

## MEMORANDUM

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DATE: 16 AUGUST 2010

TO: MITSUHIRO TAKEMURA AND MICHAEL KRAEHNKE

FROM: FINANCIAL REPORTING STANDARDS BOARD

SUBJECT: REQUEST FOR COMMENT ON THE PRE-BALLOT DRAFT TO AMEND IAS 12

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### Purpose

1. Set out below are the comments of the Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants on the pre-ballot draft to amend IAS 12 *Income Taxes*.
2. We thank you for the opportunity to comment at this stage on a matter that is significant to New Zealand. If you require clarification of any matters in this memo or if we can be of assistance, please do not hesitate to contact Clive Brodie (email: [clive.brodie@nzica.com](mailto:clive.brodie@nzica.com), ddi: +64 4 917 5624) in the first instance, or us (email: [ASD@nzica.com](mailto:ASD@nzica.com)).

### Drafting of exception in paragraph 51B

3. The drafting of the proposed exception is inconsistent with the IASB's tentative decision reported in the IASB Update. The drafting includes additional criteria that were not included in the tentative decisions as reported. Specifically, the words at the end of the lead-in sentence "...if that taxable temporary difference was created by the..." and the words at the end of 51B(c) "...if the acquirer will subsequently use the fair value model in IAS 40 or the revaluation model in IAS 16 and IAS 38 for those assets..." create additional qualifying criteria and thereby make the exception much narrower than originally reported. We suggest removing the proposed requirement that the taxable temporary difference must have been created by the revaluation. We suggest aligning the wording of the exception with the wording used in the introduction - in particular, to remove any references to "a taxable temporary difference" and refocus the wording on the asset rather than the taxable temporary difference.

*"...if that taxable temporary difference was created by the..."*

4. In New Zealand there is no capital gains tax. Therefore, if for example an entity sells a building, generally speaking, it pays no tax on the sale proceeds in excess of building's historical cost. In addition, broadly speaking, until recently New Zealand entities have been able to claim a tax deduction for depreciation on buildings that they own. However, on 21 May 2010 the New Zealand Government enacted legislation which has effectively removed this depreciation deduction for buildings with expected lives of 50 years or more by setting the depreciation rate for tax purposes to 0%. The removal of tax deductions for depreciation on buildings has resulted in a large deferred tax liability if the buildings are held for use. In IAS 12 the tax base of an asset is defined as the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. The Government's removal of tax deductions for depreciation on buildings means that there will no longer be tax deductions to claim against the taxable benefits generated through use of buildings and, therefore, the tax base of the buildings is reduced to nil. Under IAS 12, a "taxable temporary difference" arises between the carrying amount of the buildings for accounting purposes and their new tax base of nil resulting, in most cases, in a substantial increase in the amount of deferred tax liability recognised. The significant increase in deferred tax liability recognised is required to be charged to profit and loss in the year of the change in tax law.

5. Based on the IASB's reported tentative decision, if a building is revalued under either IAS 16 or IAS 40, we had expected that the exception would apply. However, because the exception is limited to situations in which the taxable temporary difference is "created by" the revaluation, the proposed exception is likely to be ineffective and it is unclear if and when the proposed exception would apply. That is, if the taxable temporary difference already exists (possibly as a result of timing of depreciation expense between the accounting and taxation systems), the proposed exception will be ineffective.
6. One could argue that, in the New Zealand case, the taxable temporary difference was "created by" the loss of tax deductions, not the revaluation, since this difference arises irrespective of whether the building is revalued or carried at cost. However, it is unclear whether this means that the exception applies only to the extent that the total taxable temporary difference arises from the revaluation.
7. Consider the example of a building that cost 100, has been depreciated for tax purposes to 80, and is revalued to 150. If its tax base (measured on a use basis) reduces from 80 to nil through the loss of depreciation deductions, then part of the total taxable temporary difference of 150 relates to the loss of depreciation deductions (80) and the other part of the taxable temporary difference relates to the revaluation (70). Since only part of the taxable temporary difference was "created by" the revaluation, one possible interpretation of the exception could be that it is applied to only 70 of the total 150 taxable temporary difference. Another possible interpretation could be that the exception applies to the whole of the temporary difference, since the first part of the sentence in paragraph 51B states that an entity measures the deferred tax liability based entirely on sale or, if lower, entirely by use. Thus, it appears that it does not envisage some sort of dual-use approach, which could be possible if one took the view that the exception applies only to the extent that the taxable temporary difference is created by the revaluation. Yet another interpretation could be that if any part of the taxable temporary difference does not arise from the revaluation, then an entity fails the criteria to apply the exception. But the entity would then be back to assessing whether the building will be recovered through sale or use, and recognising a deferred tax liability on the revaluation and the loss of depreciation deductions if the asset is expected to be recovered through use (and no capital gains tax exists) – thus the problem that the exception is trying to resolve.
8. We consider that the best way to resolve the above issues and ensure the exception is workable is to remove the proposed requirement that the taxable temporary difference must have been created by the revaluation. We suggest aligning the wording of the exception with the wording used in the introduction to the exposure draft - in particular, to remove any references to "a taxable temporary difference" and refocus the wording on the asset rather than the taxable temporary difference. We recommend redrafting the exception to something along the lines of:

Notwithstanding paragraphs 51 and 51A, the measurement of a deferred tax liability shall reflect the tax consequences of recovering the carrying amount of an asset entirely by sale or, if lower, the tax consequences of recovering the carrying amount entirely by use, where the asset is:

- a) an investment property measured using the fair value model in IAS 40; or
- b) an item of property, plant and equipment or an intangible asset measured using the revaluation model in IAS 16 or IAS 38.

We suggest that the exception in respect of business combinations be dealt with in a separate paragraph.

9. Some might suggest that, rather than introducing an exception, the IASB clarify what is meant by recovery through use. However, if recovery through use were considered to mean depreciation rather than generation of taxable income, such a clarification would only solve the issue faced with investment property, and not the issue faced with property, plant and equipment.

### **Inserting paragraph 30(e)**

10. Paragraph 30(e) seems to suggest that, in assessing the recognition of a deferred tax asset, an entity can consider the deferred tax liability that would have arisen had the entity determined deferred tax in relation to an asset on the basis of using the asset rather than selling it. It is unclear why this paragraph is inserted in respect of the proposed exception when no such paragraph is provided in respect of the initial recognition exemption (paragraph 22 of IAS 12) which gives rise to a similar situation.