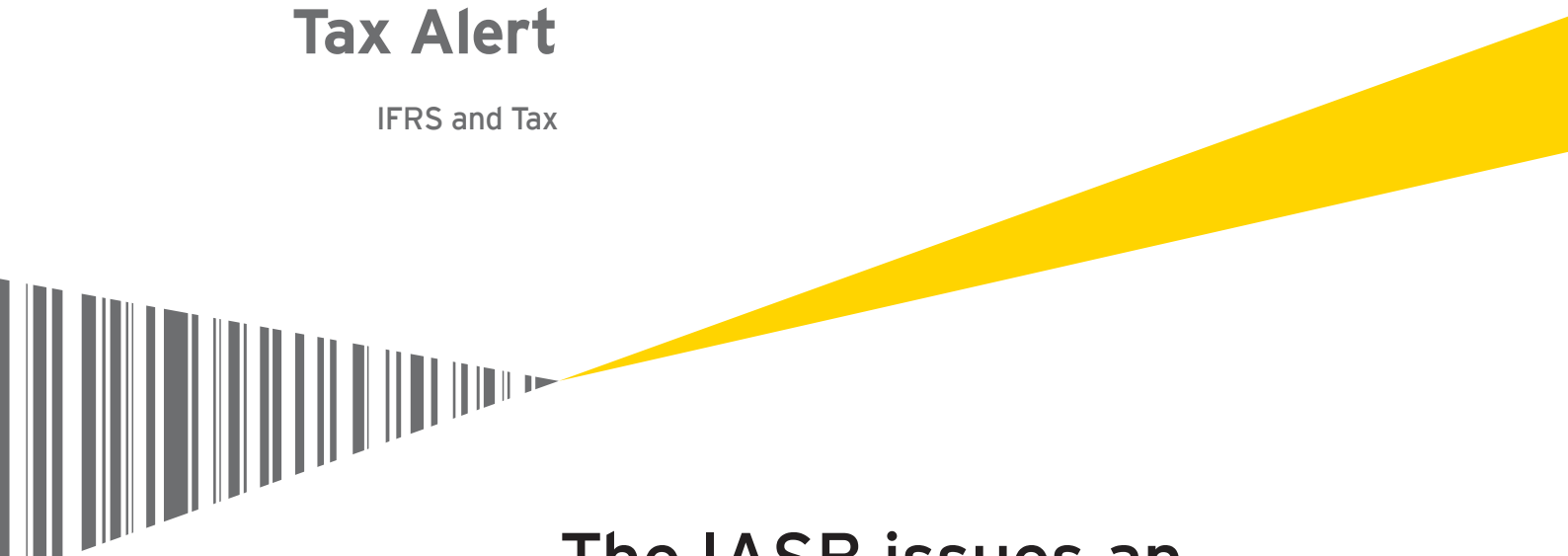


Tax Alert

IFRS and Tax



The IASB issues an Exposure Draft to replace IAS 12 (Income Taxes)

Background

On 31 March 2009, the International Accounting Standards Board (IASB) published an Exposure Draft (ED) of a new International Financial Reporting Standard (IFRS) to replace International Accounting Standards 12, *Income Taxes* (IAS 12). Comments are invited, to be received by 31 July 2009. After the comment period, the IASB will then decide to either issue the new standard or take another course of action.

The IASB's project on income taxes originally was a joint project with the US Financial Accounting Standards Board (FASB), undertaken as part of a short-term convergence project aimed at eliminating differences between US GAAP and IFRS.

Accounting for income taxes seemed an ideal topic for convergence. IAS 12 is based on the temporary difference approach as is FASB Standard No. 109, *Accounting for Income Taxes* (Statement 109) and both Boards agreed not to reconsider this approach in this project. However, the project proceeded rather slowly and the FASB announced last year that it had 'suspended indefinitely' its deliberations on the income taxes project. The FASB is expected to solicit input from constituents using US GAAP by issuing an *Invitation to Comment* that contains the IASB's ED. It will then decide whether to undertake a project to eliminate the remaining differences in the accounting for taxes by adopting the proposed new IFRS standard.

Continued overleaf ►

In developing Statement 109 and IAS 12, the FASB and the International Accounting Standards Committee (IASC - the IASB's predecessor) both independently concluded that it would be undesirable to recognise deferred tax on all temporary differences. Accordingly, both standards contain exceptions to their general recognition principle (i.e., that deferred taxes be recognised on all temporary differences). The real challenge for the project, in our view, has been that the exceptions in IAS 12 are quite different from those in Statement 109, which has made it more difficult than expected to bridge the gaps between the two standards in the proposed revision to IAS 12. Thus, while the ED does propose to eliminate some of the differences between IAS 12 and Statement 109, other differences will remain.

Summary of proposed changes

The ED proposes numerous changes to IAS 12, principally affecting:

- ▶ Definitions of 'tax basis' and 'temporary difference'
 - ▶ Exemptions to the temporary difference approach
 - ▶ Elimination of the initial recognition exemption
- ▶ Changes to the application of the temporary difference approach to investments in subsidiaries, branches, and associates, and interests in joint ventures
- ▶ Recognition of deferred tax assets
- ▶ Measurement of deferred tax assets and liabilities
- ▶ Allocation of tax to components of other comprehensive income or equity ('backward tracing')
- ▶ Balance sheet classification
- ▶ Uncertain tax positions
- ▶ Definitions of tax credit and investment tax credit
- ▶ Significant disclosures
- ▶ Other miscellaneous changes
- ▶ Transitional and first-time adoption provisions

Definition of 'tax basis' and 'temporary difference'

The temporary difference approach essentially measures deferred taxes by reference to the carrying amounts of assets and liabilities in the financial statements and the amount at which they would be carried in notional financial statements prepared by applying the accounting requirements implicit in tax legislation. The carrying amount of an asset or liability in the notional financial statements prepared using fiscal accounting principles is known as the 'tax base' or 'tax basis'.

IAS 12 currently defines the tax base of an asset as the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. The entity's expectation as to the manner in which it will recover the carrying amount of an asset or settle the carrying amount of a liability can affect the tax base. For example, if an entity would pay a different amount of tax depending on whether an asset is consumed in the business or sold, the entity measures deferred tax according to the expected method of realisation. This effectively makes deferred tax a function of management's intent, which the IASB has striven to eliminate from other areas of financial reporting.

The ED proposes to change the definition of a tax base to 'the measurement, under applicable substantively enacted tax law, of an asset, liability or other item'. (The ED also renames it 'tax basis' - the current Statement 109 term). Tax basis is the amount determined under tax law applicable to the asset, liability, or equity instrument, whether or not that item is recognised for financial reporting. The tax basis of an asset is determined by the tax consequences that would arise if it were recovered for its carrying amount through sale at the reporting date. The tax basis of a liability is determined by the tax consequences that would arise if it were settled for its carrying amount at the reporting date. This change eliminates from the determination of tax basis the entity's expectation as to manner of recovery of an asset (or settlement of a liability).

IAS 12 currently defines a temporary difference as the difference between the carrying amount of an item and its tax base. The ED redefines a temporary difference as difference between the carrying amount of an item and its tax basis that the entity expects will affect taxable profit when the carrying amount of the related asset or liability is recovered or settled (or, in the case of items other than assets or liabilities, will affect taxable profit in the future). In effect, this means that, while the entity's intentions do not determine the tax basis, they, nevertheless, determine the measurement of deferred tax in some cases, so that the IASB has not been able to remove management intent from the picture entirely.

Exemptions to the temporary difference approach

Initial recognition exception

IAS 12 currently requires a deferred tax asset or liability to be recognised for all deductible or taxable temporary differences, except for:

- ▶ a deferred tax liability arising from the initial recognition of goodwill; or
- ▶ a deferred tax asset or liability arising from the initial recognition of an asset or liability in a transaction which is not a business combination, and at the time of the transaction affects neither accounting profit or loss nor taxable profit or loss.

This 'initial recognition exception' (IRE) - as it has generally become known - appears somewhat arbitrary, but essentially, it is a pragmatic solution to what were seen as inappropriate accounting consequences of a strict application of the temporary difference approach.

For example, if an entity acquired a non-deductible building, a 'pure' temporary difference approach would require a deferred tax liability to be recognised on its carrying amount. The result would be either immediate recognition of tax expense or an adjustment of the real cost of the asset to the notional cost that would have been paid for an equivalent, but fully tax-deductible, asset (the approach broadly required under US GAAP). The former International Accounting Standards Committee (IASC) saw both these outcomes as undesirable.

The ED's proposals in this area are complex. The IASB has concluded that the initial recognition exception could no longer be justified conceptually. On the other hand, it clearly wanted to avoid the accounting consequences which the exemption seeks to prevent. Accordingly, the 'initial recognition exception' is abolished, with deferred tax being recognised on all temporary differences, whenever they arise, except that a deferred tax liability should not be recognised on the initial recognition of goodwill.

Where a temporary difference arises on the initial recognition of an asset or liability, the asset or liability should be disaggregated into:

- ▶ the asset or liability, excluding any entity-specific tax effects; and
- ▶ the entity-specific tax effects - broadly, the extent to which the tax treatment of an item in the hands of the entity places the entity in a better or worse position than taxpayers as a whole.

The former amount becomes the carrying amount of the asset or liability. Deferred tax is recognised on any temporary difference arising from this carrying amount.

Where an asset or liability is recognised, other than in a business combination or in a transaction that affects comprehensive income, equity or taxable profit, the entity also recognises a premium or allowance (the difference between the amount paid for an asset, or received for a liability, and its carrying amount together with any associated deferred tax asset or liability). Such a premium or allowance is offset against the deferred tax balance.

The impact of this, in net terms, is that the former initial recognition exception is retained, in the sense that any deferred tax recognised on initial recognition of an asset or liability, other than in a business combination or a transaction that affects comprehensive income, equity or taxable profit, is immediately offset by a premium or allowance.

Investments in subsidiaries, branches, and associates, and interests in joint ventures

IAS 12 currently requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied: (a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and (b) it is probable that the temporary difference will not reverse in the foreseeable future. A deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates,

and interests in joint ventures, is not recorded, except to the extent that, and only to the extent that, it is probable that: (a) the temporary difference will reverse in the foreseeable future; and (b) taxable profit will be available against which the temporary difference can be utilised. The recognition of a deferred tax asset also would be subject to the rules in IAS 12 for recognition of a deferred tax asset discussed further below.

The ED proposes that an entity should recognise a deferred tax asset or liability for any temporary difference associated with an investment in a subsidiary, an associate or an interest in a joint venture except for a difference relating to an investment in a foreign subsidiary and or foreign joint venture that is essentially permanent in duration, and it is apparent that the temporary difference will not reverse in the foreseeable future. There is no exception for an investment in an associate, thus an entity should recognise a deferred tax asset or liability from that investment.

Temporary differences on tax branches are to be treated in the same way as those on subsidiaries.

Recognition of deferred tax assets

IAS 12 currently requires a deferred tax asset to be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. IAS 12 also requires an entity to re-assess, and where appropriate recognise, previously unrecognised deferred tax assets at each balance sheet date. A deferred tax asset is not reported gross, less a 'valuation allowance', as is required under Statement 109, but as a net amount.

The ED proposes to change how deferred tax assets are recognised and disclosed in the financial statements as follows:

- ▶ An entity recognises a deferred tax asset for all temporary differences that are expected to reduce taxable profit in the future and for unused tax losses.
- ▶ A valuation allowance is then recognised, where necessary, to reduce the net carrying amount of deferred tax assets to the highest amount that is more likely than not to be realisable against taxable profit.

Deferred tax assets that were previously not recorded under IAS 12 will now have to be recorded with offsetting valuation allowances. This change affects presentation and disclosure rather than comprehensive income or equity.

It is important to note that the use of the word 'probable' in IAS 12 with respect to recognition of deferred tax assets has been dropped in the ED in favor of the term 'more likely than not'. Although 'probable' is defined to be 'more likely than not' in other standards, such as IAS 37, it had not been defined in IAS 12, and the IASB felt that this lead to some jurisdictions which use IFRS attributing a higher likelihood to 'probable' than 'more likely than not'.

Measurement of deferred tax assets and liabilities - tax rates

Enacted or substantively enacted tax rates and laws

Applying a liability method of accounting for income taxes (such as the temporary difference approach) requires multiplying the cumulative temporary differences by the tax rate expected to apply to taxable income in the periods in which the deferred tax liability is expected to be settled or deferred tax asset realised.

IAS 12 currently requires an entity to measure its tax assets and liabilities at the tax rates that are expected to apply to the period when the assets are realised or the liabilities settled based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

The ED proposes that tax assets and liabilities should be measured using 'substantively enacted' tax rates and laws. The ED notes that, in some jurisdictions (including the US tax jurisdiction), substantive enactment is achieved only on enactment. In other jurisdictions, actions by the government relating to tax rates and tax laws have the substantive effect of actual enactment. An entity should regard tax rates as substantively enacted when future events required by the enactment process historically have not affected the outcome and are unlikely to do so.

Distributed or undistributed tax rates

Certain jurisdictions tax corporate income at different rates depending on whether or not it is distributed to the entity's shareholders. IAS 12 currently requires the use of the tax rate applicable to undistributed profits in measuring tax assets and liabilities. The ED proposes that an entity should take into account, and disclose, expectations regarding future distributions and the ability to make distributions in determining the applicable tax rate to use (i.e., use the distributed rate for profits that are expected to be distributed; otherwise, use the undistributed rate).

Allocation of tax to components of comprehensive income or equity ('backward tracing')

IAS 12 currently requires current tax and deferred tax to be charged or credited in other comprehensive income (OCI) or directly in equity if the tax relates to items that were credited or charged, whether in the current or previous period, in OCI or directly in equity. Subsequent changes to those amounts, that may be caused by factors such as changes in assessments of recovery of deferred tax assets or changes in tax rates, laws, or other measurement attributes, are also allocated to OCI or equity as applicable. This is commonly referred to as 'backward tracing'. Items recognised directly in other comprehensive income may include unrealised gains or losses on available for sale financial instruments, fair value

movements associated with cash flow hedges, actuarial gains and losses and exchange differences arising on translation of the financial statements of a foreign operation. Items recognised directly in equity comprise transactions with shareholders, such as dividend payments, share-based payment transactions and the raising of equity capital, together with any associated costs.

The ED proposes that any change to a tax asset or liability, including the remeasurement of an uncertain tax position, relating to an item accounted for in an earlier period should, with the exception of some changes to valuation allowances for deferred tax assets, be recognised in profit or loss, without any backward tracing. However, the current requirement for 'backward tracing' of share-based payment transactions is retained (i.e., any tax deduction received in excess of the cumulative expense for an award is accounted for in equity).

As for the allocation of current and deferred tax to components of comprehensive income and equity, IAS 12 does not currently provide guidance. The ED explains how tax expense is to be allocated between continuing operations, discontinued operations, items in other comprehensive income or equity. In essence, the method is a 'with and without' approach whereby the tax expense arising from items recognised outside continuing operations is calculated as the difference between the total tax expense including and excluding the tax effect of those items.

Unusually, the ED also presents for comment an alternative method of allocation not proposed by the Board, based on the current standard, but with more specific guidance than in the current standard on the methodology of allocation between components. The IASB 'does not propose to adopt' this alternative approach but, nevertheless, seeks commentators' views on it.

Balance sheet classification

IAS 1 *Presentation of Financial Statements* currently requires all deferred tax assets and liabilities to be classified as non-current, regardless of the classification of the underlying asset and liability giving rise to the temporary difference.

The ED proposes to amend IAS 1 and require the classification of deferred tax assets and liabilities to be consistent with the underlying asset or liability. A deferred tax asset or liability not related to a recognised asset or liability (such as a deferred tax asset relating to an unused tax losses or tax credits) should be classified as current or non-current depending on when the entity expects the temporary difference to reverse.

Uncertain tax positions

IAS 12 currently does not explicitly address the recognition and measurement of uncertain tax positions. However, it notes that, while IAS 37 generally excludes income taxes from its scope, its principles are relevant to the disclosure of tax-related contingent assets and contingent liabilities, such as unresolved disputes with taxing authorities. Since there is no direct guidance on this topic in IAS 12, there are some variations on how entities currently account for uncertain tax positions in practice.

The ED proposes comprehensive new guidance on uncertain tax positions, which draws on the principles underlying the IASB's liabilities project.

For recognition, an entity with an uncertain tax position has a stand-ready obligation to pay tax, the amount of which is uncertain. No probability threshold should be applied to the recognition of the stand-ready liability. This means that an entity needs to look at, and measure, all its uncertain tax positions.

For measurement, an entity is to use the probability weighed average amounts of possible outcomes, assuming the tax authorities will examine the amounts reported to them, and have full knowledge of all relevant information. In other words, 'detection risk' should not be taken into account by the entity. The requirements for the measurement of uncertain tax positions 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 which 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, deferred tax.

For disclosure, the ED proposes that entities should disclose information about the major sources of estimation uncertainties relating to tax effects to enable users to assess the possible financial effects of the estimation uncertainties and their timing (for example, the effects of unresolved disputes with the tax authorities), including:

- ▶ a description of the uncertainty; and
- ▶ an indication of its possible financial effects on amounts recognised for tax and the timing of those effects.

This would require disclosure of estimation uncertainty in respect of both recognised and unrecognised tax assets and liabilities.

In addition, entities would disclose the effect on deferred tax expense of any change in the effect of the possible outcomes of a review by the tax authorities.

The ED notes that IAS 10 *Events after the Reporting Period* already requires disclosure of the effect of tax rates or tax laws substantively enacted after the end of the reporting period on its current and deferred tax assets and liabilities.

The proposed changes in the ED regarding the accounting and reporting of uncertain tax positions would bring greater uniformity to how these uncertainties are reported under IFRS. These proposals, which also greatly increase the disclosures required for what are typically sensitive issues, may prove one of the most contentious aspects of the ED

Definitions of tax credit and investment tax credit

IAS 12 currently does not define tax credits or investment tax credits. Current practice for accounting for such credits varies, but entities typically draw guidance from either IAS 12 or IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, depending on the nature of the credit.

The ED proposes to bring tax credits and investment tax credits within the scope of the income tax standard. The proposed definition of tax credit is a tax benefit that takes the form of an amount that reduces income taxes payable. An investment tax credit is defined as a tax credit that is directly related to the acquisition of depreciable assets.

Other miscellaneous changes

Alternative taxing systems

IAS 12 currently does not address the impact on tax rates that may be caused by the alternative tax systems that exist in certain jurisdictions (e.g., the US alternative minimum tax).

The ED proposes that an entity required to pay taxation based on one or more tax systems should determine the applicable tax rate in a manner consistent with the tax law, giving consideration to any interaction between the two systems.

Changes to the tax status of an entity

Accounting for changes to the tax status of an entity (i.e., a taxable entity becoming non-taxable and vice versa) is currently not addressed by IAS 12, but in Standards Interpretation Committee Interpretation 25 *Income Taxes - Changes in the Tax Status of an Entity or its Shareholders* (SIC-25).

The ED proposes to incorporate the requirements of SIC-25 directly into IAS 12. It would also add guidance (derived from Statement 109) that the effect of an election for a voluntary change in tax status is recognised on the approval date or, if approval is not necessary, on the filing date of the final required document. The effect of a change in tax status that results from a change in tax law is recognised on the date the tax law is substantively enacted.

Allocation of current and deferred taxes to entities within a group filing a consolidated tax return

IAS 12 does not currently address the allocation of current and deferred taxes to individual entities within a group that file a consolidated tax return. The ED requires such an allocation to be made, but without prescribing a single method for doing so. However, the method chosen should be systematic, rational, and consistent with the broad principles of the new standard. This could include a method that allocates current and deferred taxes by applying the standard to each member of the group as if it were a separate taxpayer on a basis consistent between years. The ED also lists examples of allocation methods that would not be acceptable.

Accounting policy decisions

The ED also explains that an entity will make accounting policy decisions on the classification of exchange differences on foreign tax liabilities and assets as well as the classification of interest and penalties.

Significant disclosures

The ED proposes several changes to the disclosures required by IAS 12, including:

- ▶ New disclosure showing a numerical reconciliation of the opening and closing amounts of deferred tax assets and liabilities, for each type of temporary difference and for each type of unused tax credits and tax losses.
- ▶ Clarification on the disclosure to reconcile actual to expected tax rate. IAS 12 currently requires a reconciliation of the actual to the 'expected' tax charge and/or rate, but does not specify the 'expected' rate to be used. The ED proposes that 'expected' tax charge or rate should be based on the 'applicable tax rate', being the rate of tax in the country in which the entity is domiciled, aggregating the tax rate for national taxes with the rates for any local taxes that are computed on a substantially similar level of taxable profit. Any changes in the expected rate from the previous reporting period should be explained.
- ▶ Additional disclosure of the tax effect of an intercompany transfer of assets between taxing jurisdictions with different effective tax rates (for example, an intragroup sale of inventory), or of the modifications of such an arrangement.
- ▶ New disclosure where public entities are not subject to income taxes because their income is taxed directly to their owners (e.g., partnerships). They now must disclose that fact and the difference between the tax basis and the carrying amounts of assets and liabilities.
- ▶ New disclosure of the effect on deferred tax expense of any change in the effect of the possible outcomes of a review by the tax authorities.
- ▶ New disclosure of any change in the tax status of an entity.
- ▶ New disclosure of any tax benefits allocated directly to contributed capital or goodwill. The reference to this disclosure is found in the *Basis of Conclusion* document which supplements the ED, but the disclosure is not in the body of the ED itself. This may indicate the IASB had intended this disclosure to be directly in the ED.
- ▶ New disclosure where an entity is a member of a group that files a consolidated tax return. The entity should disclose in its individual or separate issued financial statements (or the consolidated financial statements of its sub-group) the amount any tax related balances with other members of the group. It should also disclose the principal provisions of the method used to allocate tax expense within the group, and any changes in that method during the periods presented.
- ▶ Removal of the current requirement to disclose the amount of a deferred tax asset and evidence supporting its recognition in situations where the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences and the entity has suffered a loss in either the current or the preceding period in the tax jurisdiction to which the deferred tax asset relates.

Transitional and first-time adoption provisions

Existing IFRS preparers are generally required to apply the proposed new standard retrospectively. The resulting net change in assets and liabilities will be recorded as an adjustment to retained earnings. However, the new requirements for the allocation of tax to components of profit or loss, OCI or equity must be applied prospectively from the date of the first opening statement of financial position. Where deferred tax has not been recognised on items due to the initial recognition exception, the new requirements that replace the initial recognition exception are applied as if the items concerned had been acquired for their carrying amounts outside a business combination at the date of the first opening statement of financial position.

Entities transitioning to IFRS are generally required to apply the proposed new standard retrospectively. However, the new requirements for the allocation of tax to components of profit or loss, OCI or equity must be applied prospectively from the date of transition to IFRS. Moreover, entities with a transition date before the date on which any final standard is issued may apply the current IAS 12 for periods presented that begin before that date.

A first-time adopter of IFRS may apply the new requirements that replace the initial recognition exception with full retrospective effect. Alternatively, it may disaggregate an asset or liability into an amount excluding any entity-specific tax effects and the entity-specific tax effects as at the date of transition to IFRS.

Business impact

The proposed amendments will affect virtually all tax-paying entities, given the pervasiveness and materiality of income tax items on the financial statements. Entities will need to assess the effects of these amendments across the entire spectrum of their tax life cycle – tax planning, tax provision/tax accounting, tax compliance and tax controversy. Adjustments may need to be made to an entity's tax processes, technology, internal controls, and training of its people with the adoption of a new income tax standard. Entities should also analyse the potential impact of the proposals on their effective tax rate. For example, the removal of backward tracing could increase volatility in the effective tax rate as the remeasurement of the tax effects of prior year items is recognised in profit and loss instead of in other comprehensive income or equity.

Apart from the financial statement impacts of this ED, entities must be particularly cognizant of the impact on their data gathering and record-keeping. For example, the introduction of the concept of valuation allowances to offset deferred tax assets will require additional tracking and documentation. Likewise, the proposals in the ED surrounding the accounting for and disclosure of uncertain tax positions will have far-reaching data gathering, documentation, and support implications to the entity as well as affect an entity's dealings with tax authorities worldwide.

Ernst & Young can help

Please call your local Ernst & Young representative or contact one of our Global IFRS Tax or Tax Accounting and Risk Advisory Services leaders below.

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