Income Taxes — Background Information and Basis for Conclusions

Section 3465

Foreword

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard and, since that standard was fully converged with Part II of the Handbook, it remains relevant.

The Accounting Standards Board believes published Background Information and Basis for Conclusions material will assist:

- CPA Canada Handbook – Accounting readers in understanding and applying the standards;
- users of financial statements in understanding the information provided by reporting enterprises; and
- everyone interested in financial reporting in obtaining a better appreciation of the work that has gone into the development of new standards.

The contents of this booklet do not form part of the CPA Canada Handbook – Accounting. The Accounting Standards Board does not intend to include in Background and Information and Basis for Conclusions booklets any guidance that is necessary for applying a Recommendation.

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INTRODUCTION

1 This document summarizes considerations that were deemed significant by the Accounting Standards Board (the Board) in reaching the conclusions in income taxes, Section 3465. It sets out the reasons the Board undertook the project to develop the Recommendations, the process of research and deliberation, the key decisions made and the principal reasons for accepting certain approaches and rejecting others. In approving the Recommendations, individual Board members gave greater weight to some factors than to others. Nothing in this document is to be taken as overriding the Recommendations in Section 3465, however, the discussion may assist *CICA Handbook* users in understanding the Recommendations and the Board's intent with respect to their interpretations and application.

BACKGROUND

2 CORPORATE INCOME TAXES, Section 3470, had been in existence since 1968, with few changes made to it since then. This Section required the use of the deferral method of accounting for income taxes. CORPORATE INCOME TAXES — ADDITIONAL AREAS, Section 3471, was issued in 1973.

3 In 1992, the Financial Accounting Standards Board (FASB) in the US issued Statement of Financial Accounting Standards Number 109, entitled "Accounting for Income Taxes," which requires the asset and liability approach to accounting for income taxes. In 1994, the International Accounting Standards Committee issued E-49, "Income Taxes," which also proposed an asset and liability approach to accounting for income taxes. (The IASC issued IAS 12 (revised) based on E-49 in 1996.) Recognizing that these changes in the US and internationally would result in differences between Canadian generally accepted accounting principles ("GAAP") and both US and International Accounting Standards, the CICA's Accounting Standards Board commenced a project in 1994 to amend its standards for accounting for income taxes. A major objective of the project was international harmonization. The first phase of the project involved issuing an Invitation to Comment in Canada based on the International Accounting Standards Committee's exposure draft on Accounting for Income Taxes, E-49.

4 In 1996, the Board issued an exposure draft of proposed Recommendations for accounting for income taxes, which factored in the input gathered through the Invitation to Comment issued in 1994. In response to the ED, 74 comment letters were received. In June 1997, the Board approved INCOME TAXES, Section 3465, which was unchanged from the ED in most major respects, as described below.

ASSET AND LIABILITY METHOD OF ACCOUNTING FOR INCOME TAXES

5 Under the asset and liability method of accounting for income taxes, the future income tax outflows and inflows related to the realization of assets and the settlement of liabilities for their carrying amounts are recognized as future income tax liabilities and future income tax assets. Since these future income tax liabilities and future income tax assets meet the conceptual definition of liabilities and assets, the Board agreed with the FASB and IASC conclusions that the asset and liability method of accounting for income taxes was preferable to the deferral method. A majority of ED respondents also agreed with the proposed asset and liability approach to accounting for income taxes.

6 One area in which the Board decided to differ from SFAS 109 and IAS 12 (revised) was in the use of the term "future income taxes." This term is used in Section 3465 in place of the term "deferred taxes" used in both SFAS 109 and IAS 12. The Board concluded that "future income taxes" is a more meaningful description of those tax outflows or inflows that will be paid or realized in future periods. In addition, the change in terminology serves to emphasize the change from the deferral to the asset and liability method of accounting for income taxes. The Board felt that this matter is simply one of nomenclature. Use of the term "deferred income taxes" would also be appropriate.

Temporary differences and tax basis

7 Under Section 3465, future income tax liabilities and future income tax assets are calculated based on temporary differences between an asset or liability's carrying amount and its tax basis. The tax basis of an asset or liability is often, but not always, the amount that could be deducted in the determination of taxable income if an asset were recovered for its carrying amount or the liability were settled for its carrying amount. Detailed guidance on determining an asset or liability's tax basis in various situations is presented in paragraph 3465.12 and .13. Determining the nature of temporary differences is discussed in paragraph 3465.14.

8 In most cases, an asset or liability will only have one amount that is attributable to it for tax purposes and the asset or liability's tax basis for purposes of Section 3465 will be equal to this amount. In some cases, however, an asset, in particular, may have more than one possible value for tax purposes, depending on whether the asset is used or sold. In such cases, the Board concluded that the tax basis to be used for purposes of calculating the temporary difference under Section 3465 should be the greater of the asset's possible values for tax purposes. This approach results in the recognition on the balance sheet of the minimum tax consequences that could result from realizing the asset for its carrying amount.

9 Alternatively, it may be possible to recover an asset's carrying amount or settle a liability without tax consequences. In such cases, the asset or liability's tax basis is considered to be the same as its carrying amount for purposes of Section 3465 so that no temporary difference results and no future income taxes are recognized, reflecting the fact that the asset can be recovered or the liability settled without tax consequences. This concept is illustrated in the discussion of compound financial instruments, which appears in paragraph 3465.18.

Unused tax losses, income tax reductions and certain other items

10 Unused tax losses and income tax reductions may generate future benefits in the form of reduced tax payments in future periods. Such items would be recognized as future income tax assets when the appropriate criteria are met, since they satisfy the conceptual definition of assets.

11 In addition, some items have a tax basis but cannot be identified with a particular asset or liability in the balance sheet. Such items can give rise to temporary differences and future income tax liabilities or future income tax assets, since they have future income tax consequences associated with them. Examples of such items are set out in paragraph 3465.15.

FUTURE INCOME TAX ASSETS

12 Future income tax assets can arise from deductible temporary differences, unused tax losses and income tax reductions. The Board considered two basic approaches to accounting for future income tax assets. Under the "affirmative judgment" approach, a future income tax asset is recognized for deductible temporary differences, unused tax losses and income tax reductions if it is more likely than not that the future income tax asset will be realized. Under the "impairment" approach, a future income tax asset is recognized for deductible temporary differences, unused tax losses and income tax reductions and a valuation allowance is recorded to reduce the future income tax asset to the amount that is deemed more likely than not to be realizable.

13 Under either approach, it is necessary to establish a recognition criterion based on the probability of realizing the future income tax asset. The Board considered whether that criterion should be described as "probable," as is used in IAS 12 (revised) or "more likely than not," as is used in SFAS 109. The Board was concerned that the term "probable" was not sufficiently precise for application in Canada. Research has indicated that different accountants will have different interpretations of the likelihood attached to this term.

14 Moreover, selection of more likely than not as the criterion for recognizing a future income tax asset has the effect of eliminating virtually any difference between the affirmative judgment and the impairment approaches to accounting for future income tax assets. In practice, there should be no substantive difference between the accounting results of either:

a) Recognition of future income tax assets if the likelihood of realizing the future tax benefit is more than 50% (i.e., the affirmative judgment approach); or

b) Recognition of a future income tax asset unless the likelihood of not realizing the future tax benefit is more than 50% (i.e., the impairment approach).

15 SFAS 109 requires the use of the impairment approach to accounting for future income tax assets based on the probability criterion of more likely than not. The Canadian exposure draft proposed the use of the affirmative judgment approach based on the criterion of "likely," which was defined as a probability of greater than 50% (i.e., the same definition as the one set out in SFAS 109 for more likely than not). Almost half of respondents commenting on the issue agreed with the ED approach. A few respondents indicated that they would have preferred an approach even more like that taken in SFAS 109.

16 In finalizing Section 3465, the Board continued to agree with the FASB's conclusions that the appropriate recognition criterion should be based on a probability threshold of greater than 50%. The Board also decided that the terminology should be changed from "likely," which was used in the ED, to "more likely than not" so that the Canadian and US standards would both be using the same term when the meaning is the same. "More likely than not" is defined in Section 3465 as a greater than 50% probability. Thus, the change from the ED is one of terminology only.

17 On the matter of the affirmative judgment versus impairment approach, however, the Board took a different approach from SFAS 109. Since the amount of the future income tax asset recognized in the balance sheet will be the same under either approach, given the more likely than not criterion, the Board considered the ease of applying the two different approaches. Under the impairment approach, the enterprise must calculate the future income tax assets associated with all deductible temporary differences and unused tax losses and income tax reductions, even if the benefits of those future income tax assets are not considered more likely than not to be realized. The affirmative judgment approach, on the other hand, is easier to apply since it only requires the enterprise to calculate future income tax assets related to those deductible temporary differences and unused tax losses and income tax reductions that are more likely than not to

be realized. Therefore, since the effects of the two approaches are the same, the Board concluded that the affirmative judgment approach is preferable based on the fact that it is easier to apply than the impairment approach. As a result, under paragraph 3465.24, a future income tax asset is to be recognized, with certain exceptions, for deductible temporary differences, unused tax losses and income tax reductions to the extent that the future income tax asset is more likely than not to be realized. As noted, in paragraph 3465.30, it would be possible to apply the impairment approach required by SFAS 109 and still comply with the requirements of Section 3465.

18 Like Section 3465, IAS 12 (revised) follows the affirmative judgment approach. However, as discussed above, under IAS 12 (revised), deferred tax assets would be recognized when it is probable that the benefits will be realized.

Future income tax assets related to unused tax losses versus deductible temporary differences

19 Under Section 3470, the benefit related to unused tax losses would only be recognized if the enterprise were virtually certain of realizing that benefit. By contrast, the benefit related to deferred tax debits resulting from timing differences would be recognized if there were reasonable assurance that the timing differences would reverse. A similar distinction was not made in Section 3465 because the Board agreed with the FASB conclusion that the substance of the benefit in either case is the same. Both unused tax losses and deductible temporary differences result in amounts that can reduce income taxes payable in future periods, within any applicable carryforward period. As a result, under Section 3465, the requirements for the recognition of future income tax assets are the same regardless of whether those assets result from unused tax losses or deductible temporary differences.

Favourable and unfavourable evidence and tax planning strategies

20 The benefits associated with a future income tax asset are realized when these amounts can be used to reduce income taxes payable in future periods. As a result, taxable income in future periods must be sufficient to allow these benefits to be realized and an assessment of the expected sources of future taxable income must be made in order to determine whether future income tax assets are more likely than not to be realized.

21 Consistent with SFAS 109 and IAS 12 (revised), Section 3465 requires consideration of both favourable and unfavourable evidence in determining whether the benefits associated with deductible temporary differences, unused tax losses and income tax reductions are more likely than not to be realized. In addition, the enterprise would consider tax planning strategies that would be implemented in order to realize a future income tax asset. These considerations are discussed in paragraphs 3465.25-.29.

RECOGNITION OF FUTURE INCOME TAXES

22 The basic principle underlying Section 3465 is that future income taxes should be recognized for all temporary differences. There are, however, a few exceptions, as discussed below.

Goodwill

23 The Board agreed with the position taken in SFAS 109 that a future income tax liability should not be recognized related to the temporary difference associated with goodwill that is not deductible for tax purposes. The reason for this position is that recognizing a future income tax liability would simply gross up both sides of the balance sheet because the amount of goodwill recognized and the amount of the related future income tax liability are mutually dependent. Since goodwill is simply a residual, the Board did not believe that this result would be appropriate. Therefore, under Section 3465, no future income tax liability is to be recognized for taxable temporary differences related to goodwill that is not deductible for tax purposes. This position is unchanged from the ED and consistent with both SFAS 109 and IAS 12 (revised).

Integrated foreign operations

24 As noted in paragraph 3465.33, a future income tax asset or liability is not to be recognized for a temporary difference arising from the difference between the historical exchange rate and the current exchange rate translations of the costs of non-monetary assets or liabilities of integrated foreign operations. As explained in paragraph 3465.34, the reason for this position is to avoid the recognition of future income taxes on exchange gains and losses that are not recognized under FOREIGN CURRENCY TRANSLATION, Section 1650. This approach is unchanged from the ED and consistent with SFAS 109. IAS 12 (revised) provides no similar exception.

Intra-group transfers

25 As indicated in paragraph 3465.35, when an asset is transferred between enterprises within a consolidated group, a future income tax asset or liability is not to be recognized in the consolidated financial statements for a temporary difference between the tax basis of the asset in the buyer's jurisdiction and its cost reported in the consolidated financial statements. As explained in paragraph 3465.36, the reason for this exception is to avoid the recognition of future income taxes related to inter-company gains or losses that are not recognized under CONSOLIDATED FINANCIAL STATEMENTS, Section 1600. This approach is unchanged from the ED and consistent with SFAS 109. IAS 12 (revised) provides no similar exception.

26 Any taxes paid or recovered by the transferor as a result of the transfer would be recognized as an asset or liability until the gain or loss is recognized in the consolidated financial statements. The asset or liability related to the payment of such taxes would be excluded from future income tax assets and liabilities for measurement purposes, since it would not be appropriate to remeasure the asset or liability to reflect expected changes in tax rates because the asset or liability relates to taxes already paid or recovered.

Investments in subsidiaries and interests in joint ventures

27 As explained in paragraph 3465.38, temporary differences related to investments in subsidiaries and interests in joint ventures arise in different ways. Temporary differences between the carrying amounts of individual assets of a subsidiary (or a joint venture) in the consolidated (or proportionately consolidated) financial statements and the tax bases of these assets and liabilities are referred to as "inside basis differences."

28 However, differences also may arise between the carrying amount of the investment in the subsidiary or joint venture and its tax basis, for example, because of undistributed net income of the subsidiary or joint venture or because of changes in foreign exchange rates when the parent (or joint venturer) and the subsidiary (or joint venture) are in different countries. These differences are referred to as "outside basis differences." Such differences reverse, possibly resulting in the payment of taxes, when the subsidiary (or joint venture) pays dividends or otherwise distributes earnings to the parent (or joint venturer).

29 Section 3465 specifies that a future income tax liability or asset is to be recognized for all temporary differences related to investments in subsidiaries or interests in joint ventures, except the difference between the carrying amount of the investment and its tax basis when it is apparent that this difference will not reverse in the foreseeable future. In other words, when the parent (or joint venturer) plans to reinvest the subsidiary's (or joint venture's) profits for the foreseeable future as part of its permanent investment, a future income tax liability would not be recognized since no future income taxes are expected to be paid related to the difference between the carrying amount of the investment in the subsidiary or interest in the joint venture and its tax basis.

30 An important element of this exception is the ability to control (or jointly control) the amount and timing of distributions so that the parent (or joint venturer) can determine that the difference between the carrying amount of the investment and its tax basis will not reverse in the foreseeable future. In the case of a parent / subsidiary relationship the parent's control over the subsidiary extends to the subsidiary's dividend policies. Similarly, a joint venturer has joint control over the distribution policies of the joint venture.

31 Similar "inside" and "outside basis differences" can also arise related to an investment that is accounted for using the equity method. In addition to investments in subsidiaries and interests in joint ventures, the Canadian ED proposed that a future income tax liability or asset should not be recognized related to undistributed income of an investment in a significantly influenced investee if the investor is able to control the timing of distributions and it is likely that distributions will not be made in the foreseeable future. In finalizing Section 3465, the Board concluded that there should be no such exception for investments in significantly influenced investees. Since an investor in a significantly influenced investee would rarely have the ability to control the amount and timing of distributions of the investee's distributions, the exception proposed in the ED was considered unlikely to apply in practice. Therefore, Section 3465 includes no exception for the recognition of future income taxes related to investments in significantly influenced investees. This position is more consistent with SFAS 109, which also does not provide any exception related to investments in significantly influenced investees.

32 The remaining difference between Section 3465 and SFAS 109 is that SFAS 109 specifies that future income taxes would not be recognized related to the difference between the carrying amount of an investment in a *foreign* subsidiary or joint venture and the tax basis of the investment. Unlike Section 3465, the exclusion for such future income taxes related to domestic subsidiaries or joint ventures is not permitted under SFAS 109. In finalizing Section 3465, the Board did not think that, in most cases, this different approach taken in the Canadian accounting standard would create a difference in accounting results between Canadian and U.S. GAAP. Under many jurisdictions, mechanisms are available such that the effect of the temporary differences can be realized without the incidence of tax (e.g. through consolidated tax returns, intercorporate dividend deductions, etc.). Both Section 3465 and SFAS 109 permit the consideration of such aspects in determining the amount of future (deferred) income taxes to be recognized on the balance sheet.

33 IAS 12 (revised) provides similar exceptions related to investments in subsidiaries and joint ventures as Section 3465. In addition, IAS 12 (revised) provides an exception such that future income taxes would not be recognized related to investments in branches and associates where the investor is able to control the timing of the reversal of temporary differences and it is probable that the temporary difference will not reverse in the foreseeable future.

ASSETS ACQUIRED OTHER THAN IN A BUSINESS COMBINATION

34 In some cases, an asset may be acquired, not as part of a business combination, and the asset's carrying amount on initial acquisition will be different from its tax basis. This can occur, for example, in a tax-deferred "rollover" where the related party transaction is measured at exchange amount (as defined in RELATED PARTY TRANSACTIONS, Section 3840). The buyer of the asset has a temporary difference on acquisition of the asset.

35 Section 3465 requires that the tax effects of such temporary differences arising on initial acquisition be recognized as part of the cost of the asset. Where the asset's tax basis is less than its carrying amount on initial acquisition, a future income tax liability arises. Rather than increasing income tax expense in the period, the amount of this future income tax liability is added to the initial carrying amount of the asset. Where the tax basis is greater than its carrying amount and a future income tax asset is recognized, an amount equal to the future income tax asset is deducted from the initial carrying amount of the asset.

36 Paragraphs 3465.44 and .45 present the formulae for calculating the future income tax liability or asset related to a temporary difference arising on initial acquisition. These formulae were considered necessary to adjust for the fact that

including the income tax effects in the initial carrying amount of the asset creates a new temporary difference, leading to the need for a series of calculations. Applying the formulae eliminates this need for a multi-step calculation and allows the calculation of a single amount to be added to or deducted from the cost of the asset.

37 This treatment of temporary differences arising on initial acquisition of an asset was also proposed in the Canadian ED. A significant portion of respondents raised concerns about this proposal. Many were concerned that the effect of the proposal is the recognition of assets at amounts above their laid down cost and, possibly, above fair value. Another concern was that the proposed treatment unduly complicated the accounting for income taxes.

38 SFAS 109 is silent on the question of how these temporary differences arising on initial acquisition of an asset should be accounted for. IAS 12 (revised) provides an exception to the recognition of future income taxes such that no future income taxes would be recognized related to a temporary difference arising on initial acquisition of an asset in a transaction that is not a business combination.

39 The Board considered different approaches for dealing with these temporary differences arising on initial acquisition in light of concerns raised over the ED proposals. However, the Board concluded that the ED proposals represented the best approach and reaffirmed this approach in finalizing Section 3465 for the following reasons:

a) The approach taken in Section 3465 is consistent with Section 3800, ACCOUNTING FOR GOVERNMENT ASSISTANCE, and Section 3805, INVESTMENT TAX CREDITS. Under both these Sections, the benefits related to the acquisition of the asset are either deducted from the initial carrying amount of the asset or deferred and amortized to income in step with any amortization expense related to the asset. The Board concluded that the situation where an asset's tax basis is greater than its carrying amount is very similar to the situations addressed by these two existing Sections; the benefit will be realized through enhanced deductibility of the asset for tax purposes, reducing income taxes payable in future periods. The Board, therefore, concluded that an amount corresponding to a future income tax asset arising on initial acquisition of an asset should be deducted from the carrying amount of the asset, mirroring the treatment in Sections 3800 and 3805. Adding an amount corresponding to the future income tax liability arising on initial acquisition to the carrying amount of the asset is also consistent with this approach.

b) In addition, the approach taken in Section 3465 of including any future income tax effects in the cost of the asset is analogous with the Section 3465 approach to business combinations. A temporary difference between the tax basis of an asset and the fair value assigned to the asset in allocating the purchase price associated with a business combination would result in the recognition of a future income tax liability or asset. An amount corresponding to this future income tax liability (or asset) would be added to (or deducted) from the amount of goodwill recognized as a result of the business combination. Including the cost of future income taxes arising on initial acquisition of an asset outside of a business combination in the cost of the asset acquired is therefore consistent with the approach taken for business combinations.

c) With respect to concerns about recognizing an asset at an amount different from its cost and, possibly, above its fair value, the Board observed that an asset's tax attributes and future deductibility for tax purposes would likely be taken into account in determining the amount to be paid for the asset. As a result, it is expected that a buyer would pay less for an asset that is not fully deductible for tax purposes than for one that is fully deductible. As a result, adding the future income tax cost to the cost of the asset may not necessarily result in recognizing the asset at an amount greater than its fair value.

d) It was considered to be logical that the amount of the future income tax effects be considered part of the cost of the asset. Immediately upon acquisition, the acquirer is certain to incur the future income tax cost if the laid down cost of the asset is to be recovered. The tax consequences are an unavoidable aspect of the acquisition and therefore should be recognized as part of the cost of the acquisition.

e) In any case, when assessing asset impairment, Section 3060, CAPITAL ASSETS, requires that the asset's carrying amount be compared with its net recoverable amount, rather than its fair value. This notion has not changed and the future income tax effect on initial acquisition of an asset is required to be factored into the asset's cost for accounting purposes (see paragraph 3060.19). When an asset is acquired that will not be fully deductible for tax purposes (i.e., its tax basis on initial acquisition is less than its carrying amount), the asset must be expected to generate enough future cash flows to cover both its laid down cost and the increased amount of income taxes that will be payable in future periods because the full amount paid for the asset will not be deductible for tax purposes. If the future cash inflows from the asset are not expected to be sufficient to cover the cost of operating the asset and its higher tax cost, a write down would be recognized. Conversely, when an amount greater than the asset's laid down cost will be deductible for tax purposes, the reduction in the asset's cost equal to the amount of the future income tax asset recognized reflects the fact that the use of the asset is expected to result in a reduction of the amount of income taxes payable in future periods. Lower future cash inflows are required to recover the cost of the asset, less the benefit of the asset's enhanced deductibility.

f) Under the SFAS 109 approach of remaining silent on this issue there is a risk that the full cost (or benefit) associated with a future income tax liability (or a future income tax asset) recognized on acquisition of an asset would increase (or decrease) income tax expense in the period of acquisition. As noted above, the Board concluded that it is not appropriate to recognize the full cost or benefit of future income taxes arising on initial acquisition of an asset in income tax expense of the period. Instead the future income tax cost (or benefit) should be reflected in the cost of the asset and increase (or reduce) the expenses recognized as the benefits of that asset are realized. For example, in the case of a capital asset acquired for an amount greater than its tax basis, the increased tax cost associated with the temporary difference is included in the asset's cost and thus amortized over its useful life. In other words, the added tax cost associated with the asset is reflected through increased amortization expense that is recognized in each of the periods that the enterprise benefits from the use of the asset. The increased amortization is offset by a reduction of income tax expense in the income statement, generally in the same amount. Because of this view that the future income tax effects associated with the asset are part of the cost of the asset, the Board also rejected the IAS (revised) approach of not recognizing future income tax liabilities or assets arising on initial acquisition of an asset. Furthermore, the Board concluded that the IAS 12 (revised) approach would also increase accounting complexity since that initial temporary difference would have to be tracked separately throughout the life of the asset in order to avoid recognizing any related future income taxes.

g) The Board also rejected the IAS approach because it effectively ignores the effects of changes in income tax rates between the date of the asset acquisition and the date the carrying amount is fully realized or amortized. The Board felt that this would not be consistent with the objectives of the Standard.

BUSINESS COMBINATIONS

Allocating the cost of the purchase

40 Values are assigned to identifiable assets and liabilities acquired in the allocation of the purchase price of a business combination accounted for as a purchase. These assigned values will frequently be different from the tax bases of the acquired assets and liabilities.

41 Under the previous Recommendations in Sections 3470 and 1580, BUSINESS COMBINATIONS, the values assigned to the identifiable assets and liabilities acquired were based on their fair values and took into account their values for tax purposes. The Board agreed with the conclusion underlying SFAS 109 that this approach to allocating the cost of a purchase business combination was not appropriate. The reason for this view is that such a "net of tax" approach mixes the normal amounts of expenses and revenues with their tax effects thus confusing the relationship between various items of earnings in subsequent years.

42 Therefore, Section 3465 takes an approach consistent with that taken in SFAS 109. The cost of the purchase is required to be allocated to the identifiable assets and liabilities acquired without taking into account their tax bases (i.e., on a "pre-tax" basis). Future income tax balances are then calculated based on the temporary differences between the values assigned to the identifiable assets and liabilities acquired and recognized in the allocation of the cost of the purchase business combination. This approach is unchanged from that taken in the Canadian ED and is consistent with both SFAS 109 and IAS 12 (revised).

Recognition of future income tax assets

43 At the time of a business combination accounted for as a purchase, both the acquired company and the acquiring company may have unrecognized future income tax assets that are considered to be more likely than not to be realized as a result of the business combination. Under Section 3465, previously unrecognized future income tax assets of both the acquired and the acquiring companies that are considered more likely than not to be realized as a result of the business combination would be included in the allocation of the cost of the purchase. This approach is unchanged from the ED and consistent with both SFAS 109 and IAS 12 (revised). It does, however, represent a change from Section 3470, under which deferred tax assets of the acquiring company would not be recognized at the time of a business combination and unused tax losses of the acquired company would only be recognized if there was reasonable assurance that the related benefits would be realized.

44 When, at the time of a business combination, it is not considered to be more likely than not that the acquired company's future income tax assets will be realized, these future income tax assets would not be recognized and would not be included in the allocation of the cost of the purchase. In future periods, however, the benefits associated with these unrecognized future income tax assets may be realized or the enterprise's assessment may change such that it is considered more likely than not that the benefits will be realized. In either case, Section 3465 requires that the benefit associated with acquired, previously unrecognized future income tax assets be recognized in such a way that they first reduce to zero any unamortized goodwill related to the business combination, then reduce to zero any unamortized intangible properties, and lastly reduce income tax expense of the period. This approach addresses concerns that the opportunity to reduce income tax in future years might sometimes influence the assessment of the recoverability of future income tax assets at the time of a business combination. Thus the requirements of Section 3465 limit the recognition of income after an acquisition when it is caused merely by a change in assessment of the likelihood of realizing an acquired income tax benefit. The approach taken in Section 3465 is consistent with that taken in SFAS 109.

45 The Canadian ED proposed that the benefit of previously unrecognized acquired future income tax assets be applied only against unamortized goodwill acquired in the business combination before reducing income tax expense of the period. It was not proposed that the carrying amount of intangible properties should be reduced since, unlike goodwill, they represent identifiable assets acquired in a business combination. However, the majority of respondents expressed a preference for the SFAS 109 approach, under which unamortized intangible assets acquired in the business combination

are also reduced to zero before applying the benefit associated with a previously unrecognized acquired future income tax asset to reduce income tax expense of the period. In finalizing Section 3465, the Board agreed with the FASB's underlying conclusion that goodwill and acquired intangibles should be treated in a similar manner because of difficulties in obtaining fair values for certain intangible assets and the necessary ambiguity between intangible assets and goodwill in some business combinations. The Board noted that this approach prevents accounting arbitrage in the designation or identification of items as between goodwill and intangibles.

Pooling of interests and comprehensive revaluations of assets and liabilities

46 In finalizing Section 3465, the Board concluded that material should be added to clarify the implications of accounting for income taxes on business combinations accounted for as poolings of interests and on comprehensive revaluations of assets and liabilities. This material appears in paragraphs 3465.52 to .55.

MEASUREMENT

47 Section 3465 requires that income tax liabilities and income tax assets should be measured at the balance sheet date using income tax rates and laws that are expected to apply when the liability is settled or the asset is realized. Normally, these rates and laws is would be those that are enacted as of the balance sheet date. However, Section 3465 allows that there are circumstances in which liabilities and assets should be measured using tax rates and laws that are substantively, rather than fully, enacted.

48 This position is consistent with that proposed in the Canadian ED. It is, however, different from the position taken in SFAS 109, which specifies that only tax rates and laws that are enacted at the balance sheet date should be used to measure income tax liabilities and assets. The use of substantively enacted rates was proposed in the Canadian ED to reflect the nature of the Canadian legislative process where tax changes may be announced by a majority government and still take months or years to become fully enacted in the legislation. In the meantime, there is very little doubt that many of these changes will be enacted and taxpayers are assessed and pay taxes based on the proposed changes.

49 Respondents to the Canadian ED were divided on the proposed use of substantively enacted rates to measure income tax liabilities and assets. Some expressed the view that the difference from SFAS 109 was justified based on differences in our legislative process. Other respondents viewed the proposed approach as an unnecessary difference from SFAS 109 and noted that the judgment involved in determining whether a substantively enacted rate should be used in a particular situation can lead to inconsistent application of the accounting standard.

50 In finalizing Section 3465, the Board concluded that the approach proposed in the ED was preferable since it results in income tax liabilities and assets that are measured using the best estimate of the tax rates and laws that are expected to apply when the liability is settled or the asset is realized. Material was added to provide guidance on determining when it is appropriate to measure income tax liabilities and assets using substantively enacted, as opposed to enacted, tax rates and laws (see paragraph 3465.58).

51 The position taken in Section 3465 with respect to the measurement of income tax liabilities and assets is consistent with that taken in IAS 12 (revised).

Discounting

52 Section 3465 specifies that discounting future income tax liabilities and assets is not permitted. This is consistent with the proposals in the Canadian ED and responses to on this issue were mixed.

53 If future income taxes were to be discounted, detailed analyses of when temporary differences were expected to reverse would be necessary or arbitrary rules would be required. Because of many complexities associated with discounting future income tax balances, the Board concluded that discounting should not be required. The Board considered whether discounting should be permitted instead of required. The Board concluded, however, that permitting discounting would lead to inconsistencies in practice and that the broader issue of discounting should be dealt with on a comprehensive basis.

54 The Section 3465 requirement that future income tax liabilities and assets not be discounted is consistent with both SFAS 109 and IAS 12 (revised).

INTRAPERIOD TAX ALLOCATION

55 As explained in paragraph 3465.65, the cost (or benefit) of income taxes in the period represents the amount of income taxes payable (or recoverable) in respect of the period and the amount of future income tax liabilities (and assets) recognized in the period. The cost (or benefit) of income taxes in the period is recognized as income tax expense included in the determination of net income before discontinued operations or extraordinary items, unless it is required to be allocated elsewhere under paragraph 3465.63. Allocation of the cost of income taxes to an item other than income tax expense is done so that income taxes are recognized in a manner consistent with the underlying transaction when the transaction occurs in the same period as the income tax effects are being recognized. For example, the cost or benefit of income taxes related to a capital transaction is also recognized as a capital transaction, rather than being included in income tax expense of the period. Similarly, the cost or benefit of income taxes arising as a result of a business combination is allocated to the goodwill recognized in the business combination. The cost or benefit of income taxes related to discontinued operations or extraordinary items of the current period is included in the income statement with the results of discontinued operations or extraordinary items.

56 The benefit associated with an unused tax loss or income tax reduction recognized in the period of the loss is recognized in the same manner as the related loss. However, when the benefit of an unused tax loss or income tax reduction is not recognized until a period following the loss, that benefit is recognized as part of income tax expense in the determination of net income before discontinued operations and extraordinary items, regardless of the classification of the loss in prior periods. The only exception is the benefit of an unused tax loss or income tax reduction related to a business combination or financial reorganization but which was not recognized at the time of the business combination or financial reorganization. According to paragraph 3465.48, the benefit of such a future income tax asset is recognized first as a reduction of the unamortized portion of goodwill related to the business combination, then as a reduction of the unamortized portion of intangible properties related to the business combination and, lastly, as a reduction in income tax expense included in the determination of net income before discontinued operations and extraordinary items. Paragraph 3465.52 requires that a similar approach be taken for future income tax assets related to a financial reorganization but not recognized at the time of the reorganization.

57 The position taken in Section 3465 with respect to the allocation of the cost of income taxes and the recognition of the benefit of unused loss carryforwards and income tax reductions in periods after the loss or income tax reduction arose is consistent with the proposed positions in the Canadian ED. However, both SFAS 109 and IAS 12 (revised) take a different approach since these standards would require that the benefit associated with previously unrecognized deferred tax assets related to items charged or credited directly to equity would also be recognized directly in equity, rather than as part of income tax expense. In other words, while SFAS 109 and IAS 12 require a greater degree of "backwards tracing," Section 3465 requires it only to the extent discussed in the previous paragraph. The Board was advised by respondents and FASB staff and others to avoid the complexities associated with backwards tracing.

58 The cost or benefit of income taxes associated with changes in future income tax liabilities or assets as a result of changes in tax laws or rates is included in income tax expense for the period and included in the determination of net income before discontinued operations and extraordinary items. The reason for this view is that such changes arise from normal business conditions. This position is consistent with that proposed in the Canadian ED.

REFUNDABLE TAXES

59 As explained in paragraph 3465.74, refundable taxes are payable related to certain investment income earned by Canadian corporations. The taxes are refundable when certain distributions are paid to shareholders. As such, the taxes represent an advance distribution to shareholders.

60 Consistent with the recognition of a future income tax asset, how refundable taxes are recognized under Section 3465 depends on whether the refundable taxes are considered more likely than not to be recovered. If not, refundable taxes are recognized as part of income tax expense for the period.

61 If, on the other hand, refundable taxes are considered to be more likely than not to be recovered, the refundable taxes paid or payable would be charged to retained earnings or recognized as a future income tax asset, depending on whether the related financial instrument is classified as equity or as a liability under Section 3860, FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION. This distinction between refundable taxes based on the balance sheet classification of the related financial instruments was made for consistency with Section 3860 since distributions related to a financial instrument classified as debt will be expensed, regardless of the legal form of the financial instrument. Therefore, the refundable taxes paid, which represent an advance distribution to shareholders, are recognized as an asset, similar to a prepaid expense, rather than being charged to retained earnings.

PRESENTATION

Balance sheet classification

62 Section 3465 requires that enterprises that segregate assets and liabilities between current and non-current should classify future income tax liabilities and assets between current and non-current in the balance sheet based on the classification of the assets and liabilities to which the future income tax balances relate. This position is consistent with both the Canadian ED and with SFAS 109. IAS 12 (revised) takes a different approach, requiring that deferred tax liabilities and assets be classified as non-current. The Board rejected the IAS approach, noting that it would not be consistent to require that a future tax asset related to a current liability to be treated as non-current (e.g. the future tax asset related to a warranty liability).

Offsetting

63 Section 3465 requires that income tax liabilities and assets be offset only if they relate to the same taxation authority and the same taxable entity. Current and future income tax balances would not be offset against each other, nor would current and non-current future income tax balances be offset against each other. This position is consistent with the proposals in the Canadian ED and also with the offsetting provisions of Section 3860, FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION. The position taken in Section 3465 is also fundamentally consistent with SFAS 109. Under Section 3465, offsetting is allowed for different taxable entities if tax planning strategies could be used to combine the different taxable entities into a single tax paying entity. Under IAS 12 (revised), current tax assets and liabilities may be offset if the enterprise has the legally enforceable right to set off the amounts and intends to settle on a net basis or to realize the asset and settle the liability simultaneously. Deferred tax assets and liabilities may be offset if the enterprise meets the criteria for offsetting current items and the amounts relate to the same taxation

authority and taxable entity or, for different taxable entities, the assets and liabilities will be settled net or simultaneously.

DISCLOSURE

64 Paragraph 3465.91 sets out the disclosure requirements for all enterprises. These requirements are unchanged from those proposed in the Canadian ED except for the disclosure related to unused tax losses, income tax reductions and deductible temporary differences for which no future income tax asset was recognized. The ED proposed that the amount of unrecognized future income tax assets should be disclosed, meaning that the amounts would have to be tax effected. In response to ED respondents' concerns that disclosing unrecognized future income tax assets adds undue complexity, the Board concluded that disclosure be required only for the amount of unused tax losses, income tax reductions and deductible temporary differences, and not the tax effects.

65 Paragraph 3465.92 sets out additional disclosure that is required only for public enterprises. This approach of specifying certain requirements for public enterprises only was taken to alleviate concerns that the disclosure would be unduly onerous and would not add useful information for other than public enterprises.

66 Section 3465 also sets out disclosure to be provided by non-taxable enterprises. These would normally relate to entities such as partnerships, including limited partnerships whose units are publicly traded. Paragraph 3465.101 presents the disclosure requirements for enterprises that are part of a group filing consolidated tax returns. Although the filing of consolidated tax returns is not currently allowed in Canada, Canadian enterprises may have operations in jurisdictions where it is possible to file consolidated tax returns. This disclosure would be provided in such cases.

RATE REGULATED ENTERPRISES

67 According to paragraph 3465.102, rate regulated enterprises are not required to recognize future income tax liabilities or assets to the extent that these future taxes are expected to be included in the approved rate charged to customers in the future and are expected to be recovered from future customers. (The definition of a rate regulated enterprise appears in paragraph 3465.09.) If a rate regulated enterprise does not recognize future income taxes it is required to disclose the reason why and the amounts of unrecognized future income tax liabilities, future income tax assets and future income tax expense.

68 The Canadian ED proposed that rate regulated enterprises should recognize their future income tax liabilities and assets and also recognize an asset (liability) for the amount of future income taxes expected to be included in future rates and recovered from (or payable to) future customers. This proposal was consistent with US GAAP. Most ED respondents commenting on this issue disagreed with the position taken in the ED. In finalizing Section 3465, the Board concluded that it would be preferable to deal with the larger issue of accounting by rate regulated enterprises, rather than doing so on a piece meal basis. As a result of this view, the exception set out in paragraph 3465.102 was put forth pending further study of accounting by rate regulated enterprises. This approach effectively extends the exemption for rate regulated enterprises from the recognition of deferred taxes that was set out in Section 3470.

TRANSITIONAL PROVISIONS

69 Under Section 3465, the requirements for accounting for income taxes are to be applied retroactively. In arriving at this position, the Board agreed with the FASB conclusion that applying the standards prospectively would not be appropriate since it would result in financial statements reporting income taxes under two different methods and require that two different methods of accounting for income taxes be maintained.

70 Restatement of prior periods on implementation of the standards for accounting for income taxes set out in Section 3465 is encouraged, but not required. In arriving at this position, the Board recognized that restatement of prior periods may be overly complex and time consuming for some enterprises.

71 For similar reasons, the Board concluded that the initial and subsequent accounting for purchase business combinations that took place in years prior to the first period restated need not be restated.

72 The transitional provisions were drafted to accommodate conformity with U.S. GAAP numbers. The Board was sensitive to the concerns of those who must reconcile their financial statements to U.S. GAAP that the differences should be minimized. The Board wanted to ensure that transitional provisions and different effective dates did not create an unjustified GAAP difference that would extend for a considerable period of time.
