Uncertain Tax Positions Acquired in a Business Combination

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The Group has previously discussed the issue of uncertain tax positions acquired in a business combination at its April 2012 and September 2015 meetings. The issue was whether to recognize and measure the uncertain tax position in accordance with the general recognition and measurement principles in IFRS 3 *Business Combinations* (i.e., at fair value) or in accordance with IAS 12 *Income Taxes* by virtue of applying the exception in paragraphs 24 and 25 of IFRS 3.

In May 2017, the IASB issued IFRIC 23 *Uncertainty over Income Tax Treatments*, with the effective date of January 1, 2019. IFRIC 23 clarifies how to apply the recognition and measurement requirements in IAS 12 when there is uncertainty over income tax treatments.

The Group discussed the recognition and measurement of uncertain tax positions present in an acquired business, both on transition to IFRIC 23 and on an ongoing basis.

Issue 1: Does IFRIC 23 apply to the measurement of deferred tax assets and liabilities that arise as part of a business combination when there is uncertainty over income tax treatments that affect such assets and liabilities?

Paragraph 24 of IFRS 3 provides an exemption to both the recognition and measurement principles of IFRS 3: "The acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with IAS 12 *Income Taxes*." As a result, the deferred tax assets and liabilities of an acquired business are to be measured in accordance with IAS 12, rather than at fair value.

Furthermore, paragraph BC24 in the Basis for Conclusions to IFRIC 23 states that IFRIC 23 applies to the deferred tax assets and liabilities of an acquired business when there is uncertainty over income tax treatments that affect deferred tax.

Therefore, as IFRIC 23 is an interpretation of IAS 12, the deferred tax assets and liabilities affected by uncertain tax positions should be measured based on the principles of IFRIC 23.

The Group's Discussion

Group members agreed with the analysis above.

Issue 2: After adopting IFRIC 23, how should current tax assets acquired and current tax liabilities assumed in a business combination be measured when there are uncertain tax positions?

Unlike the deferred tax assets or liabilities, the current tax balances of an acquired company are not explicitly addressed by the recognition and measurement exemption in Paragraph 24 of IFRS 3. Consequently, different views exist in practice on whether IFRIC 23 or IFRS 3 should be applied to current tax assets and liabilities assumed in a business combination.

IFRIC 23 and IFRS 3 set out different measurement principles that may have the following impact on the way a current tax asset or liability is measured:

- IFRIC 23 requires the current tax balance to be measured using either the most likely amount or a probability weighted expected value approach, depending on which method would be considered to best predict the resolution of the uncertainty. In calculating the current tax balance, the entity assumes the tax authority will and can examine amounts it has a right to examine (i.e., the detection risk is presumed to be 100 percent).
- Under IFRS 3, the current tax balances would be measured at fair value. The probability that the tax authority may not examine the tax position is factored into the estimation of fair value (in other words, detection risk may be considered to be less than 100 percent).

Two scenarios are used to illustrate the differences:

Scenario 1: Tax treatment is probable of being accepted by the tax authority

(a) Business combination closes on December 15. The acquired company plans to deduct $100 in arriving at its taxable income of nil for its tax year ended December 31. The $100 deduction represents an uncertain tax treatment.

(b) The acquired company's tax rate is 30 percent.

(c) The detection risk is 50 percent. The probability of the tax authority accepting the tax treatment is 60 percent.

(d) The outcome of the examination by the tax authority is binary. The tax deduction will either be accepted in full or completely denied.

Under IFRIC 23, because it is probable that the tax authority will accept the tax treatment, the current tax liability related to the uncertain tax position is $0.

Under IFRS 3, the determination fair value of the current taxes payable may consider the detection risk and the probability that the deduction may be denied in the calculation as follows:

$100 × 40% (risk that the deduction will be denied) × 50% (detection risk) × 30% (tax rate) = $6.

Scenario 2: Tax treatment is not probable of being accepted by the tax authority

Scenario 2 is the same as Scenario 1, except the entity believes it is not probable that the $100 tax deduction will be accepted by the tax authority. The probability of rejection is estimated at 60 percent.

Under IFRIC 23, since the deduction is expected to be denied, the entity will record the most likely amount of $30 ($100 × 30%) as the current tax liability.

Under IFRS 3, the fair value of the current tax liability may be determined as follows:

$100 × 60% (risk that the deduction will be denied) × 50% (detection risk) × 30% (tax rate) = $9.

The Group discussed the following three views on measurement of current tax assets and liabilities acquired or assumed in a business combination that occurs after the adoption of IFRIC 23.

View 2A – At fair value (IFRS 3)

Proponents of this view note that IFRS 3 was not amended by IFRIC 23 and IFRS 3 does not contain any specific exemptions to account for current tax assets and current tax liabilities acquired or assumed in a business combination. Therefore, they believe that the general requirements of IFRS 3 apply to current tax balances acquired and assumed in a business combination.

Under this view, the current tax liability related to the uncertain tax position is measured at $6 in Scenario 1 and $9 in Scenario 2.

View 2B – In accordance with IAS 12/ IFRIC 23

Proponents of this view believe that the exemption in IFRS 3 applies to all tax balances generated as a result of IAS 12. As IFRIC 23 was issued as interpretive guidance to IAS 12, the IFRS 3 exemption can be extended to encompass IFRIC 23.

Under this view, the current tax liability related to the uncertain tax position is recorded at $0 in Scenario 1 and at $30 in Scenario 2.

View 2C – Accounting Policy Choice

Proponents of this view believe that the literature is unclear. Therefore, either View 2A or View 2B could be supported.

The Group's Discussion

While some Group members supported View 2A and 2B based on the analysis performed, most members supported View 2C. Supporters of View C believe that the accounting literature continues to be unclear. Therefore, similar to the Group discussions in 2012 and 2015, these Group members continue to believe that there is an accounting policy choice.

One Group member observed that detection risk may not be a major contributor to the measurement differences of uncertain tax positions between IFRS 3 and IFRIC 23. There are other factors that drive differences, such as the probability of an uncertain tax position being accepted or denied.

Some Group members observed that if an entity follows View 2A in Issue 2, the entity will apply two measurement bases to the current and deferred tax balances from business combinations, even though they arose from one unit of account.

Issue 3: If IFRS 3 is applied in Issue 2 (i.e., View 2A or 2C in Issue 2), how should the entity reflect any Day 2 adjustments when applying IFRIC 23?

A "Day 2 adjustment" arises when different recognition and measurement requirements are applied to the initial and subsequent measurement of an asset or liability. This difference in requirements can result from different standards being applied at initial recognition and subsequent measurement. As illustrated in Scenario 1 to Issue 2 above, a difference of $6 could arise from the entity applying IFRS 3 at initial measurement (current tax liability: $6) but applying IFRIC 23 subsequently (current tax liability: $0).

View 3A – Apply IFRS 3 guidance on acquired/ assumed contingent liabilities by analogy

Proponents of this view believe IFRS 3 should be applied when measuring tax uncertainties related to income tax assets acquired and income tax liabilities assumed. The post-acquisition accounting for a contingent liability recorded in a business combination can be used by analogy to measure the current tax liability at the first reporting date after the acquisition. In accordance to paragraph 56 of IFRS 3, the uncertain tax treatment is recognized at the higher of:

(a) the amount initially recognized ($6 in Scenario 1 as illustrated in Issue 2 above); and

(b) the amount that would have been recognized in accordance with IFRIC 23.

Therefore, the current tax liability related to the uncertain tax position would continue to be recorded at $6 unless the measured value under the principles of IFRIC 23 exceeds $6.

View 3B – Apply IFRIC 23

Proponents of this view note IFRIC 23 should be applied to all uncertainties over IAS 12 tax balances recognized. Accordingly, the uncertainty over tax treatments associated with income tax assets acquired and liabilities assumed are recognized and measured in accordance with IFRIC 23 post-acquisition, even if the current tax balances were initially recorded at fair value under the principles of IFRS 3. The effect of the change in measurement basis is recognized in the period as a gain or a loss.

Applying the same facts presented in Scenario 1 in Issue 2 above, the entity will record a gain of $6 through the statement of income at the next reporting date (the difference between the IFRIC 23 amount of $0 and the IFRS 3 amount recorded at acquisition of $6).

View 3C – Accounting Policy Choice

Proponents of this view believe the standard is not clear. Therefore, an appropriate accounting policy should be developed in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and should be applied consistently to recognition and measurement of all such tax uncertainties.

The Group's Discussion

The Group supported View 3B. Some group members noted that IFRIC 23 is an interpretation of IAS 12, which provides more specific guidance related to all uncertainties over IAS 12 tax balances recognized. Therefore, Group members thought that an IFRIC 23 approach should be followed instead of IFRS 3 accounting for contingent liabilities. One Group member commented that the initial fair value using IFRS 3 may not be significantly different from IFRIC 23. Hence, the amount of Day 2 adjustment to be recorded through the statement of income may not be material.

Issue 4: Transition – Assuming that an entity followed the approach described under View 3A in Issue 3, how should the entity measure current tax assets and liabilities that were subject to uncertainties at the time of a business combination that occurred before the date of adoption of IFRIC 23?

View 4A – Apply IFRIC 23 to the measurement of the current tax asset or liability subject to the uncertain tax position at the date of transition to IFRIC 23 only if it is probable that the tax position will not be accepted by the tax authorities. Otherwise, leave the previously recorded amounts unchanged until the uncertainties expire.

Proponents of this view believe the intention of paragraph BC23 of the Basis for Conclusions to IFRIC 23 is to make clear that IFRS 3 applies to prior treatment of tax uncertainties where a reasonable analogy to IFRS 3 for similar assets and liabilities was taken.

Under this view, in Scenario 1 presented above in Issue 2, the entity will continue to record the current tax liability of $6 on transition to IFRIC 23, assuming the probability of the tax position being overturned had not changed. In Scenario 2, assuming that the current tax liability was recorded in the purchase price allocation at its estimated fair value of $9 and remained unchanged at the date of adoption of IFRIC 23, the entity would adjust the current tax liability associated with the uncertain tax position to $30 since it is considered probable that the uncertain tax deduction would be denied by tax authorities.

View 4B – Apply IFRIC 23 to all uncertain tax positions outstanding at the date of initial application (including uncertainties acquired in past business combinations)

Proponents of this view argue that, post-acquisition, IAS 12 and all related interpretations are the relevant standards for the recognition and measurement of all income tax asset and income tax liability balances within the scope of IAS 12. Further, IFRIC 23 applies to uncertainties of all such balances from the date of initial application, regardless of how those balances and uncertainties arose or were acquired. Therefore, the transition requirements of IFRIC 23 must be retrospectively applied without the use of hindsight under the full retrospective method, or under the cumulative catch-up method with adjustment to opening retained earnings.

Under this view, in Scenarios 1 and 2 presented above in Issue 2, the current tax liabilities associated with the uncertain tax positions would be adjusted to their respective IFRIC 23 balances of $0 for Scenario 1 and $30 for Scenario 2.

Questions can also arise as to whether the effect of this adjustment should be recorded in opening retained earnings on adoption of IFRIC 23 or as an adjustment to the goodwill that arose in the prior business combination. Generally, such an adjustment would most appropriately be recorded in opening retained earnings since adjusting the amounts recorded in the business combination would seem to require the use of hindsight, which is explicitly prohibited in the transition guidance to IFRIC 23.

View 4C – Accounting policy choice

Proponents of this view would argue that the standards are not clear and, therefore, there is an accounting policy choice.

The Group's Discussion

The Group supported View 4B, noting that a consistent application of IFRIC 23 should be followed, regardless of how those balances arose or were acquired.

One Group member noted the practical challenges of applying View 4A being the entity would be required to track all uncertain tax positions existing at the IFRIC 23 adoption date in order to distinguish any balances that arose from past business combinations; and that the entity may not have access to the required information.

Overall, the Group considered this issue to be prevalent in practice given the recent adoption of IFRIC 23 and recommended this issue be discussed with the AcSB. Specifically, the Group questioned whether the exception described in paragraph 24 of IFRS 3 could be revised to include both the current and deferred tax asset or liability. The AcSB will discuss this issue at its July 2019 meeting and consider whether to raise this issue with the IASB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).