

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Short-Term Convergence and
Uncertain Tax Positions—Income
Tax Team (Strange Ext. 442)

Subject: Minutes of the October 24, 2005
Joint Board Meeting (Short-Term
Convergence—Income Taxes) **Date:** November 11, 2005

cc: Bielstein, Smith, Petrone, Leisenring, Golden, McBride, Geary,
Mahoney, Thompson, Getz, Vincent, Sutay, Gabriele, Swift, Polley;
Project Team; McGeachin, Upton, Buchanan (IASB); FASB Intranet

Topic: Uncertain Tax Positions, Timing and Sequence
of Due Process Documents and Distributed Vs.
Undistributed Rate

Basis for Discussion: IASB Agenda Paper 4A, Agenda Paper 4B,
and Agenda Paper 4C

Length of Discussion: 4:00 pm to 5:15 pm (EDT)

Attendance:

Board members present:	FASB: Herz, Schipper, Batavick, Crooch, Seidman, Young, and Trott IASB: Tweedie, Jones, Barth, Cope, Engström, Garnett, Leisenring, McGregor, O'Malley, Smith, and Whittington
Board members absent:	Bruns, Gélard, and Yamada
Staff in charge of topic:	Thomas and McGeachin
Other staff at Board table:	Bielstein, Cassel, Duke, Golden, Strange and Upton
Outside participants:	None

Summary of Decisions Reached:

The Boards considered two issues:

- a. Uncertain tax positions; and
- b. The effect of the use of the undistributed rate to measure tax assets and liabilities on entities that regard themselves as tax exempt because of tax deductions available on distributions.

On uncertain tax positions, the Boards confirmed their desire to find converged requirements. They noted that the FASB's redeliberation of its proposals following the comments on its draft Interpretation and the IASB's further development of its proposals for inclusion in its forthcoming Exposure Draft would give the Boards the opportunity to explore possibilities for such a converged answer.

On the effect of the use of the undistributed rate to measure tax assets and liabilities on entities that regard themselves as tax exempt, the Boards expressed concern over the results presented by the staffs. They asked both staffs to explore the following options:

1. Keep the proposed requirements, noting that entities that did commit themselves to making a distribution would recognise the distributions and the available deductions
2. Create a definition of an "in substance tax-exempt entity" which would cover entities whose tax structure is set up to avoid shareholders suffering double taxation and involves tax deductions being available if the entity distributes all or almost all of its total income
3. Require a point-in-time analysis of whether an entity has the ability to be effectively tax exempt, in which case they would be treated as tax exempt. Disclosure would be required of why they qualify and what they have to do in the future to continue to qualify
5. Allow the effects of a distribution outside the entity to be included as a tax planning strategy in determining whether or not the recovery of an asset or

settlement of a liability has taxable consequences, and hence whether a temporary difference exists.

Objective of Meeting:

The meeting's objective was for the Boards to discuss whether and, if so, how to eliminate certain differences between their existing standards of accounting for income taxes relating to uncertain tax positions and the possible effects for entities that consider themselves tax-exempt from the Boards' previous decision to measure deferred tax assets and liabilities using the rate applicable to undistributed earnings.

Matters Discussed and Decisions Reached:

Uncertain Tax Positions

1. Mr. Thomas opened the Board meeting by stating that during 2004, the FASB identified significant diversity in practice in accounting for income taxes related to uncertain tax positions under U.S. GAAP. To address the significant diversity in practice, the FASB published an Exposure Draft of a proposed Interpretation of FASB Statement No. 109, *Accounting for Uncertain Tax Positions*, in July 2005.
2. Ms. McGeachin stated that the IASB had considered the FASB proposals at its June and September 2005 meetings. The IASB concluded that a different approach to uncertain tax positions would arise under IFRSs. Simply stated, the fundamental difference between the two approaches is that the FASB's approach addresses uncertainty through both recognition and measurement while the IASB's approach addresses all uncertainty through measurement. The staffs note that on every other issue in this project the Boards have reached converged decisions. The staffs did not want to fail to reach a converged answer on this issue. However, because of different approaches taken to uncertainty under IFRSs and U.S. GAAP, the staffs were unable to agree on a joint recommendation.
3. Ms. McGeachin stated that the IASB has considered its approach within the context of its thinking behind the recently issued Exposure Draft, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. The IASB approach regards the

entity as having a stand-ready liability to pay more tax than the amount in the as filed tax position. Under the IASB's most recent thinking, there should not be a probability-recognition threshold when accounting for a stand-ready obligation.¹

4. The IASB acknowledges that the IAS 37 Exposure Draft has a transaction-driven, settlement value measurement objective, which IAS 12, *Income Taxes*, does not. The IASB approach is not therefore a full application of the IAS 37 Exposure Draft within IAS 12. Nonetheless, the IASB finds merit in extending the IAS 37 Exposure Draft approach of no probability-recognition threshold to IAS 12. As a result, an additional tax liability will be recognized whenever there is a possibility of additional tax payments. That liability would be measured at the weighted average of the possible outcomes, assuming that the tax position will be examined by the taxing authority.
5. Mr. Thomas then stated that the FASB's proposed Interpretation approaches the issue from the perspective of recognition of a tax benefit because a tax position can be expressed on the balance sheet as the reduction of a liability, an asset, or a deferred tax asset or liability . The FASB's proposed Interpretation addresses uncertainty as to the ultimate sustainability of the tax position through a recognition threshold. The FASB has selected an asymmetric recognition-derecognition threshold, which is as follows:
 - a. A tax position is recognized when it is probable of being sustained based solely on the technical merits of the tax position; and
 - b. The tax position must be derecognized when it becomes more likely than not that the position will not be sustained.
6. The FASB believes that when the enterprise takes a tax position, a discrete accounting judgment should be made about recognition and measurement. Under the FASB approach, an enterprise must affirmatively prove, to a specified confidence level, that it is entitled to the economic benefits of the tax position.

¹Under the existing IAS 37 Exposure Draft, there is a "more likely than not" probability threshold for contingent liabilities.

7. Mr. Thomas outlined the arguments for the FASB benefit recognition model with a probability-based recognition threshold as follows:
 - a. There would be a high level of confidence that previously recognized benefits represent tax positions for which the enterprise is “entitled,” to a specific confidence level.
 - b. The estimates and judgments would have greater verifiability. The weight of available evidence would be considered to determine if the technical merits of the tax position are sufficient to meet the recognition criterion. Only outcomes that meet the recognition criterion would be considered for measurement.
8. Ms. McGeachin explained that the arguments for the IASB stand-ready liability approach with no recognition threshold are:
 - a. All tax positions would be available for measurement, and there would be less potential for systematic overstatement of tax liabilities.
 - b. A threshold creates a cliff hanger effect and results in all items that do not meet the threshold to be treated alike, even though they may be different. For example, with such a threshold, a claimed deduction of 100 with a 1 percent chance of being accepted and a claimed deduction of 100 with a 65 percent chance of being accepted both result in the recognition of an additional liability of 100 under the FASB approach. Relevant information about the claimed deductions is lost.
 - c. From an IASB perspective, a recognition threshold would be inconsistent with its thinking in the recent proposals to amend IAS 37, Provisions, Contingent Liabilities and Contingent Assets. Imposing such a threshold could undermine those proposals.
9. The staffs then opened the meeting for discussion.
10. Mr. Trott noted that as a result of constituent input received in comment letters and from the U.S. roundtable discussion, the FASB discovered that the degree of diversity in U.S. practice is wider than previously assumed. Much of the diversity is due to wide and confusing inconsistencies in practice as to what meets the criteria

for a liability in FASB Statement No. 5, *Accounting for Contingencies*, and suggests the FASB may need to create a new model for income taxes. Mr. Trott noted that although he hoped the Boards could achieve a converged answer, the main impediment to convergence in the uncertain tax position area is timing. The FASB needs to move faster due to the significant diversity in U.S. practice. Mr. Trott stated that he hoped the FASB would monitor the IASB's progress and would consider an approach with no recognition trigger during the redeliberations of the FASB's proposed Interpretation.

11. Mr. Whittington stated that he prefers the IASB approach because expected outcome is conceptually superior to the present FASB best estimate measurement. He disagrees with the staffs' assertion that there is no recognition threshold in the IAS 37 Exposure Draft. He explained that as he understood the conceptual foundation of IAS 37 to be 100 percent certainty that a company has a stand-ready obligation for income taxes (therefore always meeting the recognition threshold) only measurement issues remain.
12. Mr. McGregor clarified that the IAS 37 Exposure Draft, while relevant to uncertain tax positions, is out for comment as a part of the FASB's conceptual framework project.
13. Ms. McGeachin stated that the IASB expects to issue an Exposure Draft in March 2006 that includes everything in the short-term convergence project (and would include the IASB's conclusion on uncertain tax positions). The final IASB Standard is expected to be issued in the first quarter of 2007. Mr. Thomas noted that the FASB will be redeliberating their proposed Interpretation in November and December 2005 with a final Interpretation expected in the first quarter of 2006.
14. Mr. Herz stated that the FASB will consider decisions made by the IASB regarding an expected outcome measurement attribute; however he expressed concern whether preparers could make an expected outcome measurement. He also indicated that exposure of the IAS 37 Exposure Draft would be relevant to the FASB's considerations during redeliberations. From the roundtable and comment letter analysis, most respondents to the FASB proposed Interpretation indicated

that they supported the current model with a single threshold at “more likely than not.”

15. Mr. Batavick also questioned how preparers would arrive at an expected outcome especially in the case of a tax position the entity has taken for the first time. Ms. McGeachin noted that the IAS 37 Exposure Draft has no guidance on the level of calculation and documentation needed to get an expected value. In response to a suggestion that the Boards provide some guidance in this area, Mr. Upton stated that auditors should ensure the entity has a solid understanding of the possible outcomes to support the entity’s assertion of expected outcome.
16. Mr. Trott noted that to calculate the best estimate under the FASB’s proposed Interpretation the preparer would need the same information they would need to calculate expected outcome.
17. Ms. O’Malley stated the Canadian Board’s experience was one that auditor and preparer members currently evaluate as “more likely than not” by calculating percentages which indicates little need for change to comply with the IASB’s proposed probabilistic approach. Mr. Herz noted that U.S. roundtable participants indicated otherwise.
18. In response to a Board member’s question, Ms. McGeachin responded that the IASB has not yet discussed disclosure (general or specific disclosure consisting of a tabular reconciliation from the beginning to the ending balance of the stand-ready liability).
19. Ms. Schipper noted that a tabular reconciliation of the beginning and ending balances of the tax reserves would be easy to provide only since the stand-ready liability (and not the tax position as filed) would be remeasured at each reporting period under the IASB approach. Ms. McGeachin stated the staffs may need more time to consider disclosure requirements if the stand-ready liability and the as filed tax position are separated.
20. Mr. Leisenring stated that if the FASB uses a probable-recognition threshold they are implying that preparers know the difference between percentages (for example,

if probable is defined at 75 percent, preparers must be confident in the difference between 74 and 76 percent). He noted that determining an expected outcome with no recognition trigger would be less difficult. However, because of the IASB's requirement to remeasure all stand-ready obligations at each reporting period, many people would perceive that the IASB approach requires more work. Mr. Leisenring emphasized that the FASB approach would also require remeasurement of the best estimate but only for positions that as of the reporting period remain between probable and more likely than not. Mr. Batavick clarified that under the IASB approach a preparer would remeasure only if new information becomes available.

21. Ms. O'Malley noted that if the tax position expectations are symmetrically distributed the best estimate will equal the expected outcome. Only when the distribution is asymmetric would there be a different result under the FASB and IASB proposals.
22. Ms. Schipper noted that tax outcome distributions are bounded and are probably unimodal. If the distribution is also symmetric, those properties limit the problems of convergence so long as few tax positions would fail to meet a "more likely than not" recognition threshold.
23. Mr. Thomas stated that using a 50.1 percent recognition threshold ("more likely than not") would not result in a major difference in recorded amounts from the IASB's approach since neither include detection risk. Thus items included in the expected outcome calculation are likely to be similar to amounts recognized at a "more likely than not" threshold." He noted that the staffs would bring supplemental analysis to the Boards.
24. In response to Ms. Schipper's assertion, Mr. Whittington commented that he believed the typical distribution of possible outcomes for uncertain tax positions was likely bimodal as the entity either received the deduction or it did not.
25. Mr. Upton noted that few uncertain tax positions would result in permanent reduction of taxes (bimodal distributions). Most uncertain tax positions are a

question of timing in that the entity may get the deduction now or as depreciation or amortization over a longer period (unimodal distributions). The timing question results in either a current or deferred tax impact.

26. Ms. Seidman suggested that there may be a significant difference between the FASB best estimate approach and the IASB expected outcome approach in certain types of leveraged leases. Originally U.S. preparers had should level opinions for leveraged leases; however now that the leases have been challenged it may be impossible for them to obtain should level opinions.

27. Ms. Schipper noted that a change in tax regime would also call into question the assertion that there would not be a significant difference between the FASB best estimate approach and the IASB expected outcome approach.

28. Several Board members expressed the desire to work toward a converged answer for uncertain tax positions; noting there is room for coordination despite the timing differences of the projects.

Distributed Vs. Undistributed Rate

29. Mr. Thomas stated that in some jurisdictions, income can be taxed at different rates depending upon whether or not it is distributed to shareholders. Earlier this year, the Boards separately agreed to measure deferred tax assets and liabilities using the rate applicable to undistributed earnings. Mr. Thomas stated that the staffs think that decision will significantly change the financial reporting by some types of entities (REITs, RICs, and Coops) that currently view themselves as “tax-exempt.” Many of them do not currently report deferred taxes. The staffs also think the upcoming Exposure Drafts should clearly communicate the effect of the Boards’ decision on those entities so they can understand and comment on the Boards’ proposals.

30. Mr. Thomas stated that those who view the undistributed rate as the most appropriate rate believe the obligation to distribute earnings (for example, when a dividend is declared) is the requisite measurement event. Those who view the

distributed rate as the most appropriate rate believe the requisite measurement event for the use of the distributed rate is earning the income coupled with the requirement to pay income taxes. Under this approach it is argued that the ultimate distribution to shareholders, in some form, is presumed in the financial statements and therefore, the financial statements should reflect the tax on earnings with the consideration of the distribution.

31. Mr. Thomas stated that as a result of paragraph 145 in FASB Statement No. 109, *Accounting for Income Taxes*, entities such as REITs, RICs, and Coops offset the benefit of the dividends paid deduction so that no income tax expense is presented on the income statement. Those entities have also interpreted paragraph 145 of Statement 109 in such a manner that they do not recognize deferred taxes.
32. Mr. Thomas stated that some in the preparer community have asserted that REITs are, effectively, economically compelled to distribute earnings because the loss of tax status for inadequate distribution (for example, less than 90 percent of taxable income) is of such significance that common sense dictates the minimum distribution of 90 percent. The staffs do not support these arguments and would argue that temporary differences that exist should be measured in accordance with the Boards' decision at the undistributed rate. Mr. Thomas asked if the Boards agreed with the staffs' analysis of the application of the undistributed rate decision as described in this memorandum.
33. Mr. Leisenring stated that he did not agree with the conclusion that this was a distributed versus undistributed rate issue; instead, he believed this was a special deduction issue. As such, under Statement 109 entities may not anticipate special deductions.
34. Ms. McGeachin replied that there was uncertainty about which rate to apply. She stated that under IAS 12 the staffs deemed it inappropriate to anticipate distributions outside the entity. IAS 12 is silent on special deductions.
35. Ms. Barth stated that Statement 109 appeared to exempt these types of entities. Mr. Thomas stated that paragraph 145 deals with classification of the dividends

received deduction on the income statement. In practice, preparers have analogized guidance pertaining to classification of current taxes to include the recognition of deferred taxes.

36. Mr. Cassel stated that Statement 109 and FASB Statement No. 96, Accounting for Income Taxes, did not provide guidance on multiple-rate jurisdictions; however, the theory that supports the Board's conclusion on exempting the entities is that all income will ultimately be distributed to shareholders. If an entity can eliminate their tax liability by distributing it to shareholders, then it is effectively tax-exempt. The IASB approach supports that view within the organization by using the distributed rate for remittances from investees but does not accept that view for remittances to shareholders (it requires use of the undistributed rate). Mr. Leisenring disagreed with Mr. Cassel's conclusion on the Statement 109 exception on undistributed earnings because he believed paragraph 145 was only intended to deal with display issues.
37. Mr. Herz agreed that the entities are effectively tax exempt. He suggested that although the technical merits could be debated, it is practical and provides more useful reporting to assume that the entities are tax-exempt to prevent deferred taxes from being set up then reversed in a short period. He agreed that the entities have a substantive liability to distribute earnings.
38. Sir David Tweedie proposed that if an entity's charter or articles of incorporation required it to distribute 90 percent of its income, then the entity could use the distributed rate. He noted the entity would establish a liability for earnings distribution in that case.
39. Ms. Schipper stated that although the entities were not technically tax exempt, they should be treated as such because they are tax-exempt in substance. She noted that she was interpreting the characterization of entities included in paragraph 145.
40. Ms. O'Malley stated that she agreed with Ms. Schipper that this was not purely a display issue because paragraph 145 takes the tax consequences out of equity and

into income. The display required in paragraph 145 seems to indicate that the entity is considered tax-exempt.

41. Mr. Cope stated that there were many types of entities worldwide that share similar characteristics with the three U.S. entities discussed in this memorandum. He stated he was having difficulty finding the principle behind allowing these types of entities to use the distributed rate. Ms. O'Malley provided the example of Canadian income trusts.
42. Mr. Cassel indicated that there are jurisdictions where entities pay marginal rates if they perform certain actions. He questioned whether they should record at the higher income tax rate until they have completed the action that would allow them a lower income tax rate. Ms. Bielstein stated that some entities may wait years before they are required to distribute, or may be required to meet different requirements before getting to the marginal rate.
43. Ms. McGeachin asked if IAS 12 should include an explanation for the entities that are "in substance tax-exempt" and should be treated as nontaxable entities.
44. Sir David elaborated upon his earlier proposal by stating that the staffs should explore the issue further before including guidance for entities that are "in substance tax-exempt"—whether the distribution of earnings is required by law, corporate charter, or a vote of the directors.
45. Mr. Smith questioned whether the entity's control to avoid paying tax should be considered instead of an exemption approach.
46. Mr. Thomas stated that he believed what he was hearing from the Board members was that the staffs should address guidance for allowing "in substance tax-exempt" entities the ability to use the distributed rate. The exception would have tight boundaries and be due to law or the rules of operation for an entity's structure.
47. Ms. McGeachin stated that she was not confident that the staffs would be able to capture only the certain types of entities that the Boards desire.

48. Ms. O'Malley stated that it should be clearly indicated that the exception is for an entity's entire income, not just certain kinds of income.
49. In response to a Board member's question, Mr. Leisenring believes entities should not anticipate future events that affect the tax position. Mr. Leisenring stated that he believes the Boards should stay consistent with the principles in Statement 109 for this amendment and paragraph 145 does not provide persuasive support for the discussed exemption.
50. Mr. Golden stated that a point-in-time analysis could help in determining whether an entity is in substance tax exempt. At a point in time an entity would evaluate if it still met the criteria for the tax-exempt status and if it had the future ability to distribute earnings. If income has not been distributed yet (but will be in the future), then disclosures should be required.
51. Mr. Thomas confirmed that the staffs will prepare analysis of the following approaches:
- a. Keep the proposed requirements, noting that entities that did commit themselves to making a distribution would recognize the distributions and the available deductions
 - b. Create a definition of an "in substance tax-exempt entity" which would cover entities whose tax structure is set up to avoid shareholders suffering double taxation and which involves tax deductions being available if the entity distributes all or almost all of its total income
 - c. Require a point-in-time analysis of whether an entity has the ability to be effectively tax exempt, in which case they would be treated as tax exempt. Disclosure would be required of why they qualify and what they have to do in the future to continue to qualify.
 - d. Allow the effects of a distribution outside the entity to be included as a tax planning strategy in determining whether or not the recovery of an asset or

settlement of a liability has taxable consequences, and hence whether a temporary difference exists.

Follow-up Items:

None.

General Announcements:

None.