquired asset or liability. In other words, if there was no rebuttable presumption, the acquirer would be required to assess whether any change was a result of facts and circumstances that exist at the acquisition date. There is no rebuttable presumption for other assets and liabilities for which the measurement period applies.

The identified alternatives for addressing whether there should be a rebuttable presumption are:

- a. Remove the rebuttable presumption and require that the measurement period guidance apply to all acquired assets and liabilities.
- b. Retain the rebuttable presumption that recognized acquired deferred tax benefits and decreases in the recognized acquired deferred tax benefits should be adjustments to goodwill.
- c. Retain the rebuttable presumption that recognized acquired deferred tax benefits should be adjustments to goodwill and add a rebuttable presumption that decreases in the recognized acquired deferred tax benefits (that is, increases in the valuation allowance) should be adjustments to income.

Alternative A is consistent with the established requirements for all other subsequent adjustments to acquired assets and liabilities in a business combination. Alternatives B and C are operationally easier to implement because analysis would only be required to rebut the presumption. Within the measurement period, Alternative C is consistent with the abuse prevention notion that is currently in Statement 109 and IAS 12—preventing the recognition of income in future periods by reversing inflated valuation allowances.

Staff Recommendation

The staff recommends that the Boards affirm the guidance in the Exposure Draft on business combinations to amend paragraph 30 of Statement 109 with slight modification to:

- a. Require that qualifying measurement period adjustments (both increases and decreases) in the acquired deferred tax benefits recognized within the measurement period be recognized as adjustments to goodwill (increases in the acquired deferred tax benefits recognized would be limited to reducing goodwill to zero).

- b. Require that other changes in the acquired deferred tax benefits be recognized in income, rather than as an adjustment to goodwill.

Question 3: Does the Board wish to affirm the guidance for the recognition of acquired deferred tax benefits, with modifications to:

- a. *Clarify the length of the period of adjustment?*
- b. *Require the same accounting approach for all changes in the amount of acquired deferred tax benefits (both increases and decreases)?*
- c. *Remove the rebuttable presumption and require that the measurement period guidance apply?*

ISSUE 4: CHANGES TO ACQUIRED TAX UNCERTAINTIES AFTER THE BUSINESS COMBINATION

EITF Issue No. 93-7, “Uncertainties Related to Income Taxes in a Purchase Business Combination,” and Question 17 of the FASB Special Report, *A Guide to Implementation of Statement 109 on Accounting for Income Taxes*, provide the following examples of some of the tax uncertainties that may exist or arise in connection with a business combination:

- a. Allocation of the purchase price to individual assets and liabilities for income tax purposes in a taxable business combination (such as uncertainties about the acceptability by the taxing authority of the basis under the tax law for the allocations claimed in initial filings with the tax authority)
- b. Uncertainties about the carryover bases of assets, liabilities, and carryforwards at the date of acquisition in a nontaxable combination
- c. Uncertainties about tax returns of the acquired company for periods prior to the acquisition date.

Prior to adopting FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, Issue 93-7 and Question 17 require that an acquirer recognize deferred tax assets and liabilities based on the management’s best estimate of the ultimate tax basis that will be accepted by the tax authority (or for liabilities, the best estimate of the ultimate settlement). The effects of adjustments to those best estimates are required to be recognized in the same manner as the reversal of a valuation allowance for acquired tax benefits subsequent to an acquisition. Therefore, the effect of those adjustments are

applied first to goodwill attributable to that acquisition (reductions are limited to reducing goodwill to zero), second to other noncurrent intangible assets related to that acquisition (reductions are limited to reducing intangible assets to zero), and third to income. Those adjustments would continue to be applied in that manner until the contingency is resolved, which may be many years after the acquisition.

Upon adoption, Interpretation 48 would apply to the acquirer's recognition and measurement of those uncertainties at the date of a business combination. However, Interpretation 48 retains the guidance pertaining to the accounting for the effects of the adjustments (first goodwill, then noncurrent intangible assets, then income) and it retains the indefinite adjustment period for those uncertainties.

The FASB issued its Exposure Draft on business combinations and the proposed Interpretation, *Accounting for Uncertain Tax Positions*, at approximately the same time. The Exposure Draft on business combinations proposes that income tax uncertainties be accounted for in accordance with Statement 109 (rather than requiring them to be fair valued at acquisition like other contingencies, which is consistent with current requirements in paragraph 40 of Statement 141).

The Exposure Draft on business combinations included Issue 93-7 and Question 17 in its anticipated effect on related authoritative literature. That analysis stated that the proposed Statement "amends the guidance for the subsequent recognition of deferred tax benefits acquired in a business combination in paragraph 30 of Statement 109." The guidance for subsequent adjustments of tax uncertainties in Issue 93-7 and Question 17 copies the pattern of a reversal of the valuation allowance in paragraph 30 of Statement 109. Therefore, the staff's intention in including that effect was to indicate that the amendments to paragraph 30 of Statement 109 also would be applied to tax uncertainties. However, because this issue had not been explicitly considered by the Boards in deliberations, the staff is asking the Board to address this issue for the final Statement.

Staff Recommendation

The staff recommends that the proposed requirements for the reversal for the valuation allowance (Section B, Issue 3) also apply to changes in acquired tax uncertainties subsequent to the acquisition date.

Question 4: Does the Board wish to require that the proposed requirements for changes to acquired deferred tax benefits after a business combination (Section B Issue 3) be applied to changes to tax uncertainties subsequent to the acquisition date?

ISSUE 5: EXEMPTION FOR INDEFINITE-LIVED INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION

Both Statement 109 and IAS 12 require recognition of deferred tax assets and liabilities for taxable and deductible temporary differences related to identifiable intangible assets, including those that are indefinite lived. The Exposure Draft proposed no changes to that requirement and carried forward the existing guidance in Statement 109 and IAS 12 for intangible assets without reconsideration.

The Board received several comment letters urging it to consider amending Statement 109 to eliminate the current requirement to recognize deferred taxes related to intangible assets that are expected to be held indefinitely.

The FASB has considered this issue in the past—most recently in the redeliberations of the revised Exposure Draft, *Business Combinations and Intangible Assets—Accounting for Goodwill*, in 2001. At that time, the FASB decided not to amortize goodwill and intangible assets with indefinite lives. The lack of expected settlement in the foreseeable future caused nine respondents to view the deferred tax liability as a less-than-legitimate liability that *should not* be recognized until such time as the asset is sold, impaired, or otherwise disposed of—all of which are future events that those respondents believe are unlikely to occur. Respondents also suggested that the nonrecognition of deferred taxes related to intangible assets with indefinite lives were analogous to exceptions in Statement 109 for foreign unremitted earnings and nondeductible goodwill. The Board considered those comments, but rejected the suggestion to provide more exceptions to comprehensive recognition of deferred taxes, noting the following:

- a. Statement 109 requires comprehensive recognition of deferred taxes. The only exceptions to that requirement are identified in paragraph 9.
- b. Similar issues arose during the development of Statement 109 and other similar situations currently exist for which Statement 109 does not provide exceptions. For example, constituents requested that the FASB permit nonrecognition of deferred tax liabilities for taxable temporary differences related to inventory under the last-in-first-out method and for temporary differences related to land. The Board has denied those requests.

- c. Indefinite-lived intangible assets are not analogous to nondeductible goodwill because goodwill is measured as a residual. There is no reason to exempt other types of intangible assets because they are separately identifiable and measured apart from goodwill.

The theory in the analysis from Statement 109 also would apply to IAS 12. Additionally, recent IASB efforts to simplify IAS 12 have focused on eliminating exceptions to the principles of IAS 12, wherever possible. Adding a new recognition exception would be counter to those initiatives.

Staff Recommendation

The staff recommends that the Board affirm the requirements of Statement 109 and not provide an exception to comprehensive recognition of deferred taxes for indefinite-lived intangible assets.

Question 5: Does the Board wish to affirm the requirements of Statement 109 and not provide an exception to comprehensive recognition of deferred taxes for indefinite-lived intangible assets?



Board Meeting Handout

**STATEMENT 133 IMPLEMENTATION ISSUE –CLARIFICATION OF THE
APPLICATION OF THE *SHORTCUT METHOD*.**

January 31, 2007

PURPOSE

At today's meeting, the Board will discuss matters related to the Statement 133 Implementation Issue – Clarification of the Application of the *Shortcut Method*.

BACKGROUND

In February 2006, the Board added a project to its agenda to clarify certain criteria in paragraph 68 of FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*.

In October 2006, the staff presented the results of its research, the potential accounting alternatives, and its recommendations to the Technical Application and Implementation Committee (the Committee). The Committee unanimously agreed with all of the staff's recommendations except for the recommendations on zero-coupon bonds and late hedging. On those two issues, one Board member disagreed with the staff's recommendations. The staff reconsidered these issues, and their updated recommendations appear below.

SUMMARY OF STAFF RECOMMENDATIONS

Clarifications to Paragraph 68(a)

Amortizing Debt

The condition in paragraph 68(a) would explicitly be met if the portion of the total principal amount of the hedged item decreases during the term of the hedging relationship, so long as the notional amount of the interest rate swap adjusts to always match the changing principal amount throughout the hedging relationship.

Zero Coupon Debt

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The shortcut method is not permitted as paragraph 68(a), and (e) are not met.

Paragraph 68(b)

Trade Date-Settlement Date

The condition in paragraph 68(b) should be modified to explicitly permit qualifying for the shortcut method in situations in which an entity enters into a swap on the trade date of the hedged item provided all other conditions in paragraph 68 are met.

Paragraph 68(e)

Clarity of paragraph 68(e)

Paragraph 68(e) should **not** be removed. However, it should be clarified to indicate that all the other terms of the swap and the hedged item must (1) be typical of such instruments **and** (2) not invalidate the assumption of no ineffectiveness.

Normal Market Convention

Paragraph 68(e) should be modified to permit the par value of the hedged item to not equal its fair value at inception of the hedging relationship **only** in instances in which normal market conventions are the cause of that difference (that is, a slight market discount or premium).

Late Hedging

Late hedging should not be addressed within the scope of this project. However, should the Board direct the staff to develop guidance on non-shortcut eligible hedges, late hedging should be included in the scope of that project.

TRANSITION

The Implementation Issue K5 approach should be used.

QUESTION TO THE BOARD

Does the Board want to issue guidance to answer some or all of these questions?