

# Searching for clarity in uncertain tax positions

Insights for entities using or converting to IFRS

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# Executive summary

**“Uncertain tax positions” (UTPs) refers to items for which the tax treatment is unclear, or is a matter of dispute between the reporting entity and the relevant tax authority. These scenarios generally occur where there is uncertainty as to the meaning of the law, or to the applicability of the law to a particular transaction, or both.**

Entities that use a national accounting standard other than IFRS, but plan to convert to IFRS, struggle with a lack of guidance on the accounting for UTPs under IAS 12 *Income Taxes* in its current state. This has led many entities to wonder how to properly account for and report on UTPs in conversion to IFRS. Currently, there is a broad diversity of practice in how IAS 12 is applied for analysing, accounting, reporting and disclosing UTPs. In March 2009, the International Accounting Standards Board (IASB) had issued an Exposure Draft (ED) to replace the current IAS 12, which included proposals on UTPs. But that project was stopped in November 2009 for various reasons. Entities expecting to adopt IFRS in the near future may find they have less guidance with respect to the accounting for UTPs than they currently have in their country's local GAAP. In addition, these entities may find themselves in a situation where they have to adopt an accounting method for UTPs twice in the next few years – once when they first convert to IFRS, and again if the IASB issue a new standard on accounting for income taxes.

Tax professionals, chief financial officers, controllers, chief accounting officers and many others will need to understand how their transition to IFRS is to be made for UTPs.

Even entities currently using IFRS would benefit from taking a second look at how they are currently uncovering, tracking, documenting and accounting for UTPs – given the bright spotlight that the IASB has placed on this topic recently and its desire to eventually address the gaps in the guidance.

Other stakeholders, including regulators and tax administrators are already increasing their focus on this topic. For example, the Internal Revenue Service (IRS) in the United States recently issued proposals which could require certain business tax payers to disclose details of their uncertain tax positions at the time they file their tax returns. For more information, please see [www.ey.com/uncertaintaxpositions](http://www.ey.com/uncertaintaxpositions).

What follows is an analysis of the current IAS 12 standard with respect to uncertain income-based tax positions, and what might be considered a framework for analyzing the options for recognizing and measuring them. This framework would include an analysis of key areas such as:

- ▶ Unit of account
- ▶ Recognition
- ▶ Measurement
- ▶ Disclosure
- ▶ Other issues

Understanding what is different in these areas compared with how an entity currently accounts for UTPs will help management to create a plan for the adjustments, if any, to be made on either transition to IFRS, or implementation of a possible new standard in the future.

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# Uncertain tax positions under the current IAS 12

## Overview

IAS 12 does not provide explicit guidance for accounting for UTPs. It basically states that current tax liabilities (assets) are measured at the amount expected to be paid to (or recovered from) tax authorities using the tax rates (and tax laws) enacted or substantively enacted at the balance sheet date. The implication is that amounts are recorded based on estimates of what will be owed or realized. Alternatively, one can view the recording of a liability for a tax authority's challenge of a tax position (or positions) as how much the entity "expects to pay" to settle a specific tax position or a settlement that aggregates a number of tax positions. No other guidance is provided for recognising or measuring a tax asset or tax liability subject to tax uncertainty.

For disclosure of UTPs, IAS 12 points to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for "tax-related contingent liabilities and contingent assets" that may arise from "unresolved disputes with taxation authorities." However, IAS 37 specifically excludes income taxes from its scope – leading to additional confusion and divergence in practice.

When IFRS is silent on a matter, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that management should "use its judgment in developing and applying an accounting policy." IAS 8 also says that entities should refer to other IFRSs dealing with similar or related issues, and even the pronouncements of other standard-setting bodies if those standards follow a similar conceptual framework as IFRS and do not conflict with it.

With IAS 8 in mind, some entities refer to IAS 37 as one possible framework for recognition and measurement of their UTPs, while others devise other methods based on other IFRSs or other acceptable country accounting standards.

For those who have traditionally looked to IAS 37, it is important to note that IAS 37 itself is in a state of flux. An ED to replace IAS 37 was first issued in 2005. Then, in January 2010, the measurement section of the ED was re-exposed after the IASB received feedback that the 2005 proposals lacked clarity in that area.

Later, this article considers the alternative model the IAS 37 ED proposes for recognition and measurement compared with the existing model in the current IAS 37. This may impact not only those looking to convert to IFRS in the next few years, but also those entities already using IFRS today and refer to IAS 37 for guidance on UTPs.

## Unit of account

To begin to understand where an entity may have tax uncertainty, a decision must be made as to how tax positions should be analysed. A unit of account can be thought of as the base unit for an entity's UTP methodology – or as the item that the entity determines to be the "tax position" to be evaluated. But IAS 12 does not determine how different taxpayers in the same industry, or different taxpayers in different industries, should define this base unit of measurement for a tax position, so that balances accrued for tax uncertainty are comparable to some degree.

In practice, a unit of account could be an entire tax computation, individual uncertain positions, or a group of related uncertain positions (i.e., all positions in a particular tax jurisdiction, or all positions of a similar nature or relating to the same interpretation of tax legislation).

It is important that an accounting policy for a unit of account is established in order to determine which positions the entity's UTP methodology will be applied to. This will also aid in the consistency and comparability of an entity's UTP and any changes from one accounting period to another.

## Recognition

IAS 12 relies on the general principles under IFRS to determine what is recorded (recognised) as a tax asset or liability, but does not elaborate on how tax uncertainty impacts recognition or de-recognition. However, IAS 12 does provide that, at each balance sheet date, an entity will re-assess any unrecognised deferred tax assets. It further provides that a deferred tax asset is recognised for the carry forward of unused tax losses or tax credits to the extent it is "probable that future taxable profit will be available."

Beyond this, we can look at other guidance and the general IASB *Framework* on which IFRS is based. In the *Framework*, an asset is recognised "when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably." Alternatively, a liability is "recognised when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably."

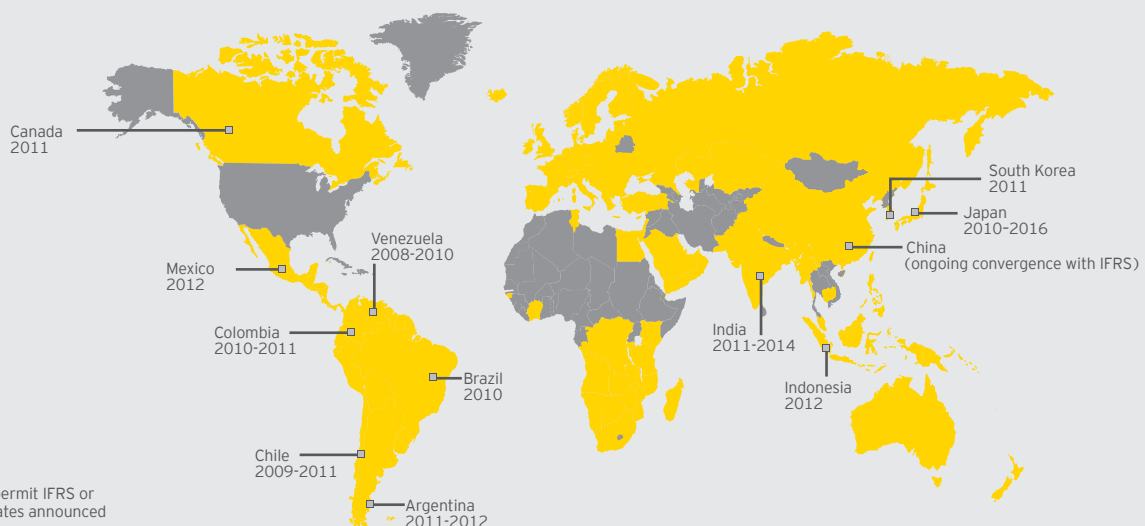
## Measurement

IAS 12 provides that tax assets and liabilities should be measured at the amount expected to be paid (or recovered), based on enacted or substantively enacted tax legislation. How tax uncertainties affect this measurement is unclear. In the absence of direct guidance, some entities apply the principles of IAS 37 to their tax provisions and tax contingencies, even though IAS 37 states that it does not apply to income-based taxes.

In the model used in the current IAS 37, there is a provision for a liability to be recognised where it is probable (more likely than not) that a present obligation exists and a reliable estimate can be made of the amount of the obligation. That provision is then measured using the "best estimate" of the expenditure required to settle the obligation. The new IAS 37 ED proposes a different model which we take a closer look at later in this paper.

## IFRS adoption around the world

Over 110 countries currently require or permit IFRS or are in the process of adopting it



Source: Ernst & Young



# Recognition and measurement in practice: one or two steps

For uncertain tax positions, an entity must make a key decision in developing any methodology as to whether to adopt a “one step” approach or a “two step” approach to the recognition and measurement of uncertain tax positions.

Under a one step approach, each uncertain tax position is recognised, but the measurement of the position reflects the likelihood that the position will crystallise. This is essentially the approach that was contained in the 2009 IAS 12 ED.

Under a two step approach, a position is recognised only if there is a certain minimum probability (usually referred to as the “recognition threshold”) that it will crystallise. This raises the linked question of whether the uncertainty relates to an asset or a liability. An uncertain tax position is very often, but not always, a tax deduction claimed by the entity, the validity or amount of which, the tax authority challenges or is expected to challenge. This raises the question of whether the uncertainty relates to the total current tax liability or to the tax asset represented by the potential deduction, if considered in isolation. This can affect the accounting analysis, since IFRS imposes a much higher recognition threshold for uncertain assets than for uncertain liabilities. In practice, most of the methods currently applied under IAS 12 implicitly regard the uncertainty as relating to the total tax liability.

Where a two step approach is adopted, the recognition threshold selected for a liability is typically “more likely than not” – i.e., more than 50%. This has doubtlessly been influenced by the “more likely than not” recognition threshold for provisions in IAS 37 described above, and by uncertain tax positions under US GAAP which has a two step approach with a “more likely than not” recognition threshold.

The one step and two step methods both attract quite passionate support. Those who favor a two step approach argue that, until a minimum recognition threshold is reached, it is not possible to make an informed estimate of the likely outcome. Those who favor a one step approach argue that the determination of whether or not a recognition threshold has been reached is, itself, highly subjective. Also, a relatively small difference in view in the estimated probability of a liability crystallising (say from 51% to 49%) may result in a disproportionate impact on the amount of tax recognised.

It could be argued that, in practical terms, the real difference between the one step and two step approaches is less whether there should be a recognition threshold than the level at which it should be set. Even where a one step approach is adopted, it might well be that no liability would be recognised where the probability of its crystallisation was very low.

Once it has been concluded that a liability needs to be recognised, an entity then needs to consider how to measure that liability. Measurement approaches vary in practice among IFRS users and include options such as a weighted average probability of outcomes (as proposed in the 2009 IAS 12 ED and the IAS 37 ED), the most likely single outcome, or an “all or nothing approach” (i.e., no liability is recognised for an uncertain position with a probability of occurrence below the selected recognition threshold and a full liability for a position with a probability of occurrence above the threshold).

The requirements for the measurement of UTPs apply to current and deferred taxes alike, since an uncertain tax position may not simply affect the amount of current tax payable or receivable. For example, where an entity has claimed a deduction for an item in its tax return that is subject to uncertainty, the uncertainty will determine not only the measurement of current tax, but also that of the tax basis of the item recorded and, therefore, will impact deferred tax as well.

## Detection risk

Practice may also vary as to whether an entity either explicitly or implicitly considers “detection risk” in its analysis of what it expects to pay. By detection risk, we mean what is the chance that a particular tax authority actually uncovers a tax position that it may consider aggressive or uncertain and challenges the entity on it? This may be for a number of reasons, such as: the tax authority may not have as much information as the entity has; or does not have the resources or time to do a comprehensive tax audit; or lacks technical expertise in international tax planning structures. IAS 12 is currently silent on whether or not detection risk can be taken into account when assessing how much the entity “expects to pay” to settle with the tax authority. However, many of the more developed taxing jurisdictions operate on a full disclosure principle, whereby entities should consider the technical merits of their issue, and not whether or not the tax authority would detect it or has the information to make their own assessment. Therefore, the fact that IAS 12 is currently silent on the issue of detection risk should be a moot point in most cases.

The IASB, apparently worried that entities may be inappropriately considering detection risk in their analysis, ensured that the 2009 IAS 12 ED explicitly stated that entities need to assume that taxing authorities will examine the amounts reported to them and have full knowledge of all relevant information. Detection risk should not be taken into account by an entity when assessing the possible outcomes of a UTP.



# Disclosure

Under IAS 12, current or deferred tax is recorded “consistent with the accounting for the transaction or event itself.” But no explanation is provided for accounting for uncertain tax positions other than that disclosure must be made “in accordance with IAS 37.”

IAS 37 describes various items for disclosure relating to provisions or contingent liabilities, including:

- ▶ Changes made to the provision in the period
- ▶ A description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits
- ▶ An indication of the uncertainties about the amount or timing of those outflows
- ▶ For contingent liabilities, an estimate of the financial effect.

IAS 37 also allows an entity not to disclose all or some of the above information, in “extremely rare cases” where such disclosures “can be expected to prejudice seriously the position of the entity in a dispute with other parties.” However, an entity taking advantage of this exemption is required to disclose the general nature of the item, and why no disclosure has been made.

Although IAS 12 states that the disclosure requirements of IAS 37 are applicable to tax uncertainties, it can be difficult to identify examples of disclosures of uncertain tax positions, which may suggest that entities are unclear as to the scope of this requirement.

The entity may also need to consider the requirement of IAS 1 – *Presentation of Financial Statements* whereby entities must disclose information about “major sources of estimation uncertainty” that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities.



# Other issues

## Interests and penalties

Another related item that may impact the entity's uncertain tax positions, and how they are accounted for, is how the entity chooses to account for tax interest and penalties.

IAS 12 is silent on whether tax interest and penalties are part of income taxes (and, therefore, accounted for under IAS 12) or not and whether they should be treated "above the line" as part of interest expense or another expense category in the financial statements. The 2009 IAS 12 ED did not propose one method over another, but stated that the entity should choose one method as an accounting policy and apply it consistently.

Generally, a tax authority will impose a charge for interest and penalties for the underpayment of tax in defined circumstances. If the amount of a tax deduction claimed on a tax return is uncertain, then presumably the potential interest and penalties on that amount (should the deduction be wholly or partially denied) would also be uncertain. If an entity chooses to treat interest and penalties as part of the tax liability, then the uncertainty of how much interest and penalties it may end up paying should be accounted for the same way that the entity accounts for other uncertainties under IAS 12. Having said that, if the interest and penalties are "above the line," then the uncertainty about them means that an entity may instead look to the principles in IAS 37 and treat them the same way that it would treat other provisions or contingent liabilities. In general, IAS 37 provides that the nature of the obligation, the uncertainty, timing and probability of outflows should be disclosed, as indicated above.

## First-time adoption considerations

The basic principle under IFRS 1 *First-time adoption of International Financial Reporting Standards* is that IAS 12, like other standards, should be applied retrospectively. There are some exceptions to retrospective application in IFRS 1 in respect of certain areas that would require judgments by management about past conditions after the outcome of the particular transactions. UTPs are one such area where assumptions need to be consistent with what was known at the time, unless the correction of an error is involved. IFRS 1 disclosures should be sufficiently detailed to enable users to understand the material adjustments to the balance sheet, income statement and statement of comprehensive income, and the entity should distinguish between the correction of errors and changes in accounting policies. The cumulative effect of a change will become part of the aggregate adjustment, if any, to retained earnings under the general principles of IFRS 1 for first-time adopters.



## Impact of the 2009 IAS 12 ED

Entities in transition to IFRS should also keep one eye on any potential future modification of IAS 12 by the IASB. As conversion is planned, the tax function must not only work on conversion to the existing standard, as previously discussed, but it needs to prepare for some possibility of a revised IAS 12 standard being re-proposed. There is a great deal of uncertainty, however, as to what any eventual revision of IAS 12 might look like. There was very little support for the 2009 IAS 12 ED and the IASB stopped the project in November 2009 for various reasons. At that time, the IASB said it wanted to refocus attention on a number of limited adjustments and improvements to IAS 12. However, the content, timing and format of those improvements remain to be seen. Entities should monitor with interest how the IASB proceeds with its goal of improving IAS 12, especially given that the ED on IAS 37 may be finalised in 2010, and that standard could influence the future direction of IAS 12, as noted below.

It is beyond the scope of this paper to compare and contrast what will need to be done if IAS 12 is slightly modified, significantly amended or replaced in the future. The IASB had attempted to address some of the issues mentioned above in the proposals in the 2009 IAS 12 ED, but other issues were not addressed, and until the IASB provides further guidance, a wide variety of practices in the accounting for UTPs will continue.



## Impact of the IAS 37 ED

The IAS 37 ED now being analysed is a combination of both the 2005 IAS 37 ED and the January 2010 re-exposure of the measurement section of that ED.

For recognition, the IAS 37 ED proposes to eliminate the explicit recognition guidance in IAS 37 and replace it with a reference to recognition inherent in the definition of a liability in the IFRS *Framework*. Therefore, there will still be a recognition threshold, but it will not be described explicitly in the new IAS 37.

For measurement, where the outflows required to fulfill an obligation are uncertain, an entity should estimate their expected value using a "probability-weighted average of the outflows for the range of possible outcomes, adjusted for the risk that the actual outflows might differ from those expected." This differs from the "best estimate" that is currently in IAS 37 and would likely lead to a different amount of liability being recognised due to the mechanics of the calculation.

The IASB acknowledged that determining the various possibilities and associated probabilities could be onerous and complex in some circumstances, so it indicated that "a limited number of discreet outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes."

For both current IFRS users and those converting to IFRS in the next few years, the key significance of the proposed changes to IAS 37 in respect of tax uncertainties is three-fold:

1) As discussed earlier, many entities using IFRS currently look to IAS 37 as a model for their uncertain tax positions absent guidance in IAS 12, so any changes to IAS 37 could mean a re-assessment of how they calculate their UTPs.

2) In their November 2009 meeting the IASB staff indicated a desire to ensure future IAS 12 guidance on UTPs is consistent with what is eventually prescribed in IAS 37. In fact, the meeting papers indicated the IASB would need to consider whether any future proposals on UTPs are consistent with IAS 37 and it would also need to "justify any inconsistencies." As such, changes to IAS 37 could be an early indicator of eventual changes to IAS 12.

3) Provisions and uncertainties for non-income based tax liabilities (such as many value-added taxes), have always come within the scope of IAS 37 rather than IAS 12, so any changes to IAS 37 would impact how those non-income based taxes are accounted for.

More detailed analysis of the 2009 IAS 12 ED proposals and the IAS 37 ED can be found at [www.ey.com/IFRS](http://www.ey.com/IFRS).



## Moving forward – leading practices for the tax function to consider

Accounting for uncertain tax positions is an area where many entities will need to expend effort. Some leading practices in approaching that effort are outlined below:

1. Entities should assess their current policy under their current national GAAP (or IFRS). The documentation of these policies should consider uncertainties for both income-based taxes to which IAS 12 applies, and non-income based taxes (for example, transactional taxes like value-added taxes) to which other standards will apply, such as IAS 37. Careful documentation of the current policy will help clarify the roadmap that management will follow in the adoption of IFRS and IAS 12, in general, and for tax uncertainties, specifically.
2. Management would then need to determine which policy will be adopted under IAS 12 as it is currently written for tax uncertainties, with consideration given to industry practice and country regulatory bodies that may influence the adoption and application of IFRS standards.
3. Once the accounting policies are defined, then the accounting and tax functions need to determine what information will be gathered and the tax process changes, if any, to be implemented in gathering that information. This is particularly important in multi-national entities with diverse business units in many different countries. Understanding whether the adoption of IFRS will cause the entity to modify its technology platform is critical for a tax department. The tax department will need to position itself to be part of that process to be sure it can obtain the tax data it needs to evaluate uncertain (and other) tax positions.
4. The ability to comply with tax reporting and disclosure requirements is affected by changes in the tax process and data gathering. The tax department should coordinate with the company's various operations around the world to agree and document roles and responsibilities for the review and evaluation of uncertain tax positions that arise in different countries and tax jurisdictions in which the entity may do business. To the extent that external regulatory bodies are involved, those regulations will need to be considered, particularly as to what needs to be disclosed in the financial statements and how it is to be disclosed.
5. Financial statements will usually present several years of information. Consistency between years past, present and future is important. Entities should understand the transition provisions in IFRS 1. Tax departments should also coordinate with their accounting function and external auditors on any matters of accounting policy change, adoption, reporting and disclosure.
6. The change in accounting for UTPs will challenge a tax department to review its preparation for tax controversy and examinations by national and local country tax authorities. How sensitive tax positions are reported and disclosed will be of interest to third-party users for a variety of reasons, and the tax function should anticipate and be prepared to respond to any inquiries.
7. Finally, the tax function and management may want to watch for any potential future proposals to change IAS 12.

# Conclusion

Accounting for tax uncertainty has never been easy, regardless of which taxing jurisdictions the entity interacts with around the world, and the generally accepted accounting standards that have been applied. With the adoption of IFRS, it is not likely to get any easier. In the absence of specific guidance, the tax function must consider the alternative approaches and determine a consistent and well-documented policy for dealing with UTPs under IAS 12 as it is currently applied. At the same time, it must keep an eye on the future, recognising the IASB's desire to eventually change IAS 12.



# Contacts

Name	Location	Role	Telephone	Email
<b>Global IFRS Tax services</b>				
Geoffrey C. Koslov	Houston, United States	Global Tax – IFRS Leader	+1 713 750 1475	geoffrey.koslov@ey.com
Charles Chaho	London, United Kingdom	Global Tax – IFRS Center	+44 207 980 0464	charles.chaho@uk.ey.com

<b>Global Tax Accounting and Risk Advisory Services area leadership team</b>				
Andrew Lee	Warsaw, Poland	Global TARAS and EMEA TARAS Leader	+48 22 557 7510	andrew.lee@pl.ey.com
Carolyn Colias	Houston, United States	Americas Leader	+1 713 750 1530	carolyn.colias@ey.com
Chester Abell	Washington DC, United States	US National Director of Tax Accrual and IFRS Services	+1 202 327 5695	chester.abell@ey.com
David L. Williams	Sydney, Australia	Oceania Leader	+612 9248 5606	david.l.williams@au.ey.com
Bruce W. Miller	Tokyo, Japan	Japan Leader	+813 3506 2422	bruce.w.miller@jp.ey.com
Choong San Lee	Kuala Lumpur, Malaysia	Far East Leader	+603 2087 4417	choong-san.lee@my.ey.com

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