



Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

17 November 2010

Dear Kevin

Exposure Draft 204 *Deferred Tax: Recovery of Underlying Assets*

I am enclosing a copy of the PwC response to the International Accounting Standards Board's exposure draft ED/2010/11 *Deferred Tax: Recovery of Underlying Assets (Proposed amendments to IAS 12)*. The letter reflects the views of the PricewaterhouseCoopers network of firms and as such includes our own comments on the matters raised in the exposure draft.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (03) 8603 3868 if you would like to discuss this further.

Yours sincerely

A handwritten signature in cursive script that reads 'Jan McCahey'.

Jan McCahey
Partner
Assurance



Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

9 November 2010

Dear Sir

Deferred tax: Recovery of underlying assets (Proposed amendments to IAS 12)

We are pleased to respond to your exposure draft 'Deferred Tax: Recovery of Underlying Assets (Proposed amendments to IAS 12)' ('the exposure draft' or 'the proposals') on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of the member firms that commented on this Exposure Draft. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Overall comments

The existing model for income tax accounting is complex and preparers and users find some aspects of the model difficult to understand and apply. These difficulties arise from exceptions to the principles in the current standard, and from areas where the accounting does not reflect the economics of transactions. We support the Board's efforts to address some of these issues in a way that provides more useful financial information, and we welcome the opportunity to comment on the exposure draft in that context. We also encourage the Board to undertake a far-reaching review of the principles for deferred tax accounting when the timetable allows. This review should address situations in which the current accounting does not reflect the underlying economics – for example, the requirement that deferred taxes are not discounted.

There are circumstances where the requirement to recognise deferred tax on assets measured at fair value – for example, long leasehold investment property - does not reflect the economic consequences of recovering the asset. It is also sometimes difficult to measure deferred taxes in a way that reflects the manner in which management expects to recover the carrying value of the underlying asset, particularly in jurisdictions where income and capital gains are taxed separately.

The exposure draft addresses these valid issues but also creates an exception that will not reflect the economic consequences of some transactions – for example, when an asset is recovered substantially but not entirely through use. We are also concerned that exceptions can create further problems and the risk of unintended consequences.

We therefore do not support the specific proposals in the exposure draft. We have suggested below an alternative approach that we believe addresses valid concerns with the current model in a way that reflects the economic consequences of recovering an asset measured at fair value but also minimises the risk of unintended consequences.

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We have also suggested that the practical difficulties that sometimes arise when the current standard is applied to long-lived assets be addressed through enhanced application guidance.

Tax consequences of recovery

We support the principle in the current standard that deferred taxes reflect the tax consequences of the manner in which management expects to recover the carrying value of an asset. This will usually reflect the underlying economics. There are limited circumstances where this accounting will not reflect the economics; these are described below. We therefore support a narrower exception for these situations.

We believe that IAS 12 should be amended by extending the existing initial recognition exception to include situations where assets are measured at fair value as an accounting policy choice and an acquirer would not obtain a tax deduction for some or all of the cost of the asset. This will limit the exception to situations in which the accounting does not reflect the underlying economics and will limit the possibility for unintended consequences.

The fair value of an asset reflects the present value of the future net of tax cash flows generated by using or selling the asset. In many jurisdictions, an acquirer is able to deduct the cost of an asset against the taxes it will pay on the income generated by the asset. The fair value of the asset in these situations will reflect both the tax deduction that would be obtained by a market participant on the cost (fair value) of the asset and the taxes it will pay on future income. These effects will often offset. When the fair value of an asset increases, the current owner will not benefit from a tax deduction on the fair value uplift, and the deferred tax liability required under the current model properly reflects the tax consequences of recovering the asset for its fair value.

There are some jurisdictions, however, in which an acquirer cannot deduct the cost of the asset against the income from using the asset. The fair value of the asset in this situation will reflect the present value of future cash flows, net of future tax payments. We agree that the current model may not reflect the economic consequences of recovering the carrying value in these circumstances. When the asset is measured at fair value, the deferred tax liability duplicates a tax consequence that is arguably already reflected in the fair value. The current owner of the asset is in the same position as a potential acquirer because neither of them will obtain a tax deduction for fair value of the asset.

Our suggestion is broadly consistent with an approach developed by the IASB staff when they first considered this issue. We have included as Appendix 2 some suggested amendments to the text of the current standard and an additional example that reflect our suggestion.

Enhanced application guidance

We do not support the specific proposals in the exposure draft, but we agree there are sometimes practical difficulties applying the current standard. We suggest that the practical difficulties that arise when an entity has to determine the manner in which it expects to recover a long-lived asset are addressed through more detailed application guidance rather than the proposed exception. This would address the practical difficulty across all of the assets that are affected but would not create additional issues. The application guidance might consider an entity's business model, history of selling assets and its plans for the future. There should be clear disclosure of the significant assumptions made to determine deferred taxes.



It is sometimes difficult to determine whether a long-lived asset such as an investment property will be sold or used to generate rental income. This can make the deferred tax accounting difficult. The exposure draft addresses this issue and simplifies the accounting; however, we are concerned the proposal would not reflect the economics and would understate liabilities when management intends to use the asset for a prolonged period, even if it is not clear that all of the carrying value will be consumed through use. We are aware, for example, that there are some jurisdictions where a tax deduction is available when an asset is sold, but there is no deduction when an asset is used. The proposals would understate liabilities when these assets are used in the business and measured at fair value.

The proposals apply only to certain assets measured at fair value and to certain assets measured at fair value in a business combination. The same issues arise from other assets measured at fair value as well as from long-lived assets measured at depreciated cost. It is not clear why the proposed exception should apply only to certain assets and only to assets measured at fair value. It is also unclear why the recognition of a liability in purchase accounting should be determined by an accounting policy applied to certain assets.

The proposals will also make accounting for deferred tax assets more complex. An entity that uses deferred tax liabilities as a source of taxable income to support the recognition of deferred tax assets might assume it will hold an asset just long enough to generate income sufficient to recover its deferred tax assets. The proposals would require the entity to either derecognise the deferred tax asset, to be consistent with the accounting for the deferred tax liability, or continue to recognise the deferred tax asset, supported by future tax consequences that are not recognised as a liability. It is not clear how either approach reflects the underlying economics.

Comprehensive review of accounting for income taxes

When the current limited project is completed, we encourage the board to perform a more comprehensive review of the income tax model. This review should consider all options and changes that might improve the usefulness and transparency of income tax accounting by making it easier understand the tax consequences of transactions and the impact of income taxes on future cash flows. We suggest the board solicits fresh views from preparers and users about the information they would find most useful and about challenges with the existing model, such as whether or not deferred taxes should be discounted.

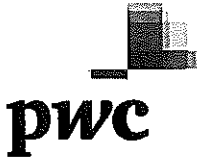
We have responded to the specific questions raised in the Invitation to Comment in the exposure draft in an appendix to this letter.

If you have any questions in relation to this letter, please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 207 804 2497) or Tony de Bell (+44 207 213 5336).

Yours faithfully

A handwritten signature in cursive script that reads "PricewaterhouseCoopers LLP".

PricewaterhouseCoopers LLP



Deferred tax: Recovery of underlying assets (proposed amendments to IAS 12)

Appendix 1

Response to detailed questions

1. Do you agree that this exception should apply when the specified underlying assets are remeasured or revalued at fair value? Why or why not?

We do not agree with the specific proposals in the exposure draft. We agree that the existing principle should be amended so the accounting properly reflects the underlying economics. We believe, however, that the proposed exception is too broad for the reasons explained in the attached letter. We suggest that the exception is narrowed so that it applies only to assets measured at fair value as an accounting policy choice in jurisdictions in which any acquirer of the asset would not obtain a tax deduction for some or all of the cost of acquiring the asset.

2. Do you agree with the underlying assets included within the scope of the proposed exception? Why or why not? If not, what changes to the scope do you propose and why?

We believe the proposed exception should be narrowed as described above.

If the board proceeds with the proposed amendments, we do not support a broader scope, as this could have unintended consequences and the exception is designed to address a specific practical issue. The board should articulate why the exception does not apply to other assets measured at fair value and long-lived assets such as investment properties measured at depreciated cost; why it applies only to certain assets acquired in a business combination; and how an entity should consider the criteria for recognising deferred tax assets.

3. Do you agree with the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale when the exception applies? Why or why not? If not, what measurement basis do you propose and why?

We do not generally believe that setting a rebuttable presumption is consistent with principles-based standards. The rebuttable presumption is also inconsistent with many other aspects of IAS 12, which require consideration of management's intentions and expectations. It might also be inconsistent with other management assumptions and assertions related to the same asset. We therefore do not agree in this situation that the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale necessarily reflects the economic consequences of recovering the carrying value.

Where management has a specific plan to use an asset covered by the proposed exception for a period of time and then sell it, the proposed exception disregards the economic consequences of this intention and requires deferred tax to be measured on a sale basis. The exposure draft will therefore result in some deferred taxes that do not reflect the future tax consequences of management's intentions. It will also result in an accounting outcome that is inconsistent with the expected economic consequences when management intends to sell the asset at some point in the



future but does not have a specific plan, or when management's current intention is to use the asset for the foreseeable future, but the foreseeable future is less than the life of the asset.

If the amendment proceeds, we suggest that the board clarifies, perhaps by way of illustrative examples, what is meant by "clear evidence that an entity will consume the asset's economic benefits throughout its economic life."

4. Do you agree with the retrospective application of the proposed amendments to IAS 12 to all deferred tax liabilities and deferred tax assets, including those that were recognised in a business combination? Why or why not? If not, what transition method do you propose and why?

We agree that any amendments made to IAS 12 should be applied retrospectively to all deferred tax liabilities and deferred tax assets so that meaningful comparative information is available to users of the financial statements.

However, the information required to restate past business combinations may no longer be available to many entities. It may therefore be impractical to determine the effect of the restatement on goodwill and on each component of equity at the beginning of the earliest comparative period. We suggest that the proposed amendments include transition provisions that permit retrospective application with some modifications, which we have described below.

Where the amendment is applied to the measurement of deferred tax on investment properties acquired in a business combination and full restatement is impractical, entities should be permitted to adjust opening retained earnings for the full amount of the restatement.

Where the amendment is applied to the measurement of deferred tax on property, plant and equipment or intangible assets acquired in a business combination and full restatement is impractical, entities should be permitted to first adjust the revaluation reserve and, to the extent that the adjustment to deferred tax is in excess of the tax on post-acquisition movements in the revaluation reserve, to adjust retained earnings.

5. Do you have any other comments on the proposals?

Application to business combinations

Paragraph BC 16-17 of the exposure draft would effectively result in two identically situated companies – both acquiring a target company with the same property, plant and equipment with the same fair values – recognising different amounts of deferred taxes and goodwill based solely on the post-acquisition accounting policy of revaluing its assets or using the cost method. We do not believe this reflects the economics of the transaction and would erode comparability between entities.

Impact on recoverability of deferred tax assets

Paragraph BC25 of the exposure draft explains that the amendments may lead to a reduction in deferred tax liabilities and might call into question the recoverability of deferred tax assets. Paragraph BC26 of the exposure draft notes that IAS 12 requires an entity to recognise a deferred tax asset to the extent that it has sufficient temporary differences *or probable future taxable profits (including those created by tax planning opportunities)* to support recognition [emphasis added].



This is not clear, but it suggests that an entity might recognise deferred tax assets based on the expected taxable profits that reflect management's expectations (that is, use of an asset for a period of time prior to sale) but the measurement of deferred tax liabilities will ignore these expectations. This is inconsistent and does not appear to reflect the economics of the transaction.

Withdrawal of SIC 21

The proposed amendments will supersede SIC-21 'Income Taxes – Recovery of Revalued Non-Depreciable Assets' (SIC-21), as the measurement of deferred tax on revalued non-depreciable assets is now covered by the proposed amendments.

We are aware that many entities apply the rationale in SIC-21 by analogy to circumstances other than land carried at fair value. For example, entities in some jurisdictions apply SIC-21 by analogy to intangible assets with indefinite lives to support non-recognition of a deferred tax liability arising in a business combination.

The impact of the withdrawal of SIC-21 on accounting for deferred tax in these circumstances is unclear. We do not support the withdrawal of SIC-21 without further consideration and we suggest that entities are permitted to continue to apply the rationale in SIC-21 by analogy; that is, any exception to the principles in IAS 12 should not inadvertently preclude entities from applying the rationale in SIC-21 to similar circumstances.

Changes in accounting policies

The exposure draft does not explain how the accounting for the deferred tax consequences of a change in accounting policy for property, plant and equipment or intangible assets. IAS 16 and IAS 38 require that the change in accounting to adopt the revaluation model is treated as a revaluation in the year of change, but it is not clear how the tax consequences would be recognised. We suggest that this is clarified.



Deferred tax: Recovery of underlying assets (proposed amendments to IAS 12)

Appendix 2

Proposed amendments to IAS 12, 'Income Taxes'

A new sub-paragraph (c) might be added to paragraph 15 and, a new sub-paragraph (b) might be added to paragraph 24, together with some explanatory text. Example X (based on Example B in the current standard) is added to illustrate the amendment.

Taxable temporary differences

15 A deferred tax liability shall be recognised on all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- (a) the initial recognition of goodwill; or
- (b) the initial recognition of an asset or liability in a transaction which:
 - (i) is not a business combination; and
 - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss);or
- (c) the measurement of an asset or liability at fair value as an accounting policy choice (including on initial recognition in a business combination) to the extent that a market participant acquiring that asset or assuming that liability for its fair value would have the same temporary difference on initial recognition.

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39.

22A In many jurisdictions, a market participant is able to deduct the acquisition cost of an asset against the taxes that will be paid on the income generated by the asset. The fair value of the asset in these situations will reflect both the tax deduction on the cost (fair value) of the asset and the taxes that will be paid on the income. These effects will often offset. When the fair value of an asset increases, the entity currently holding the asset will not obtain the benefit of a tax deduction on the fair value and the deferred tax liability reflects the tax that will be paid if the asset is recovered for its current fair value. The deferred tax liability will reflect manner in which the entity expects to recover the carrying amount of its asset.

22B There are some jurisdictions, however, in which a market participant is unable to deduct the cost of acquiring the asset against the income from using the asset. In that case, the fair value of the asset will reflect the present value of future cash flows, net of tax payments. When the asset is measured at fair value, the deferred tax liability duplicates a tax consequence that is already reflected in the fair value of the asset. The entity currently holding the asset is in the same position as a potential market participant because neither of them will obtain a tax deduction for the fair value of the asset. Paragraphs 15(c) and 24(b) apply in situations where assets are measured at fair value as an accounting policy choice and a market participant would not obtain a tax deduction for some or all of the cost of the asset.



Deductible temporary differences

24 A deferred tax asset shall 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 utilized, unless the deferred tax asset arises from:

- (a) the initial recognition of an asset or liability in a transaction that:
 - (ai) is not a business combination; and
 - (bii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); or
- (b) the measurement of an asset or liability at fair value as an accounting policy choice (including on initial recognition in a business combination) to the extent that a market participant acquiring that asset or assuming that liability for its fair value would have the same temporary difference on initial recognition.

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44.

Additional example X

An asset with a construction cost of 100 is revalued to 150 as an accounting policy choice. No equivalent adjustment is made for tax purposes, i.e., an entity holding the asset does not receive additional tax deductions for the remeasurement gain. The entity's tax deductions are limited to the construction cost of the asset. A market participant acquiring the same asset for its fair value would not receive any deduction for the remeasurement gain of 50 but would receive a deduction for the original construction cost. If the asset is sold for more than tax written down value, cumulative tax depreciation will be included in taxable income, but proceeds in excess of cost will not be taxable. Cumulative depreciation for tax purposes is 30 and the tax rate is 30%.

The tax base of the asset is 70 and its carrying value (fair value) is 150. An entity that expects to recover the carrying amount by using the asset will only be able to deduct tax depreciation of 70. There is a taxable temporary difference of 80. Paragraph 15(c) requires that no deferred tax is recognised to the extent that a market participant acquiring the asset for its fair value would have the same temporary difference. No deferred tax is therefore recognised on a taxable temporary difference of 50 that would exist for a market participant acquiring the asset. Deferred tax is recognised on the remaining taxable temporary difference of 30 and a deferred tax liability of 9 (30 at 30%) is recorded as follows:



	Taxable temporary difference	Tax rate	Deferred tax liability
Difference between carrying value and book value	30	30%	9

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of 150, the gain arising from the remeasurement of 50 is not taxed, leaving the temporary difference arising from cumulative tax depreciation of 30 to be accounted for as follows:

	Taxable temporary difference	Tax rate	Deferred tax liability
Cumulative tax depreciation	30	30%	9