# Income Tax Accounting under IFRS: A look ahead*

## Accounting for uncertain tax positions

*connectedthinking

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## About this series

The IASB has proposed significantly changing the current IFRS standard on accounting for income tax. This is the fifth article in a series that explores how the proposed changes might impact companies. Each article focuses on a particular aspect of the IASB's proposal. The articles can be found at www.pwc.com/usifrs/tax.

## The proposed changes

Because income tax laws are complex and are subject to differing interpretations, there may be uncertainty about whether a company will ultimately sustain a position it has taken on a tax return. In its proposal, the IASB provides guidance on accounting for such uncertain tax positions. This is the first time the IASB has provided explicit guidance on this subject.

The IASB has proposed that companies measure current and deferred tax assets and liabilities using the probability-weighted-average amount of all the possible outcomes. Companies would be required to assume that the taxing authorities will review the amounts reported to them and will have full knowledge of all relevant information. Importantly, in this regard, companies are not allowed to consider the possibility that the position will go undetected. The IASB's proposal requires that changes in measurement be based on new information, not a new interpretation of previously available information.

The IASB's proposal does not define an uncertain tax position. Further, there would be no probability-based recognition threshold. Instead, any uncertainty about whether the tax authorities will accept the position taken is included in the measurement of the tax assets and liabilities themselves.

## Comparison to IAS 12

IAS 12 does not explicitly address the accounting for uncertain tax positions. In practice, companies reporting under IAS 12 generally record liabilities for uncertain tax positions that are not more likely than not to be sustained by using either a probability-weighted-average approach or a single-best-estimate approach.

Eliminating the recognition threshold of more-likely-than-not and the single-best-estimate approach is expected to have a significant impact on the accounting for income tax uncertainties—in particular, on highly certain and highly uncertain positions.

**Under a single-best-estimate approach, highly c*ertain* positions may have resulted in a full benefit being recognized. Conversely, under a probability-weighted-average approach, some level of reserve may be recorded.**

Assume that Entity A takes a deduction for an uncertain tax position that results in a potential tax benefit of C100 and that management is 80 percent certain the entity will sustain the position.

| Potential benefit | Individual probability | Probability weighted calculation |
|---|---|---|
| C100 | 80% | C80 |
| 0 | 20% | 0 |
| | | **C80** |

Under a single-best-estimate approach, Entity A would recognize the full benefit (C100) of the tax deduction. Under a probability-weighted-average approach, Entity A would recognize a C80 tax benefit and a C20 liability.

**Under a single-best-estimate approach, highly *uncertain* positions may have resulted in a full liability being recognized. Under a probability-weighted-average approach, some level of benefit may be recorded.**

Assume that management was 80 percent certain the tax position would *not* be sustained.

| Potential benefit | Individual probability | Probability weighted calculation |
|---|---|---|
| C100 | 20% | C20 |
| 0 | 80% | 0 |
| | | **C20** |

Under a single-best-estimate approach, Entity A would recognize no tax benefit and a C100 liability. Under a probability-weighted-average approach, Entity A would recognize a C20 tax benefit and a C80 liability.

## Comparison to US GAAP

US GAAP provides explicit guidance on uncertain tax positions. In FIN 48, *Accounting for Uncertainty in Income Taxes*, the FASB requires that a company evaluate its tax positions by using a two-step process:

- Step 1: Determine whether it is more likely than not that the tax position will be sustained upon examination, based on the position's technical merits (this likelihood is the "recognition threshold")
- Step 2: Measure the amount of tax benefit that is to be recognized in the financial statements

A tax position that meets the recognition threshold is measured at the largest amount of benefit that has more than a 50 percent likelihood of being realized upon settlement. No benefit is recorded for tax positions that do not meet the recognition threshold.

The IASB's proposal and FIN 48 are significantly different in terms of recognition and measurement of uncertain tax positions. The following example illustrates how the absence of a recognition threshold in the proposal can cause a different outcome between the proposal and US GAAP.

**The IASB's proposal does not establish a recognition threshold. Consequently, more tax positions could result in a tax benefit under the proposal than under US GAAP.**

Assume that Entity A takes a deduction for an uncertain tax position that results in a potential tax benefit of C100 and that it believes the position has only a 20 percent chance of being sustained.

| Potential benefit | Individual probability | Probability weighted calculation |
|---|---|---|
| C100 | 20% | C20 |
| 0 | 80% | 0 |
| | | **C20** |

Under FIN 48, the tax position would not meet the recognition threshold. Therefore, Entity A would recognize no tax benefit and a C100 liability. Under the proposal, Entity A would recognize a C20 tax benefit and a C80 liability.

FIN 48 and the IASB's proposal also differ in their measurement approaches. FIN 48 requires companies to use a cumulative-probability approach to measure the amount of tax benefit they must recognize, whereas the IASB's proposal requires the use of a probability-weighted-average approach. As illustrated below, the difference in approaches is likely to affect the amounts companies record in their financial statements.

The proposal and FIN 48 both require that changes in measurement be based on new information. However, for positions that do not meet FIN 48's recognition threshold, the period in which a company recognizes measurement changes under FIN 48 may differ from the period it would recognize those changes under the IASB's proposal.

Assume, for example, that a taxpayer obtains favorable new information supporting a tax position that has not met FIN 48's recognition threshold. Unless the new information were to cause the tax position to meet the recognition threshold, the company would not record a benefit until the company effectively settles the position. Since the IASB's proposal does not establish a recognition threshold, changes in measurement would be recognized when new information is obtained.

## In summary

The guidance provided in the IASB's proposal is different than under both the international and US standards today. The following example illustrates this difference.

Assume Entity A takes a deduction for an uncertain tax position that results in a tax benefit of C1,000. The tax position meets the FIN 48 recognition threshold. Entity A estimates the probability of potential outcomes as follows:

| Potential benefit | Individual probability | Probability weighted calculation | Cumulative probability |
|---|---|---|---|
| C1,000 | 15% | C150 | 15% |
| 800 | 20% | 160 | 35% |
| 600 | 20% | 120 | 55% |
| 400 | 30% | 120 | 85% |
| 200 | 15% | 30 | 100% |
| | | **C580** | |

Under FIN 48, Entity A would recognize the largest amount of tax benefit that has a likelihood of greater than 50 percent in this case, a tax benefit of C600, with a corresponding liability of C400.

Although IAS 12 does not provide specific guidance in this area, we believe companies may recognize a tax benefit under IAS 12 by using the probability-weighted-average of the expected outcomes (C580), or the single-best-estimate of the most likely outcome (30% probability). Under a single-best-estimate approach, Entity A would recognize a tax benefit of C400 and a C600 liability.

Under the proposal, Entity A would recognize a tax benefit for the probability-weighted-average of the expected outcomes. Accordingly, Entity A would recognize a tax benefit of C580 and a C420 liability.

## Questions to consider

Several important questions come to mind in contemplating the practical application of the IASB's proposed guidance:

### How should highly certain (or uncertain) tax positions be assessed?

In response to concerns that it would be unduly onerous to use a probability-weighted-average approach of the expected outcomes in all cases, including when the possibility of a different outcome is remote, the IASB noted in its Basis for Conclusions that it did not intend for entities to seek out additional information to apply the guidance in its proposal. It is unclear what the IASB meant by this statement.

### How should the appropriate unit of account be determined?

FIN 48 requires tax positions to be analyzed at the level of an individual tax uncertainty. That analysis depends on how the taxing authority may view a company's tax position and how the company supports the position. For example, a company may determine that a unit of account comprises all research credits, or that it consists of an individual research project (perhaps even just an individual cost within a project).

The IASB's proposal does not provide guidance on determining the unit of account. However, in an illustrative example accompanying the IASB's proposal, the uncertainty of two positions is assessed at the level of each deduction. It remains unclear whether the unit of account could be assessed at a higher level in certain circumstances. This is likely to be an area where significant judgment will need to be applied in practice.

### How should companies account for and classify interest and penalties?

FIN 48 requires a company to begin expensing interest and penalties in the period that they start accruing per the tax law. Because IAS 12 does not address interest and penalties, practice is diverse. Some argue that interest and penalties are part of a lump sum payment to the taxing authority and cannot be separated from tax expense. They account for and classify interest and penalties as tax expense. Others argue that interest and penalties are not based on taxable income and should be accounted for and classified as financing or operating costs, respectively. The IASB's proposal does not provide guidance on interest and penalties, except to require disclosure of the entity's classification policy. Does the lack of guidance allow for alternatives in accounting for and classifying interest and penalties?

### How should companies classify liabilities for uncertain tax positions?

FIN 48 requires companies to classify liabilities for uncertain tax positions as noncurrent unless payment of cash is anticipated within one year. The proposal does not provide guidance on the classification of liabilities for uncertain tax positions. It is unclear, therefore, whether liabilities for uncertain tax positions should be recorded separately from the related current and deferred tax assets and liabilities (i.e., gross presentation) and, if so, whether a company should classify those liabilities according to expected reversal or expected cash payment. Another approach may be to classify all as current liabilities on the basis that the entity does not have an unconditional right to defer settlement once the taxing authority demands payment.

## Next steps

The IASB's proposal was released on March 31, 2009. The comment period ends on July 31, 2009. We encourage companies to consider the impact of the proposed accounting and to provide the IASB with comments.

The FASB plans to issue an Invitation to Comment on the IASB's proposal to solicit input from US constituents as it considers its own convergence efforts. Upon completing its review, the FASB will decide whether and how to proceed with eliminating remaining differences between FAS 109 and IAS 12. We encourage companies to consider the questions that the FASB will pose in its Invitation to Comment and to provide comments to the FASB.

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