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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir/Madam,

Deferred tax liability arising from tax law change

Concerning your review of IAS 12 Income Taxes I wish to bring to your attention an issue that has recently arisen in New Zealand. The New Zealand Government, as part of its annual budget, announced that from 2011 it would no longer allow depreciation on buildings, with some exceptions for buildings with a life fewer than 50 years.

This must be taken in context of our current law whereby there is no capital gain tax, unless property was purchased with the intention of resale, and no deduction is allowed for a loss on sale of buildings.

Therefore as the law currently stands there is no tax base for buildings in New Zealand as we cannot deduct them nor claim any loss on disposal.

We reviewed IAS 12 and determined that any deferred tax asset currently recognised on the buildings would have to be written off and a deferred tax liability would need to be recognised on the accounting value of the buildings, as the tax base is nil, where the buildings will be held for use. We noted the specific exemption for new buildings acquired after this law change.

We therefore wrote-off a deferred tax asset of \$4 million and recognised a deferred tax liability of \$25 million in our 30 June 2010 annual financial statements giving a total write-off of \$29 million.

Analysis of IAS 12

In our opinion, we believe it is arguable that the principles of the standard may not require us to recognise the deferred tax liability. We believe that there are paragraphs that support this line of reasoning, however there are also clauses that specifically require the recognition of the deferred tax liability.

We accept that we needed to write-off the deferred tax asset of \$4 million, as this was created through the income statement, by the difference between the accounting and tax depreciation. Under the standard there is no doubt that this has to be expensed.

What was not so clear cut is the treatment for setting up of a liability. The standard provides an exemption for the buildings purchased, that you do not need to set up a deferred tax liability on purchase. This is because the transaction or event creating the deferred tax liability did not go through the earnings statement.

To set up a deferred tax liability in this situation would require you to debit the asset itself and credit deferred tax liability. However the very act of doing this creates an even bigger difference between the accounting base and the tax base of nil and a larger deferred tax liability would have to be set up. Although it is possible to work out the final outcome of this reiterative process the standard provides an exemption to setting up a deferred tax liability for the difference between the accounting cost in a purchase and the tax base of nil, as they believe to do so would not aid transparency in accounts, and would also overstate the value of the asset. We concur with this.

In an acquisition the standard does not provide an exemption to the recognition of the deferred tax liability, as the debit can go against the goodwill recognised on the acquisition. The standard does provide an exemption to the recognition of the deferred tax liability on the recognition of the goodwill itself, for the same reason as outlined above.

The standard does not specifically address the issue of how you treat a change in the tax base of an asset upon a change in the tax law. It requires a deferred tax charge to be taken to the earnings statement if the underlying transaction or event went through the earnings statement, with limited exemptions, some of which are outlined above.

Conclusion by the New Zealand Accounting Standards Review Board (ASRB)

The view that the ASRB took was that IAS 12 treats the loss of tax deductions for depreciation as creating an obligation to pay more tax in the future, because the entity can no longer claim depreciation as a deduction against taxable income generated from using the building over its expected useful life. Therefore, a deferred tax liability is recognised for difference between the tax and accounting book value.

Our view

In this case we do not believe that the transaction or event creating this change in tax base has gone through the earnings statement, therefore we believe that you should treat existing assets as new assets, i.e. recognise no deferred tax liability and treat all future accounting depreciation as a permanent difference.

The logic for setting the deferred tax liability up is that in the future assessable income will be higher than accounting income, therefore a deferred tax liability arises. The reality is that a future income tax liability arises only if you generate assessable income in the future.

In practice the proposed increased deferred tax liability that we have been forced to recognise is not a 'real' liability in an economic sense, particularly when any potential impact on future tax payments is unlikely to occur for decades.

Practical considerations

The current treatment will lead to difference treatments going forward, i.e. for all existing buildings we will set up a deferred tax liability and, as we depreciate the buildings the deferred tax liability will be effectively released to the earnings statement.

For any building acquired after 1 April 2011 we will depreciate the asset for accounting purposes and treat this as a permanent difference. We will then recognise the same value for the tax and accounting bases so that no future deferred tax liability is set up.

This will require changes to our subsidiaries fixed asset registers so they can split the depreciation charge between existing buildings and new buildings and also will require analysis of the closing accounting and tax book values between existing and new buildings so that we can recognise the deferred tax liability on existing buildings.

Obviously this different treatment will remain as long as the existing buildings are owned by the company. In my opinion, this is not a sensible outcome. It increase compliance costs, it defies common sense and the accounting profession loses credibility.

We are aware that this change raised little comment with the analysts' and brokers, however some companies have breached their banking covenants by making the entry and are therefore at the goodwill of their bankers over what can be considered a technical breach.

I understand that you are already considering this issue in connection with assets that are revalued, and ask you to consider this for buildings held at historic cost. In our opinion it seems that the standard does not fully anticipate such a situation and its default position gives an answer that I believe is not fair and results in a different treatment for the same class of assets depending on when the buildings were acquired.

If you have any queries or require clarification of any matters in this submission, please contact me.

Yours sincerely,

John

John Hames
Group Controller
Fletcher Building Limited

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