IFRS 3 and IAS 12: Uncertain Tax Positions Acquired in a Business Combination

Excerpt, IFRS Discussion Group Report on Meeting – April 19, 2012

Decisions taken by an entity in measuring its income tax assets and liabilities for financial statement purposes when the tax law is unclear are generally referred to as uncertain income tax positions. An entity that acquires an uncertain tax position in a business combination needs to recognize and measure that position at the date of acquisition.

IFRS 3 *Business Combinations* provides limited exceptions to its recognition and measurement principles. Paragraphs 24 and 25 of IFRS 3 provide an exception relating to income taxes stating:

> "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.
>
> The acquirer shall account for the potential tax effects of temporary differences and carry forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with IAS 12."

The issue considered by the Group was whether an uncertain income tax position that is acquired through a business combination is subject to the recognition and measurement exception in IFRS 3 relating to income taxes. Specifically, does the scope exception apply narrowly to the specified items only, or broadly to all items within the scope of IAS 12?

Fact Pattern:

- Entity A acquires Entity B in a business combination.
- Entity B has an uncertain income tax position at the acquisition date that could result in an additional current tax liability. However, the likelihood that an outflow of resources will be required is not considered to be probable at the acquisition date.

At the acquisition date, should Entity A recognize and measure the uncertain tax position in accordance with the general recognition and measurement principles in IFRS 3 (i.e., at fair value) (*View A*) or in accordance with IAS 12 by virtue of applying the exception in paragraphs 24 and 25 of IFRS 3 (*View B*)?

View A – The uncertain tax position is subject to the general recognition and measurement provisions in IFRS 3 (i.e., fair value)

Proponents of this view argue that the scope exception in paragraphs 24 and 25 of IFRS 3 is limited to the specified items (i.e., deferred income tax assets or liabilities and potential tax effects of temporary differences and carry forwards of an acquiree) as opposed to a broader scope exception to all items subject to IAS 12. Proponents of this view argue that uncertain tax positions do not fall within this scope exception because they generally relate to current income taxes.

Further, paragraphs 22 and 23 of IFRS 3 require a lower threshold for recognition of contingent non-tax liabilities assumed in a business combination in that they are recognized at fair value even if not probable. Paragraph 56 of IFRS 3 addresses subsequent measurement considerations and requires that the contingent liability be measured at the higher of the amount that would be recognized under IAS 37 and the amount recognized in the business combination, thereby avoiding any potential "day one" remeasurement issues. Given the parallels of such items with uncertain tax positions, proponents of this view argue that it seems reasonable to adopt a comparable approach.

View B – The uncertain tax position is subject to the IAS 12 recognition and measurement exception in IFRS 3

Proponents of this view argue that uncertain tax positions are excluded from the scope of IFRS 3. Paragraph IN9 in the introduction to IFRS 3 states:

> "Some assets and liabilities are required to be recognized or measured in accordance with other IFRSs, rather than at fair value. The assets and liabilities affected are those falling within the scope of IAS 12 *Income Taxes* …"

Proponents of this view argue that the fact that paragraphs 24 and 25 of IFRS 3 do not specifically refer to uncertain tax positions should not result in a limitation on the application of the exception. The introduction to the standard clearly states that the IASB intended the exception to apply to all assets and liabilities within the scope of IAS 12. Given IAS 12 does not contain explicit guidance relating to uncertain tax positions, the fact that paragraphs 24 and 25 do not explicitly refer to uncertain tax position should not be interpreted to exclude them. Also, although uncertain tax positions are more commonly associated with current income taxes, they may relate to deferred taxes.

Paragraph BC295 in the Basis for Conclusions to IFRS 3 provides some discussion about the particular problems uncertain tax positions present, albeit ultimately noting that: "the IASB decided not to modify IAS 12 as part of this project to address specifically the accounting for changes in acquired income tax uncertainties in a business combination." If uncertain tax positions are measured at fair value under IFRS 3, a day one entry may result (i.e., recognition of any difference between the IFRS 3 fair value and the IAS 12 measurement basis) because IAS 12 will be applicable after the combination.

Accordingly, proponents of this view argue that, from a practical perspective, uncertain tax positions should be recognized and measured in accordance with IAS 12 at the acquisition date and thereafter.

The Group's Discussion

While some Group members supported each view, other Group members supported both views, arguing that an accounting policy choice exists. Group members discussed their reasoning and expressed concern with the diversity in views. Some Group members noted that this issue is likely much more complex and may relate to broader issues surrounding IAS 12.

However, given the diversity in views, the Group recommended that this issue should be brought to the attention of the IFRS Interpretations Committee by the AcSB through the most appropriate vehicle. The Group directed the AcSB staff to determine the best path to move this issue forward, suggesting the IASB's IFRS 3 post-implementation review or a request for an annual improvement as possibilities.