Article from *The FASB Report,* June 30, 2004

Toward Convergence

Developing Consistent Application of Similar Principles of Accounting for Income Taxes

FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109) and International Accounting Standard 12, *Income Taxes* (IAS 12) are based on a similar principle—comprehensive recognition of deferred tax assets and liabilities based on the differences between the GAAP and tax bases of assets and liabilities. However, in developing their respective standards, both the FASB and the IASB decided to permit certain exceptions to those similar principles and reached differing conclusions about how those principles should be applied in certain circumstances. As part of their short-term convergence project, the FASB and the IASB agreed to work together toward a goal of eliminating those differences; achieving that goal will result in substantial convergence in the accounting for income taxes that will benefit both preparers of financial statements and the users of those financial statements. Eliminating those differences will:

- Benefit users of financial statements by improving the comparability of financial information reported under U.S. GAAP and with that reported using International Financial Reporting Standards (IFRS)
- Benefit preparers of financial statements by reducing the administrative costs incurred by enterprises that are required to prepare financial information under both IFRS and U.S. GAAP.

PROJECT SCOPE

The following section discusses the more significant differences between FAS 109 and IAS 12. The Boards will seek to minimize the differences between IAS 12 and FAS 109 as part of this project.

U.S. GAAP Exceptions

The following are exceptions to the principle of comprehensive recognition included in FAS 109 for which there is no comparable exception in IAS 12 (unless otherwise noted). As part of this project, the FASB and IASB plan to review the reasons for each exception, with the goal of reaching similar decisions about the nature and extent of exceptions that should be permitted under both U.S. GAAP and IFRS.

A deferred tax liability is not recognized for the following types of temporary differences, unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess in the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* that is essentially permanent in duration (IFRS has a similar exception which extends to all foreign and domestic subsidiaries.)

b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992 (IFRS has a similar exception which extends to all foreign and domestic subsidiaries.)

c. "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arose in tax years beginning before December 31, 1987

d. "Policyholder's surplus" of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992

e. The tax effects of temporary differences related to deposits in statutory reserve funds of U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992, and that were previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which FAS 109 is first applied.

IAS 12 Exception

A deferred tax effect arising in asset acquisitions is an exception to the comprehensive recognition principle in IAS 12. The Emerging Issues Task Force addressed this issue in EITF Issue No. 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations." This issue was addressed by the FASB and the IASB at the joint Board meeting in April 2004.

Structural Differences between FAS 109 and IAS 12

There are certain differences in the application and operationality of FAS 109 and IAS 12. These "structural" differences may result in differential application of the common principle of comprehensive recognition of deferred taxes. As part of this project, the Boards plan to review these differences with the goal of achieving convergence:

- Intraperiod tax allocation (the so-called "backward tracing" issue). FAS 109 requires changes in valuation allowances, tax laws and rates, and tax status be recorded in continuing operations in the period of the change. However, IAS 12 requires that current year deferred taxes related to items credited or charged to equity in prior years be recorded in equity to the extent determinable.

- Tax rate issues:

a. FAS 109 requires that the effect of a tax law or tax rate change be included in the period that includes the enactment date. However, IAS 12 requires that the tax rate be implemented in the period in which it is "substantively enacted."

b. FAS 109 requires deferred taxes be measured at the distributed rate while IAS 12 requires deferred taxes be measured at the undistributed rate.

- Deferred tax asset recognition and valuation allowance issues. FAS 109 uses the "impairment" approach whereby a deferred tax asset is presumptively recorded for deductible temporary differences and a valuation allowance is recorded to the amount that it is "more likely than not" that a deferred tax asset will not be realized. IAS 12 uses an "affirmative judgment" approach that requires that deferred tax assets be recognized for deductible temporary differences to the extent that it is probable that a deferred tax asset will be realized. The IASB has tentatively indicated that for purposes of IAS 12 "probable" means more likely than not.

- Balance sheet classification. FAS 109 requires that deferred tax amounts be recognized based on the classification of the underlying asset or liability giving rise to the temporary difference. IAS 12 requires deferred tax amounts be recognized as noncurrent regardless of the classification of the underlying asset.

TENTATIVE JOINT DECISIONS

EITF Issue 98-11

At their joint meeting in April 2004, the IASB and the FASB met to reach agreement on whether and, if so, how to recognize deferred taxes for assets acquired in transactions other than a business combination. This issue arises when an asset acquired in a transaction other than a business combination has different GAAP and tax bases. This is an explicit exception in IAS 12, but the EITF addressed this in Issue 98-11 and prescribed the use of the simultaneous-equations method. At the joint meeting, the Boards decided that neither of the existing approaches provided the most useful information. The Boards agreed, instead, to require that those transactions be accounted for as follows:

a. When recognized, the asset acquired would be measured at its fair value.

b. A deferred tax asset or liability would be measured as the difference between the fair value of the asset and its tax basis multiplied by the tax rate.

c. Any difference between the consideration paid and the sum of the fair value of the asset and the recognized deferred tax amount is recognized as a purchase discount allowance on the deferred tax asset.

Reaching that decision, the Board members primarily considered two significant issues:

1. The appropriate initial book basis of the acquired asset; and,

2. The accounting for any excess calculated deferred credits.

Additionally, one Board member cited an Enron Task Force report on the accounting for purchases of deferred tax assets in support of his view on the purchase discount allowance.

Foreign Unremitted Earnings

Board members and the staff have received a number of inquiries from constituents on the foreign unremitted earnings exception (FAS 109, paragraph 9(a)).

According to the project Board collaborator Michael Crooch, "This project is the result of our commitment to address short-term convergence issues and the project scope is solely informed by differences between U.S. GAAP and IFRS. The project is in its early stages on the foreign unremitted earnings exception and the staff is currently researching the background and current circumstances surrounding this issue. To date, the Board has not deliberated on this issue and has not made any decisions, including whether to move forward to eliminate the difference."

TIMING AND NEXT STEPS

Future Deliberations

The Boards will discuss the issues in this project over the next several months, and have a goal of issuing an Exposure Draft of any proposed amendment to Statement 109 by the end of 2004. The FASB staff is working with the IASB staff and is currently working on researching the evolution of the differences between IFRS and U.S. GAAP created by the APB 23 exceptions (excess of financial reporting over tax basis of foreign subsidiaries that are essentially permanent in duration, permanently reinvested earnings of domestic subsidiaries that arose prior to December 15, 1992, bad debt reserves of U.S. savings and loan associations that arose prior to December 31, 1987, and policyholder surplus of stock life insurance companies that arose on or before December 15, 1992). The FASB is planning to deliberate the APB 23 exceptions in mid to late July 2004. The remaining project issues will be principally deliberated in August and September 2004.

Interested parties may contact Project Manager Donald Thomas at dbthomas@fasb.org with any comments or feedback on the income tax convergence project.