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Mr Bruce Porter
Acting Chairman
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By email: standard@aasb.gov.au

19 June 2009
Our Ref: FB:DH

Dear Bruce

Re: Exposure Draft ED 178 *Income Tax*

We are pleased to respond to the Australian Accounting Standards Board (AASB) Exposure Draft ED 178 *Income Tax*, equivalent to the International Accounting Standards Board's (the IASB's) Exposure Draft ED/2009/2 *Income Tax* (collectively referred to as the 'exposure draft' or 'ED').

We acknowledge the IASB's objectives in its income tax project to address the significant practical and conceptual issues arising under IAS 12 *Income Taxes* and achieve closer convergence with United States Generally Accepted Accounting Principles (US GAAP).

However, we question whether the IASB's objectives have been met in the ED. We believe clear principles have not been established and articulated in the ED. Furthermore, many of the proposals are ambiguous or produce counterintuitive outcomes which are difficult to reconcile from a conceptual viewpoint.

In particular, we believe the proposed calculation methodology and its reliance on an assumption of sale at the reporting date is flawed, does not produce meaningful outcomes and is unhelpful in addressing the issues commonly arising under IAS 12.

We would instead strongly prefer the existing 'management intention' approach be retained and specific guidance be developed to eliminate existing uncertainties in applying the approach. In our view, this would provide more meaningful information to the users of the financial statements as it better reflects the actual future tax consequences an entity expects.

It is difficult to understand the IASB's intention in developing the various 'rules' proposed in the ED, save perhaps an intention to simplify the current standard by mandating a particular approach. However, we expect a standard based on the ED's current proposals will not be well accepted by constituents as these 'rules' will:

- produce outcomes that are inconsistent with the *Framework*
- not be representationally faithful of the economic substance of the underlying tax consequences expected
- be difficult to rationally explain.

We also have concerns about the ED's weighted probability approach to including the impacts of uncertainty in the measurement of so-called 'uncertain tax positions'. In many cases, uncertain tax positions are discrete items and the use of a probability weighted approach to measurement in these circumstances produces an outcome that does not represent any particular expected outcome, unless by chance.

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Income taxes are a complex and commercially sensitive area for major corporates and we believe the measurement proposed by the ED is onerous and, in our view, inconsistent with the relevance and reliability characteristics of the *Framework*. We recommend the use of an 'expected outcome' approach based on the existing AASB 137/IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* measuring uncertainty using a unit of account which reflects the expected method of settlement with the taxing authority.

In addition, in some areas, the ED proposes to adopt requirements *based* on US GAAP but which do not always achieve full convergence in the areas with which they deal. The US GAAP approaches have been adopted and amended without appropriate justification from a conceptual viewpoint or fully considering their efficacy in the various jurisdictions of the world.

For example, the exemption for deferred taxes associated with foreign subsidiaries and joint ventures may relieve implementation issues in the United States, but many similar difficulties exist in relation to domestic subsidiaries in other parts of the world, including in Australia in relation to investments within tax-consolidated groups. This is a significant issue for Australian constituents and we strongly suggest the AASB communicate the need to retain the investment recognition exception for domestic subsidiaries to the IASB.

We recognise there are a number of significant interpretational issues which remain unresolved in applying AASB 112/IAS 12 and diversity has arisen in practice in many areas. We also acknowledge the requirements of AASB 112/IAS 12 can be difficult to interpret and apply and the variety of tax regimes implemented on a global basis adds additional complexity in developing and implementing a global solution in this area. However, in light of the lack of clear principles, counterintuitive outcomes and the failure to meet the additional objective of achieving convergence with US GAAP, we do not believe the ED, in its current form, is an improvement on existing IFRSs.

The Financial Accounting Standards Board (FASB) withdrawing from this project eliminates some of the urgency around its completion and, accordingly, provides an opportunity for a more fundamental and comprehensive review of income tax accounting. The IASB's objective should be a conceptually superior and principles based solution to accounting for income taxes which eliminates many of the current difficulties, is easier to interpret and apply, and has widespread constituent support.

Therefore, we suggest the AASB recommends to the IASB that it does not proceed with the proposals in the ED and instead commences a more thorough and comprehensive project. We appreciate this will result in a further delay in meeting the IASB's timetable in this area and suggest any particularly pressing issues are dealt with through the improvements process whilst the more comprehensive project is undertaken.

Our detailed comments and answers to the questions on the exposure draft, along with other comments and suggested editorial changes, are included in the following appendices to this letter:

- Appendix 1 – Responses to specific IASB questions on ED/2009/2 *Income Tax*
- Appendix 2 – Common areas of difficulty in applying AASB 112/IAS 12
- Appendix 3 – Jurisdictional examples where the approach proposed by the ED produces unusual outcomes
- Appendix 4 – Additional comments on the proposals in ED/2009/2
- Appendix 5 – Responses to specific AASB questions.

Due to the later submission deadline for its Exposure Draft ED/2009/2 *Income Taxes*, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised in the IASB's Exposure Draft. Therefore, the views presented in this document in relation to ED 178 should be read in this context and may not necessarily represent the views of the global firm of Deloitte.

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If you have any questions concerning our comments, please contact Debbie Hankey on (02) 9322 7665.

Yours sincerely

Debbie Hankey
Partner
Deloitte Touche Tohmatsu

Appendix 1 - Responses to specific IASB questions on ED/2009/2 *Income Tax*

Question 1 - Definitions of tax basis and temporary difference

The exposure draft proposes changes to the definition of tax basis so that the tax basis does not depend on management's intentions relating to the recovery or settlement of an asset or liability. It also proposes changes to the definition of a temporary difference to exclude differences that are not expected to affect taxable profit.

Do you agree with the proposals? Why or why not?

We do not agree with the proposal. In our view, the ED's approach produces counter-intuitive outcomes and is inconsistent with United States Generally Accepted Accounting Principles (US GAAP).

We would strongly prefer the existing 'management intention' approach be retained and specific guidance be developed to eliminate existing uncertainties in applying this approach.

We have included in Appendix 2 details of a number of issues arising under the existing AASB 112/IAS 12 and our recommendations for how these issues might be dealt with under the existing requirements.

Temporary difference definition and guidance

There is substantial ambiguity around the definition and guidance for temporary differences in the ED.

A temporary difference definition in Appendix A to the ED explicitly references an amount "that the entity expects will affect taxable profit when the carrying amount of the asset or liability is recovered or settled". Paragraph 20 also refers to temporary differences "that are expected to increase [or reduce] taxable profit in the future".

However, it is unclear how these requirements are to be applied and two possible interpretations have arisen[1]:

- the reference to 'expectations' is referring to the initial calculation step in paragraph 10 of the ED and no further 'expectations' are to be taken into account. or
- the reference to 'expectations' is implying a *further* assessment of expectations by reference to the amount of the temporary difference arising from the sale or settlement assumption that is actually expected to give rise to an increase or reduction in tax payable in the future.

We note Illustrative Example 6 in the *Draft flow chart and illustrative examples* prepared by the IASB staff appears to imply the first approach. It shows a situation where an asset is acquired for $100 but the tax deductions available from use are higher than from sale. At the point in time the calculation is performed, the carrying amount of the asset has been depreciated to $80 and the deductions available on sale are $70, as a result of tax depreciation claimed reducing the deduction on sale. There are also different tax rates applying to use and sale.

The first step in the process is to consider whether a future tax consequence is expected from the way in which management intends to recover the carrying amount of the asset. Whether the asset is recovered through sale or by use, a net future tax consequence is expected and therefore a deferred tax calculation must be performed in applying paragraph 12(a) of the ED.

In the situation where the asset is expected to be used, the $10 (taxable) temporary difference arising from applying the sale assumption would not be expected to give rise to taxable profits. This is because there remains $120 of tax depreciation expected in the future and only $80 of taxable profits from using the asset. The outcome under the 'use' scenario is actually a net tax benefit but the example results in the recognition of a deferred tax liability that will never crystallise as a tax payment in the future.

As noted above, the example appears to support the first alternate interpretation above. The second alternate interpretation above would introduce an 'extra' step into the deferred tax calculation, reducing the $10 initial temporary difference to nil where use is expected. The temporary difference would be reduced to nil as an increase in future taxable profit is not expected, as in fact a net reduction in future tax is expected.

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[1] We note that this issue was also raised in the IASB's webcast on the ED/2009/2 proposals and is causing widespread concern amongst constituents.

It should be noted the second alternate approach does not result in the recognition of a deferred tax asset (the expected outcome), because the temporary difference can presumably only be reduced to nil. Therefore, the second alternate approach only partially ameliorates the issues arising from the assumption of sale, including those illustrated in Appendix 2 to this letter.

Conceptual basis for 'sale or settlement'

The ED does not justify the assumption of sale or settlement at reporting date, other than to note it is consistent with practice under US GAAP and seeks to resolve interpretational issues where there are different tax consequences of selling or using an asset. In our view, the assumption of sale or settlement represents a 'rule' which will produce illogical outcomes under many of the various taxing regimes existing on a global basis.

The core principle of the ED is an entity should recognise "tax payable or recoverable on taxable profit for *future* periods as a result of past transactions and events" (paragraph 1). However, the assumption of sale or settlement at reporting date reflects a taxation outcome based on a *hypothetical* transaction at the end of the *current* period.

Taxation systems commonly contemplate many different taxation events and taxing points, and the outcomes under those approaches can vary widely. To require deferred tax accounting to be based on a hypothetical outcome will not reflect an entity's actual income tax exposure and is therefore not in accordance with the core principle of the ED.

The elimination of management intention when seeking to reflect the future consequence of an item is, in our view, a flawed approach, particularly when considered in light of other requirements of the ED which introduce management intention in other aspects of the tax calculation.

The current 'management intention' requirement in AASB 112/IAS 12 is not conceptually flawed under the temporary difference approach, but there is difficulty in determining *how* management intention should be incorporated into measurement. We do not believe mandating a particular outcome is helpful in this regard. Instead, we recommend the 'management intention' requirement be retained and specific guidance be developed to eliminate existing uncertainties in applying this approach.

It is also unclear why a 'sale' assumption is made when the going concern basis underlying standards and normal business practice would ordinarily mean many assets are recovered through 'use'. The sale or settlement assumption might only be rationally supported if measurement of all assets and liabilities was based on a full fair value model using 'exit' values.

It is difficult to justify the ED's approach under the *Framework* as it suffers from a similar conceptual flaw to that identified by the IASB in objecting to the 'simultaneous equation' method used to address the initial recognition exception under US GAAP (paragraph BC27 of the Basis for Conclusions on the ED). In other words, the application of the ED's requirements result in the recognition of deferred tax balances that do not necessarily represent assets and liabilities, but rather result from computational requirements.

Lack of convergence

The Basis for Conclusions on the ED notes the proposal to assume sale or settlement is partially based on US GAAP requirements, but is "more specific" and "in most cases will result in a tax basis consistent with that used under US GAAP" (ED/2009/2.BC21). A similar outcome might also be expected under current Canadian GAAP, where the tax accounting standards are currently more closely aligned with US GAAP than IFRS.

In our view, the assumption of a sale or immediate settlement at reporting date is not routinely made under US GAAP and the 'revenue' (use) tax basis would be used in the calculation of deferred taxes in some cases.

Additionally, the assumption of sale or settlement would not necessarily be made where entities are applying US GAAP to operations outside of the United States, e.g. subsidiaries of US listed corporations. Instead, the tax basis is determined by reference to local tax law and may result in the use of a 'use' deduction as the tax basis.

Recommendations

As noted in our covering letter, we strongly suggest that the AASB recommend to the IASB that it does not proceed with these proposals in the ED and instead commences a more thorough and comprehensive project.

The objective of the project should be a conceptually superior and principles based solution to accounting for income taxes which eliminates many of the current difficulties, is easier to interpret and apply, and has widespread constituent support. The development of a strong and coherent principle for deferred tax accounting will permit easier interpretation and application of the standard.

This review could for example include a fundamental reconsideration of the 'balance sheet method' (temporary difference approach) to income tax accounting to ensure it is the most appropriate basis for deferred tax recognition, particularly in light of the IASB's ongoing conceptual framework project.

A full review of income tax accounting will be a long-term project and accordingly, we recommend certain limited improvements be undertaken to the existing AASB 112/IAS 12 through the annual improvements process. Our recommendations as to areas where improvements could be made to the existing AASB/IAS 12 to resolve issues commonly arising are outlined in Appendix 2.

In the event the IASB decides to retain the ED's approach, we have included a number of additional comments and recommendations in Appendix 4.

Question 2 – Definitions of tax credit and investment tax credit

The exposure draft would introduce definitions of tax credit and investment tax credit. Do you agree with the proposed definitions? Why or why not?

We support the development of a definition of tax credit and investment tax credit, but recommend the following additional matters be considered:

- tax credits can arise in relation to many types of assets, including intangible and financial assets – accordingly, limiting the definition to depreciable assets is too narrow
- the conditions around tax credits often require more than just the purchase of an asset and it is unclear how these impact the definition, e.g. retention of acquired assets for a period of time
- in some cases, tax credits given may be 'clawed back' if certain tax events occur, e.g. the sale of the asset
- there is limited guidance on the difference between tax credits, investment tax credits, 'special deductions', 'rebates' and other types of tax incentives and benefits.

We recommend any final standard clarify the above matters and provide examples where appropriate.

In addition, we strongly recommend guidance be developed on how tax credits (including investment tax credits) are accounted for as there are many possible approaches under the hierarchy in AASB 108/IAS 8 *Accounting Policies, Changes in Estimates and Errors*. This issue is of considerable interest in Australia at the moment due to the Federal Government's 'small and general business tax break' investment allowance.

We are aware of the following possible treatments for investment tax credits (such as the 'small and general business tax break'):

- a current tax amount only, with no impact on deferred taxes
- an adjustment to the deferred tax calculation, either by adjusting the tax base or changing the expected tax rate
- accounted for as government grants by analogy to AASB 120/IAS 20 - this produces a substantially different recognition outcome to other alternative treatments.

In addition, the lack of clarity on the accounting for other tax incentives and benefits is problematic and results in divergence in treatment under AASB 112/IAS 12.

Accordingly, it is insufficient to provide a definition of 'tax credit' and 'investment tax credit' without providing guidance on the recognition and measurement of such items.

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Question 3 – Initial recognition exception

The exposure draft proposes eliminating the initial recognition exception in IAS 12. Instead, it introduces proposals for the initial measurement of assets and liabilities that have tax bases different from their initial carrying amounts. Such assets and liabilities are disaggregated into (a) an asset or liability excluding entity-specific tax effects and (b) any entity-specific tax advantage or disadvantage. The former is recognised in accordance with applicable standards and a deferred tax asset or liability is recognised for any temporary difference between the resulting carrying amount and the tax basis. Outside a business combination or a transaction that affects accounting or taxable profit, any difference between the consideration paid or received and the total amount of the acquired assets and liabilities (including deferred tax) would be classified as an allowance or premium and recognised in comprehensive income in proportion to changes in the related deferred tax asset or liability. In a business combination, any such difference would affect goodwill.

Do you agree with the proposals? Why or why not?

We do not support the suggested approach in the ED for the following reasons:

- entity-specific tax consequences will be the same as a general market participant in many cases, resulting in the full deferral of any deferred amount
- the arbitrary deferral of a premium or discount is counterintuitive and in many cases will not result in an initial outcome which is materially different from the existing IAS 12
- the new approach introduces a new level of complexity in the calculation process without substantially changing the outcome
- in cases where an entity-specific tax consequence is identified, the determination of fair values is subjective and arbitrary.

Furthermore, the ED does not provide any guidance on how to identify entity-specific tax consequences, particularly where:

- there are numerous entities that might acquire the asset (e.g. various classes of companies, trusts, partnerships, tax-exempt entities, foreign entities, etc)
- elections can be made to change the tax base (e.g. the 'transfer' of a seller's tax base to the purchaser, election to consolidate for tax purposes, etc)
- tax structuring opportunities exist, e.g. the acquisition of assets directly or through a 'corporate shell' – the tax outcomes under each structure can be vastly different and this is a key issue both under AASB 112/IAS 12 and the ED.

The ED's proposals would not fundamentally change the different treatment arising for assets acquired individually or in a business combination. In fact, in the majority of cases, the effect of the proposals is to retain these differences and treat items in the same way as present, albeit by implementing a new and complex requirement that is subjective and difficult to apply.

The determination of fair value where the net tax consequences are different to the amount initially recognised is a long-running and fundamental issue. Accordingly, we recommend this issue would be better dealt with at a conceptual level as part of the IASB's fair value measurement and conceptual framework projects.

In the absence of a conceptual analysis of the role of income taxes in the determination of 'fair value', and due to its subjective nature, we do not support the proposed approach.

We acknowledge the existing initial recognition exceptions in AASB 112/IAS 12 were themselves not developed on a conceptual and principle-based approach and are not well-liked by constituents. However, in our view, we would prefer the existing approach be retained until such time as a principle is developed and applied to determine a conceptual approach to this issue.

As part of this review, we would also suggest consideration be given to the impact of the definition of 'fair value' and income taxes on impairment testing under the various impairment models in IFRS, including recoverable amount testing under AASB 136/IAS 36 *Impairment of Assets*. This will also need to be considered in the event this proposal is retained.

Question 4 – Investments in subsidiaries, branches, associates and joint ventures

IAS 12 includes an exception to the temporary difference approach for some investments in subsidiaries, branches, associates and joint ventures based on whether an entity controls the timing of the reversal of the temporary difference and the probability of it reversing in the foreseeable future.

The exposure draft would replace these requirements with the requirements in SFAS 109 and APB Opinion 23 *Accounting for Income Taxes—Special Areas* pertaining to the difference between the tax basis and the financial reporting carrying amount for an investment in a foreign subsidiary or joint venture that is essentially permanent in duration. Deferred tax assets and liabilities for temporary differences related to such investments are not recognised. Temporary differences associated with branches would be treated in the same way as temporary differences associated with investments in subsidiaries. The exception in IAS 12 relating to investments in associates would be removed.

The Board proposes this exception from the temporary difference approach because the Board understands that it would often not be possible to measure reliably the deferred tax asset or liability arising from such temporary differences.

Do you agree with the proposals? Why or why not? Do you agree that it is often not possible to measure reliably the deferred tax asset or liability arising from temporary differences relating to an investment in a foreign subsidiary or joint venture that is essentially permanent in duration? Should the Board select a different way to define the type of investments for which this is the case? If so, how should it define them?

We do not agree with the proposals for the following reasons:

- the rationale for the partial retention of the exception is flawed
- the proposed exception is inconsistent with US GAAP and seeks to apply existing US GAAP guidance in a manner for which it was not designed
- the exception is difficult to apply in practice without additional guidance.

Rationale for partial retention

The Basis for Conclusions in the ED notes "the Board concluded that the calculation of the amount of deferred taxes for permanently reinvested unremitted earnings of foreign subsidiaries and joint ventures is so complex that the costs of doing so outweigh the benefits" (paragraph BC43).

In our view, this same rationale can be applied to the calculation of deferred taxes arising in relation to domestic subsidiaries in many jurisdictions, and particularly in Australia in relation to tax-consolidated groups.

In Australia, entities that are part of a tax-consolidated group 'retain' the tax bases of assets and liabilities on leaving the group (due to the parent selling an interest or otherwise). The group is required to perform an 'exit calculation' which determines the gain or loss arising on disposal of the subsidiary, which relies in part on the tax bases and accounting values of certain of the underlying assets and liabilities of the subsidiary disposed at the time they are disposed. These calculations are complex and onerous in many cases.

Accordingly, the determination of the tax basis of the investment (assuming the sale of the investment at the end of the reporting period) would require an 'exit calculation' to be performed at the end of each reporting period. In complex corporate groups, the determination of the outside basis difference in respect of each entity (or groups of entities) within the overall group at the end of each reporting period would be a complex and laborious task which would produce little in the way of useful information for the users of the financial statements because of the dynamic nature of the outside basis differences in these cases.

Inconsistency with US-GAAP

The ED effectively creates two tests, an "essentially permanent in duration" test and a "foreseeable future" test, ostensibly to achieve consistency with US-GAAP.

However, the term "essentially permanent" is not used in US-GAAP in the way in which it is proposed under the ED. The "essentially permanent" concept is used in APB Opinion No. 23 *Accounting for Income Taxes—Special Areas* (APB 23) to determine the *nature* of an entity which may qualify for the exception. The APB 23 requirements provide additional guidance on how companies meet the "foreseeable future" test under FAS 109 where deferred tax *liabilities* arise.

The "essentially permanent" concept arises under APB 23 in the context of distinguishing between two types of corporate joint venture:

(1) those "essentially permanent" in duration, and

(2) those having a life limited by the nature of the venture or other business activity.

The recognition exception for deferred taxes associated with corporate joint ventures is available only in relation to those corporate joint ventures of the first type. Where a corporate joint venture is of this type, any deferred tax liabilities arising in respect of the investment are essentially assessed by reference to a "foreseeable future" test similar to the existing IAS 12 test for investments.

APB 23 argues in relation to corporate joint ventures with a life limited by the nature of the venture, project, or other business activity (i.e. the second type noted above), it is a reasonable assumption that a part or all of the undistributed earnings of the venture will be transferred to the investor in a taxable distribution. Therefore, APB 23 provides guidance in these situations that the "foreseeable future" criterion in FAS 109 cannot be met for these types of corporate joint ventures.

The effect of the drafting of the ED is to elevate the importance of "essentially permanent" in duration and to apply the concept not to the *nature* of the entity, but to *temporary differences* arising in relation to all investments in subsidiaries and joint ventures.

The guidance contained in paragraphs B5- B9 of the ED are based on APB 23 concepts, but again this guidance is only applied in respect of deferred tax liabilities under US GAAP.

Furthermore, the "essentially permanent" test cannot be readily applied to deductible temporary differences arising from investments as it is difficult to envisage a circumstance where a deferred tax asset arising would meet the criteria to be "essentially permanent". For instance, if a subsidiary incurred losses, a deferred tax asset (anticipated loss) would often arise but because future profits may 'reverse' this loss, the "essentially permanent" criterion cannot be met. Accordingly, a deferred tax asset would always be recognised for investments in subsidiaries and joint ventures, subject to any valuation allowance. This is because of the ED's incorrect application of the "essentially permanent" concept under APB 23 and the ED's requirement for both tests to be met before the recognition exception could apply.

Applying the exception in practice

In our view, the 'essentially permanent in duration' concept is unclear and insufficient guidance is provided on how the assessment is expected to be made. In practical terms, we believe whether a temporary difference is 'essentially permanent in duration' will effectively be assessed by considering whether a reversal is expected in the foreseeable future (particularly in light of our comments above regarding US GAAP convergence). Accordingly, we question whether the proposed wording is significantly better than the existing wording in IAS 12.

Furthermore, in common with IAS 12, there is little guidance in the ED as to how the recognition criterion is to be applied in practice. For instance, guidance on the following would be welcomed:

- the impact of anticipated future losses by a subsidiary on retained earnings in existence at the end of the reporting period, i.e. does this mean the "foreseeable future" criterion cannot be met
- how the reversal of amounts of other comprehensive income and equity reserves should be assessed, e.g. should outside basis differences indirectly arising as a result of changes in a subsidiary's hedging or revaluation reserves be presumed to be 'temporary' and ultimately reverse.

Furthermore, although the ED seeks to limit the exception to 'foreign' investments, it does not provide guidance on how a "foreign subsidiary" is to be determined. In particular:

- it is unclear whether the assessment of 'foreign' is made by reference to the immediate or ultimately parent of each subsidiary
- it is unclear how the 'foreign' concept should be applied where multiple levels of government exist in respect of the entity's operations, e.g. are European subsidiaries of a European entity consider 'domestic' subsidiaries regardless of the country in Europe in which they are domiciled?

If the IASB ultimately decides to proceed with the exception only for 'foreign subsidiaries', we recommend that this term be defined using an easily applied principle. In this regard, we would recommend the term 'foreign' could be applied by reference to the primary taxing jurisdiction (in respect of each relevant income tax) for each subsidiary by comparison to the taxing jurisdiction of the immediate parent entity.

Recommendations

In light of the above analysis, we recommend:

- the recognition exception for investments be retained in its current form and wording
- additional guidance be developed to clarify how the existing IAS 12 recognition exception is to be applied in practice.

Question 5 – Valuation allowances

The exposure draft proposes a change to the approach to the recognition of deferred tax assets. IAS 12 requires a one-step recognition approach of recognising a deferred tax asset to the extent that its realisation is probable. The exposure draft proposes instead that deferred tax assets should be recognised in full and an offsetting valuation allowance recognised so that the net carrying amount equals the highest amount that is more likely than not to be realisable against taxable profit.

Question 5A

Do you agree with the recognition of a deferred tax asset in full and an offsetting valuation allowance? Why or why not?

Subject to our comments below in relation to Question 6A, we agree with the proposal as it provides more meaningful information to the users of financial statements.

However, we recommend consideration be given as to how valuation allowances against deferred tax assets should be treated in a business combination under AASB 3/IFRS 3(2008), given AASB 3/IFRS 3 establishes a principle that valuation allowances should not be separately recognised in respect of acquired assets (such as financial assets) at the date of the business combination.

Question 5B

Do you agree that the net amount to be recognised should be the highest amount that is more likely than not to be realisable against future taxable profit? Why or why not?

We agree with the proposal. We note in many jurisdictions, including in Australia, the use of the term 'probable' under AASB 112.IAS 12 has been interpreted as meaning 'more likely than not'. Therefore, we believe this change will assist in achieving global consistency in application of the requirements.

Question 6 – Assessing the need for a valuation allowance

Question 6A

The exposure draft incorporates guidance from SFAS 109 on assessing the need for a valuation allowance. Do you agree with the proposed guidance? Why or why not?

We agree with the proposed guidance.

However, we strongly suggest the guidance be extended to deal with how to assess the 'more likely than not' criterion where tax losses, tax credits or anticipated losses are able to be indefinitely carried forward under the operative taxation laws of a jurisdiction.

In our experience, this has been an area of considerable debate and uncertainty under AASB 112/IAS 12 and is a common issue in the Australian context.

Question 6B

The exposure draft adds a requirement on the cost of implementing a tax strategy to realise a deferred tax asset. Do you agree with the proposed requirement? Why or why not?

We agree with this proposal. In some cases, the cost of implementing a tax strategy to realise a deferred tax asset could be significant and excluding those costs from the determination of the valuation allowance would overstate the net benefit expected.

However, we recommend guidance be provided to allow entities to differentiate between the costs of implementing a tax strategy to realise a deferred tax asset and other tax administration costs an entity might incur. In our view, the costs taken into account in the determining the valuation allowance should only be those costs which are direct and incremental to other tax administration costs the entity would ordinarily expect to incur.

Question 7 – Uncertain tax positions

IAS 12 is silent on how to account for uncertainty over whether the tax authority will accept the amounts reported to it. The exposure draft proposes that current and deferred tax assets and liabilities should be measured at the probability-weighted average of all possible outcomes, assuming that the tax authority examines the amounts reported to it by the entity and has full knowledge of all relevant information.

Do you agree with the proposals? Why or why not?

We agree it is appropriate to assume that the tax authority will examine the amounts reported by an entity and have full knowledge of all relevant information when measuring current and deferred taxes. However, we do **not** agree with the measurement aspects of this proposal.

In many cases, uncertain tax positions are discrete items and the use of a probability weighted approach to measurement in these circumstances produces an outcome that does not represent any particular expected outcome, unless by chance. In other cases, uncertainties in tax positions taken will be expected to be settled with tax authorities on an 'aggregate' basis.

Income taxes are a complex and commercially sensitive area for major corporates and we believe the measurement proposed by the ED is both onerous and, in our view, inconsistent with the relevance and reliability characteristics of the *Framework*.

Recommendation

We recommend uncertainty in the measurement of income taxes to be determined using a basis largely consistent with AASB 137/IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

On a global basis, there are numerous approaches to the resolution of uncertainties by the relevant tax authorities. At one extreme, some tax authorities consider each tax amount (deduction or income) on its own merits either allow it or not, without any scope of a negotiated settlement (i.e. a 'binary' outcome).

Conversely, other tax authorities will seek to review an entity's tax affairs for a period or a number of periods and seek to reach a negotiated settlement with the entity in relation to the various uncertainties in those periods.

In our view, the measurement of uncertainty in relation to income taxes should reflect this diversity.

Accordingly, we believe any final standard resulting from the ED should clarify:

- uncertainty is measured by reference to a unit of account which reflects how the entity expects to settle its uncertain tax positions with the relevant tax authority in each jurisdiction in which it operates
- the amount ultimately recognised should reflect the possible outcome (on the basis of the unit of account) which is 'more likely than not' of actually occurring from that settlement process with the tax authority.

The following examples illustrate how this approach would be applied:

- in a simple tax uncertainty where, for example, each particular deduction will be individually considered by the tax authority and either sustained or not, this approach would result in measurement of the uncertainty at the level of each deduction and recorded at most likely outcome (nil or the full amount of the deduction, whichever is more likely than not)
- if a taxing authority is expected to reach an aggregated negotiated settlement with the entity in respect of a range of uncertainties, the measurement would reflect the aggregate settlement across all the individual uncertainties which is more likely than not of occurring.

We also believe this approach is also consistent with the ED's approach to the determination of the valuation allowance for deferred tax assets, which also adopts a 'more likely than not' approach.

In addition, we strongly suggest additional guidance be included in relation to the recognition and measurement of income tax-related interest and penalties related to uncertain tax positions as the ED is currently silent on this matter.

Furthermore, the general disclosure requirements of the ED make it unclear on exactly what disclosure entities are expected to make in relation to uncertain tax positions. It is also important an appropriate balance between the volume and detail of the disclosures and their commercial sensitivity is found in formulating the final disclosures required. We recommend any final standard clearly outlines the natures of the disclosures required. However, we strongly recommend any disclosures be made on an *aggregated* basis, not for individual tax deductions or other amounts where uncertainty exists.

This will make the application and implementation of the requirements more consistent on a global basis and avoid the need for subsequent IFRIC interpretation or improvement amendments on this matter.

Question 8 – Enacted or substantively enacted rate

IAS 12 requires an entity to measure deferred tax assets and liabilities using the tax rates enacted or substantively enacted by the reporting date. The exposure draft proposes to clarify that substantive enactment is achieved when future events required by the enactment process historically have not affected the outcome and are unlikely to do so.

Do you agree with the proposals? Why or why not?

We agree with this proposal.

Consistent with the IASB's usual practice, we also recommend the references to specific jurisdictions in relation to this matter be reconsidered.

Question 9 – Sale rate or use rate

When different rates apply to different ways in which an entity may recover the carrying amount of an asset, IAS 12 requires deferred tax assets and liabilities to be measured using the rate that is consistent with the expected manner of recovery. The exposure draft proposes that the rate should be consistent with the deductions that determine the tax basis, i.e. the deductions that are available on sale of the asset. If those deductions are available only on sale of the asset, then the entity should use the sale rate. If the same deductions are also available on using the asset, the entity should use the rate consistent with the expected manner of recovery of the asset.

Do you agree with the proposals? Why or why not?

Consistent with our views on question 1, we disagree with this proposal.

The assumption of the sale rate in the circumstances cited is arbitrary and conceptually difficult to justify as it can produce a deferred tax balance that does not represent an actual tax outcome the entity could reasonably anticipate.

In the event the proposed requirements are retained, we would prefer additional guidance be provided on how to determine the appropriate rate to apply. The rationale for the requirements of paragraph B29, and its application, are difficult to understand and apply in practice.

Question 10 – Distributed or undistributed rate

IAS 12 prohibits the recognition of tax effects of distributions before the distribution is recognised. The exposure draft proposes that the measurement of tax assets and liabilities should include the effect of expected future distributions, based on the entity's past practices and expectations of future distributions.

Do you agree with the proposals? Why or why not?

We agree with this proposal as it better reflects the tax consequences expected by these types of entities. We also support the associated disclosure proposals as we believe this will be useful information to users of the financial statements as these structures are often tax driven.

However, we also recommend consideration be given to the interaction of this requirement with the determination of outside basis differences in subsidiaries and how this requirement interacts with the proposed recognition exception for certain investments.

Question 11 – Deductions that do not form part of a tax basis

An entity may expect to receive tax deductions in the future that do not form part of a tax basis. SFAS 109 gives examples of 'special deductions' available in the US and requires that 'the tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return'. SFAS 109 is silent on the treatment of other deductions that do not form part of a tax basis.

IAS 12 is silent on the treatment of tax deductions that do not form part of a tax basis and the exposure draft proposes no change.

Do you agree that the exposure draft should be silent on the treatment of tax deductions that do not form part of a tax basis? If not, what requirements do you propose, and why?

We do not agree with the ED remaining silent on this issue. The treatment of additional deductions is an area of difficulty in accounting under AASB 112/IAS 12, there is significant diversity in practice, and accordingly guidance would be useful. However, we do not believe deferring recognition of the deduction until it is claimed in the tax return is an appropriate recognition criterion for such items.

It can be difficult at a conceptual level to reconcile the difference between a special deduction and a tax credit in relation to assets and liabilities, as both produce an equivalent economic outcome in substance. In some cases, a special deduction or tax credit may have the effect in substance of reducing the effective tax rate applied, or expected to be applied, to a particular income tax year. In other cases, these items may effectively be a government grant for the acquisition of certain assets or the undertaking of certain expenditure. Elections available to the entity also impact the outcomes in many cases.

We recommend guidance be developed on accounting for these items to establish clear principles, definitions and guidelines. This should include details as to how these items should be classified between tax credits, investment tax credits and 'special deductions', and how each should be appropriately recognised and measured.

Question 12 – Tax based on two or more systems

In some jurisdictions, an entity may be required to pay tax based on one of two or more tax systems, for example, when an entity is required to pay the greater of the normal corporate income tax and a minimum amount. The exposure draft proposes that an entity should consider any interaction between tax systems when measuring deferred tax assets and liabilities. (See paragraph BC89 of the Basis for Conclusions.)

Do you agree with the proposals? Why or why not?

Whilst we support the application of the proposed requirements in relation to tax systems where the rate of tax applied depends on a particular factor (such as the level of taxable income), we believe the wording of the requirements could potentially capture other arrangements where there are two quite distinct tax systems which are indirectly linked in some way.

For example, production taxes are paid as a form of additional tax on the profits of oil and gas companies in a number of jurisdictions. It is quite common for these taxes to be determined on a basis that is very different from 'normal' income tax (e.g. the upfront full deduction of capital expenditure) and additionally, the production taxes paid are usually deductible against 'normal' taxable profits. Where the production tax is considered to be an income tax, is it unclear how the proposals would be applied, i.e. should an 'aggregate' rate be determined and applied to the temporary differences arising, or should separate tax calculations be performed for each tax system?

Similar issues arise where income is subject to withholding taxes in one jurisdiction but income taxes in another or where the operations of branches are subject to more than one taxing authority. In these cases, it is unclear whether an entity is meant to calculate deferred taxes on an 'aggregated' basis, or whether separate calculations are required. Again, the practical application of an 'aggregated' approach is problematic because the taxing events, methodology and timing may be very different between the jurisdictions seeking to tax the activity.

We believe this requirement, if retained, should be clarified and limited in scope to make it clear when an 'aggregate' approach is required. Additional guidance needs to be given as to when two tax systems are sufficiently related to require the 'aggregate' approach.

Question 13 – Allocation of tax to components of comprehensive income and equity

IAS 12 and SFAS 109 require the tax effects of items recognised outside continuing operations during the current year to be allocated outside continuing operations. IAS 12 and SFAS 109 differ, however, with respect to the allocation of tax related to an item that was recognised outside continuing operations in a prior year. Such items may arise from changes in the effect of uncertainty over the amounts reported to the tax authorities, changes in assessments of recovery of deferred tax assets or changes in tax rates, laws, or the taxable status of the entity. IAS 12 requires the allocation of such tax outside continuing operations, whereas SFAS 109 requires allocation to continuing operations, with specified exceptions. The IAS 12 approach is sometimes described as requiring backwards tracing and the SFAS 109 approach as prohibiting backwards tracing.

The exposure draft proposes adopting the requirements in SFAS 109 on the allocation of tax to components of comprehensive income and equity.

Question 13A

Do you agree with the proposed approach? Why or why not?

We do not agree with the proposed approach. We believe 'backwards tracing' is conceptually superior to the US GAAP approach and recommend the approach in the existing AASB 112/IAS 12 be retained.

Question 13B

The exposure draft deals with allocation of tax to components of comprehensive income and equity in paragraphs 29–34. The Board intends those paragraphs to be consistent with the requirements expressed in SFAS 109.

Would those paragraphs produce results that are materially different from those produced under the SFAS 109 requirements? If so, would the results provide more or less useful information than that produced under SFAS 109? Why?

In light of support for the existing AASB 112/IAS 12 approach to this issue, we have no comment on this question.

Question 13C

The exposure draft also sets out an approach based on the IAS 12 requirements with some amendments. Do you think such an approach would give more useful information than the approach proposed in paragraphs 29–34? Can it be applied consistently in the tax jurisdictions with which you are familiar? Why or why not?

As noted above, we prefer the 'backwards tracing' concept to be retained. Whilst there are some practical difficulties in the application of those requirements under the existing AASB 112/IAS 12, we do not believe the practical difficulties are sufficient to warrant an approach which is difficult to support from a conceptual viewpoint.

Question 13D

Would the proposed additions to the approach based on the IAS 12 requirements help achieve a more consistent application of that approach? Why or why not?

In light of support for the existing AASB 112/IAS 12 approach to this issue, we have no comment on this question.

Question 14 – Allocation of current and deferred taxes within a group that files a consolidated tax return

IAS 12 is silent on the allocation of income tax to entities within a group that files a consolidated tax return. The exposure draft proposes that a systematic and rational methodology should be used to allocate the portion of the current and deferred income tax expense for the consolidated entity to the separate or individual financial statements of the group members.

Do you agree with the proposals? Why or why not?

We agree with the proposals, but we understand the limited nature of the proposals may result in calls for further guidance. Should this occur, we believe consideration needs to be given to the impacts of any such guidance on different regimes so that sensible outcomes can be achieved in each jurisdiction.

From the Australian perspective, we do not support the retention of the existing guidance in Interpretation 1052 *Tax Consolidation Accounting* once any new standard is made. Accordingly, recommend Interpretation 1052 be withdrawn. However, the AASB may wish to bring the IASB's attention to the Interpretation as a possible source of additional guidance to include in any standard resulting from the ED.

Question 15 – Classification of deferred tax assets and liabilities

The exposure draft proposes the classification of deferred tax assets and liabilities as current or non-current, based on the financial statement classification of the related non-tax asset or liability.

Do you agree with the proposals? Why or why not?

We disagree with this proposal.

The proposals may effectively require the scheduling of temporary differences. Temporary differences may 'reverse' in a particular period and be expected to be replaced with equivalent temporary differences by the end of the period. For example, accrued expenses may be deductible for tax purposes when paid, but a similar level of accruals are expected at the end of the next period. It is unclear whether the ED would require the amount to be classified as current to be

determined by reference to the underlying accrual at the reporting date (so entirely shown as current), or the impact on future tax payments (which means only any expected reduction in the deferred tax amount is shown as current)?

We also note the ED's calculation methodology of relying on the assumption of sale or settlement at the reporting date may not accord with the entity's expectations as to reversal of the related temporary differences. In these cases, it will be difficult to determine how much of the overall temporary difference should be classified as current because there may be no rational basis for making the determination, i.e. the temporary difference will bear no relationship to the current tax implications in the subsequent reporting period.

Accordingly, in light of the complicated nature of the calculations required and the lack of meaningful information provided by arbitrarily bifurcating amounts between current and non-current, we believe the existing AASB 112/IAS 12 approach should be retained.

Question 16 – Classification of interest and penalties

IAS 12 is silent on the classification of interest and penalties. The exposure draft proposes that the classification of interest and penalties should be a matter of accounting policy choice to be applied consistently and that the policy chosen should be disclosed.

Do you agree with the proposals? Why or why not?

We agree with the proposals, particularly in light of the ED's proposals for the measurement of uncertain tax positions. In many jurisdictions, uncertain tax positions are settled on a 'net' basis that includes the tax avoided and the associated interest and penalties and providing entities with the choice of presenting such settlements as a single amount in income tax expense avoids the need to undertake arbitrary allocations.

Question 17 – Disclosures

The exposure draft proposes additional disclosures to make financial statements more informative. Do you agree with the proposals? Why or why not?

The Board also considered possible additional disclosures relating to unremitted foreign earnings. It decided not to propose any additional disclosure requirements. Do you have any specific suggestions for useful incremental disclosures on this matter? If so, please provide them.

We generally agree with the disclosures proposed as we believe they provide relevant information for users.

In relation to unremitted foreign earnings, we believe the existing disclosure requirement around this item is itself onerous as the calculations required to determine the temporary difference is onerous in some cases (as discussed in our response to Question 4). Accordingly, we would prefer any disclosure in relation to unrecognised deferred taxes associated with investments be limited to a narrative of the nature of the tax exposure of the consolidated group and how any tax amount would be determined, without providing details of the amount of those temporary differences or deferred taxes.

The proposed disclosures in paragraph 48(g) are also of concern as the entity affected may not have access to the information necessary to collate the disclosures in some cases, i.e. where the tax bases are effectively dependent upon the tax status and elections of the investors in the entity.

Question 18 – Effective date and transition

Paragraphs 50–52 of the exposure draft set out the proposed transition for entities that use IFRSs, and paragraph C2 sets out the proposed transition for first-time adopters. Do you agree with these proposals? Why or why not?

We agree with the proposals.

In relation to the proposals for first-time adoption under AASB 1/IFRS 1, we believe it is appropriate to include the impact in opening retained earnings as to adjust other accounts would be too onerous and complicated. Taken in the context of the overall transitional adjustments an entity may make on applying AASB 1/IFRS 1, the impact of alternate approaches would not produce information that is more relevant and reliable than the pragmatic approach proposed.

Appendix 2 – Common areas of difficulty in applying AASB 112/IAS 12

As noted elsewhere in this letter, we believe the proposed calculation methodology in the ED and its reliance on an assumption of sale at the reporting date is flawed, does not produce meaningful outcomes and is unhelpful in addressing the issues commonly arising under AASB 112/IAS 12. We would instead prefer the existing 'management intention' approach be retained and specific guidance be developed to eliminate existing uncertainties in applying this approach.

This appendix outlines some of the common issues arising under the existing IAS 12 and our recommendations as to how those issues might be resolved.

Nature of an income tax

The ED provides limited additional guidance on the types of government imposts which are considered income taxes and so subject to the requirements of the ED. The recent IFRIC agenda rejection statement on this matter has been incorporated into the ED without any additional details as to how the guidance might be applied.

Notwithstanding the additional guidance, there are a number of government imposts which cause difficulty in this area, including:

- 'tonnage taxes' applied in lieu of income taxes
- resource rent taxes, which are a form of 'economic rent' but exhibit characteristics of an income tax
- resource royalties and production sharing arrangements.

We recommend more guidance be incorporated on how to determine whether particular imposts are income taxes.

Calculation methodology

We recommend the existing requirements of AASB 112/IAS 12 be clarified to require a 'split' of assets and liabilities into their component tax consequences and then apply an 'expected to affect taxable profit' test to each component. This approach would then separately reflect the actual expected tax consequences arising from the recovery or settlement of assets and liabilities, which in our view is more consistent with the objectives stated in the ED.

For example, the carrying amount of a building would be bifurcated into the amount expected to be recovered through use (revenue) and the amount recovered through sale (capital). Each of these components would then be compared to the tax basis (future tax deductions or assessable amounts) expected in relation to that component and separate deferred tax calculations performed for each component.

This approach allows management intention to be more readily built into the deferred tax calculation and produces an outcome which better reflects the actual expected tax consequences from the recovery or settlement of assets and liabilities.

Where the asset or liability was expected to be fully recovered or settled only with one tax consequence, only one deferred tax calculation would be required, e.g. an asset expected to be fully used and recovered on 'revenue' account with a single revenue tax base.

We believe this approach produces an outcome that is more consistent with the objective of recording the tax payable or recoverable in future periods as a result of past transactions or events. This is because the amounts recorded using this approach produce an outcome more closely reflecting the expected future tax cash flows and therefore provides a better basis for users to make informed decisions about the taxation consequences the entity expects.

We also believe this approach, together with our other recommendations elsewhere in this appendix, would assist to resolve many of the interpretational issues arising under the existing AASB 112/IAS 12.

Tax items effectively incorporated into goodwill

In many jurisdictions, tax deductions (often in the form of depreciation or amortisation) arise in relation to business combinations where a separate, or different, asset is not recognised when accounting for the business combination under AASB 3/IFRS 3 *Business Combinations*. In the Australian context, this issue arises in relation to certain customer-related intangible assets and in relation to 'copyright' and similar assets.

In these situations, the amount giving rise to the tax deduction is often effectively recognised as part of goodwill for accounting purposes. The question then becomes whether the benefit of the deduction should be recognised as:

- a separate deferred tax asset as part of accounting for the business combination, or
- 'attached' to the goodwill as part of the tax basis of the goodwill, which may impact the recognition of deferred taxes in future periods due to the recognition exception for goodwill.

One possible method of accounting for these items is to recognise a separate deferred tax asset. Accounting professionals supporting this view believe it better reflects the economic substance of the nature of the deductions available.

However, the existing AASB 112/IAS 12 is unclear on this matter and we recommend guidance is provided on this matter.

Investment properties

There is a lot of uncertainty around the calculation of deferred taxes arising in relation to investment properties are accounted for on the fair value basis under AASB 140/IAS 40 *Investment Properties*, and diversity has developed in practice.

The key issues arising are as follows:

- whether it is possible to assume the expected method of recovery is 'hold and then sell', i.e. none of the carrying amount of the investment property is expected to be recovered through 'use'
- how deferred taxes are calculated where investment properties are held in 'shell' structures that eliminate, or effectively indefinitely defer, taxes on sale.

We recommend these two issues be reconsidered and a principle be developed reflecting the substance of the future tax consequences expected.

The key issue in this area is how the concept of 'fair value' is determined where there are multiple tax consequences and potentially conflicting requirements between AASB 112/IAS 12 and other standards (particularly AASB 140/IAS 40). The fair value determined on the application of AASB 140/IAS 40 is effectively a 'net of tax' fair value but IAS 12 would then seek to separately recognise the deferred tax consequences, potentially leading to double-counting. In other cases, the deductions available on use and sale can be quite different.

In light of these conflicts, we suggest consideration is given to implementing an interim solution whilst the longer term income tax project proceeds. One such solution could include:

- a rebuttable presumption be introduced that investment properties, as non-depreciated assets, be expected recovered fully through sale, unless the entity is able to illustrate otherwise, e.g. the investment property is being rental whilst awaiting redevelopment which involves the demolition of the structure
- the expected method of ultimate disposal should be reflected in the deferred tax accounting calculation, i.e. if the asset is expected to be sold in a 'shell' structure (effectively as an 'asset' rather than as a 'business'), the tax consequences of selling the investment property in that 'shell' structure be recognised as deferred tax
- any revenue deductions available be accounted for by applying the recommended calculation methodology outlined above.

The new guidance must achieve consistency in application of the existing AASB 112/IAS 12, eliminate the potential conflict between AASB 112/IAS 12 and AASB 140/IAS 40 and result in an outcome best reflecting the actual tax consequences expected by the entity.

The new approach must also avoid the unusual outcomes resulting from applying the 'assume sale at reporting date rule' in the ED, and additionally reflect the actual tax consequences expected.

Intangible assets

Deferred tax issues arising in relation to intangible assets are in many ways similar to the investment property example noted above.

Common areas where interpretational difficulties arise include:

- intangible assets without tax depreciation available, but which yield taxable profits by being employed in the business, e.g. brand names
- intangible assets which are not amortised for accounting purposes as they are considered to have 'indefinite' useful lives, but which have tax depreciation available (sometimes referred to as 'black hole expenditure'
- intangible assets arising in business combinations that do not separately acquire a tax value (as the tax basis is effectively ascribed to the entity as a whole).

We do not believe the 'assume sale at reporting date' assumption proposed in the ED suitably rectifies these issues as it can result in outcomes that do not represent any actual tax consequence expected.

Instead, we recommend an interim solution be implemented whilst the longer term income tax project proceeds. One possible solution could be as follows:

- the principles of SIC-21 be extended to intangible assets with indefinite useful lives, i.e. these assets are presumed to be recovered through sale and not use
- other intangible assets be assessed by reference to the amortisation calculation, i.e. the depreciable amount is recovered through use and the residual value through sale
- any revenue deductions available be accounted for by applying the recommended calculation methodology outlined above.

Any new guidance must achieve consistency in application of the existing AASB 112/IAS 12, eliminate the potential conflict between AASB 112/IAS 12 and AASB 138/IAS 38 and result in an outcome that best reflects the actual tax consequences expected by the entity.

Investments in subsidiaries

The determination of the 'outside basis difference' in relation to investment in subsidiaries can be problematic in practice. The carrying amount of investments can effectively be recovered in many ways (e.g. sale, liquidation, distribution, returns of capital). The determination of management intention and the various methods of recovery is problematic in cases where management intends to effectively 'hold' the investment for the foreseeable future.

We do not believe recognising the tax consequences of sale in these circumstances (as is proposed by the ED) best reflects the actual tax consequences expected, unless the entity clearly intends to realise the carrying amount of the investment in this manner.

Instead, we would prefer guidance to be provided on how an 'indefinite' intention to hold a subsidiary is taken into account when deferred tax accounting. In many cases, entities will utilise all available tax structuring opportunities to minimise the amount of tax that might ultimately be payable on disposal of a subsidiary, e.g. it is common in some jurisdictions for tax-free distributions to be paid for all retained earnings prior to disposal. We believe entities should be able to take these tax planning opportunities into account when determining the amount of deferred tax to recognise. To this end, we recommend the existing guidance on 'minimum' amounts of tax included in AASB 112/IAS 12 in relation to associates be extended to subsidiaries.

However, a further complication arises as a the result of the AASB and IASB's recent amendments to AASB 127/IAS 27 *Consolidated and Separate Financial Statements* and AASB 118/IAS 18 *Revenue*, requiring all distributions to be recognised as revenue. These amendments have added additional uncertainty in how to recognise the tax consequences of investments in subsidiaries in separate financial statements as it might be argued the carrying amount of the investment cannot be recovered through 'distribution', even though such a distribution may directly lead to the recognition of an impairment loss on the application of the related amendments to AASB 136/IAS 36 *Impairment of Assets*. We recommend these impacts be considered and clear guidance provided on how deferred tax accounting should be performed for investments in separate financial statements.

Appendix 3 – Jurisdictional examples where the approach proposed by the ED produces unusual outcomes

We have identified a number of examples that illustrate the proposals in the ED can result in the recognition of deferred tax balances that do not reflect the anticipated tax consequence which triggered the deferred tax calculation under paragraph 12(a) of the ED. These issues are regularly encountered by Australian entities with foreign operations in these jurisdictions.

The following are some examples of potentially counter-intuitive outcomes occurring as a result of the assumption of sale in determining the tax basis of an asset as proposed in the ED:

Australia

Certain 'pre capital gains tax' assets in Australia are exempt from taxation on sale and on occurrence of other 'capital gains tax events', but income from ongoing use is taxable and some tax depreciation is permitted.

Additionally, the tax-consolidation regime in force in Australia has the effect of 'pushing down' the cost of a business combination to the underlying assets and liabilities acquired. The effect is that assets obtain a tax basis close to fair value but which is often on 'capital account' such that the deduction is only realised on sale (or if other tax events occur).

In applying the requirements of the ED, no deferred tax is recognised, even though future tax is expected under paragraph 12(a) of the ED.

New Zealand

Capital gains in New Zealand are exempt from taxation. The assumption of sale requirement, combined with the 'rule' deeming the tax basis to be equal to carrying amount where sale would not give rise to taxable income, would mean no temporary difference arises in respect of these assets. Accordingly, no deferred tax would be recognised even though expected tax consequences arise.

Hong Kong

The sale of certain properties in Hong Kong is exempt from taxation, but tax depreciation is permitted from ongoing use. Under the ED the tax basis would be set equal to carrying amount and no deferred tax would be recognised, even though a tax consequence would be expected in future periods from use of the asset.

Canada

In Canada, the 'cumulative eligible capital' concept permits an inflated deduction on the sale of certain assets, including those that in the ordinary course of business would not be expected to be sold. Applying the ED's requirements in these circumstances can result in the recognition of a deferred tax asset, even though the expected recovery of the asset is expected to *increase* taxable profits in the future.

Additionally, the Canadian tax treatment of partnerships often results in no deferred tax on the sale of an investment in a partnership, but the partner is directly exposed to the underlying tax consequences of the partnership's assets and liabilities (similar outcomes are widespread across many jurisdictions). The application of the ED requirements would not result in the recognition of any deferred taxes on these types of investments.

United Kingdom

Under the UK tax system, many buildings, such as industrial buildings, do not receive any tax depreciation but costs and an indexed cost is deductible on ultimate sale of the building or if it becomes worthless as a 'negligible value claim'. In many cases, the building is used until it has negligible value, during which time taxable profits are generated as it is used. However, the application of the sale assumption will result in the recognition of a deferred tax asset, with possibly a corresponding valuation allowance.

Cross jurisdictional issues

In many jurisdictions, assets are commonly held and traded in 'corporate shells' or similar vehicles. There is commonly no history of the sale of assets disposed other than within the corporate shell and the tax consequences of doing so may either be unclear in the relevant jurisdiction, or alternatively the deductions permitted on sale may be punitive and never be expected in practice. However, the sale assumption would require these punitive consequences to be recognised as deferred tax.

A deduction for research and development is permitted in many jurisdictions. Commonly the expenditure is expensed for accounting purposes but deductible over a period of time (e.g. five years) for tax purposes, sometimes on an 'inflated' basis (e.g. deduction of 150% of expenditure). In some jurisdictions, in the event that the entity sells the research and development project to another party, the entitlement to deductions ceases and often the proceeds are fully taxable. In these cases, the 'assumption of sale' would produce a tax basis of nil. No deferred tax would be recognised even though the entity has a carried forward entitlement to tax deductions.

The ED includes specific guidance on how to determine the tax basis for items that do not have a carrying amount in the statement of financial position (paragraph 16). However, there is no clear justification as to why the assumption of sale or settlement at reporting date is not applied for these items.

Appendix 4 – Additional comments on the proposals in ED/2009/2

The following are additional comments and suggested editorial changes we would like the AASB and IASB to consider in the event it is decided to proceed toward the finalisation of a standard on income taxes.

Structure of the proposed standard

The structure of the proposed standard is not optimal.

To understand the key requirements, the main body of the standard must be read in conjunction with the application guidance in Appendix B. In many cases, the information contained in the Basis for Conclusions must also be consulted to fully understand the IASB's intention in particular areas.

We recommend the IASB reconsider the structure of any final standard and incorporate the key requirements into the main body of the standard. This may mean the majority of the existing content in Appendix B (application guidance) is either incorporated into the standard itself or moved to the illustrative examples. Additionally, some of the information in the Basis for Conclusions should be incorporated into the main body of the standard where it is helpful in explaining the application of the proposed requirements.

Calculation methodology

In the event the ED's proposals are proceeded with, we recommend the following changes:

- remove the assumption of sale or settlement at reporting date and remain silent on this matter (same approach as US GAAP where the revenue tax basis can be used)
- remove the assumption of the sale rate where revenue and sale deductions are different
- clarify how the assessment of "temporary differences that are expected to increase or decrease taxable profit" is to be made
- consider using the terms 'basis difference' (carrying amount less tax basis) and 'temporary difference' (amount of the basis difference that is expected to increase or reduce taxable profits in the future), as this would appear to be easier to understand and apply.

Tax elections

The ED does not provide any guidance on how tax elections should be treated and accounted for under its proposals. Tax elections are common in many jurisdictions and the outcomes under various elections may be substantially different.

In some cases, tax elections may be conditional, e.g. a concessional tax treatment that is conditional on distributing a particular portion of profit to stakeholders.

We recommend the development of a definition of 'tax elections' and the determination of how these are to be accounted for, including whether, and if so, when an anticipated tax election should be taken into account in the measurement of current and deferred taxes.

In our view, a voluntary tax election can be freely chosen by an entity should be reflected no later than the time the election is applied for (often with 'automatic' approval) or included in the tax return. However, in many cases, management would have made a firm decision to choose a particular election and it would therefore appear reasonable to permit current and deferred taxes to be reflected on this basis notwithstanding the tax return or application is yet to be made. This is particularly relevant in the case where a particular transaction has occurred but an election has not yet been formally made – current and deferred taxes cannot be calculated without anticipating the election.

It is also important that the concept of a change in tax status is differentiated from a tax election through the development of a clear principle on the nature of each item. For instance, in many jurisdictions, it is possible for an eligible consolidated group to elect to be taxed as a single entity. It is unclear whether moving from being taxed on an individual entity to consolidated basis should be considered a 'change in tax status' or a tax election.

Tax effect of equity items

The ED is silent on the treatment of the tax-effect of equity items.

In some cases, an equity item may have an anticipated future tax consequence that in our view should be recognised in the same way as for assets and liabilities. Examples include treasury shares and statutory 'taxable reserves' that can result in tax consequences if the treasury shares are reissued or the underlying item is realised through sale.

We recommend the ED incorporate appropriate requirements and guidance in relation to these matters.

Definition of tax deduction

The ED does not contain a definition of 'tax deduction', but the concept of 'amounts deductible' is used extensively in the ED in relation to the determination of the tax basis. We recommend the ED provide a definition of 'tax deduction' and provide guidance on what amounts should be considered a 'deductible amount'

Definition of effective tax rate

Paragraph 43 of the ED defines the average effective tax rate. We recommend that consideration to given as to whether this definition should be conformed with the equivalent requirements in IAS 34 *Interim Financial Reporting* or, alternatively, that differences between the use of the term in the two standards be clearly explained.

Illustrative Examples

Example 15 in the *Draft flowchart and illustrative examples* accompanying the ED illustrates the outcome of applying the ED's requirements in relation to certain assets were proceeds on sale in excess of an asset's cost are not taxable. The example's conclusion is that where the asset is expected to be used, the full amount of the temporary difference will give rise to a deferred tax liability.

We are unsure how to reconcile the outcomes in the example with the other requirements of the ED. Furthermore, we are unsure whether the outcomes in the example are as the IASB intends.

Paragraph 15(a) of the ED notes that where the recovery of an asset through sale does not give rise to taxable income, the tax basis is deemed to be equal to its carrying amount. This paragraph appears to establish a rule whereby amounts that are non-taxable on sale create an equal 'deemed' tax basis.

However, it is unclear to us whether this rule should be applied to a *component* of the carrying amount, which in the example would be the portion of the carrying amount of the asset which exceeds its original cost. No amount of the excess carrying amount above the original cost can create a tax consequence on sale (as it is exempt from tax) and if the rule in paragraph 15(a) was applied to this component would form part of the tax basis for the asset.

Where the rule in paragraph 15(a) was applied, the deductions available to the entity from use (future depreciation) would be different from those available on sale (unclaimed depreciation plus the 'deemed' excess). Accordingly, the rule in paragraph B29 of the ED would not permit the recognition of a deferred tax liability on the basis of use as the assumption of sale would need to be applied both in the initial determination of the tax basis and also the measurement of the deferred tax liability arising. This would give rise to the recognition of a deferred tax liability of CU12 (40 temporary difference at 30% tax rate).

In the event the rule in paragraph 15(a) cannot be applied in this manner, the amount of tax recognised on applying paragraph B29 will depend on whether or not the deductions from use or sale are *exactly* the same. Only if these amounts are exactly equal will the rules in paragraph B29 give rise to the CU27 deferred tax liability illustrated. However, even a $1 difference in the amount of the deduction available from use or on sale would presumably trigger the requirement to reflect the sale consequences possible from the asset and lead to the recognition of a CU12 deferred tax liability.

The fact pattern outlined in the example applies in jurisdictions without a formal capital gains tax regime, such as New Zealand. Under the New Zealand tax system, some assets are permitted tax depreciation and some are not. The application of the above requirements produces vastly different outcomes on the basis of whether tax depreciation is available or not and whether the deduction available on sale is *exactly* the same as the deduction available from use. (Our concerns regarding the outcomes in the situation where no depreciation is available are highlighted in our response to Question 1).

It is unclear to us why the deferred tax outcome is so strongly linked to the existence of tax depreciation (or other allowances) from use, when ostensibly the ED purports to focus, albeit incorrectly in our view, on sale.

We suggest these requirements and their outcomes be reconsidered and, if they are retained, it will be necessary to clearly articulate in any final standard the rationale being applied and the principle justifying this accounting outcome.

Other matters

In the event that the proposals are proceeded with, we recommend consideration be given to the following additional matters noted elsewhere in this letter:

- the interaction of the removal of the 'initial recognition exception' with the requirements of AASB 136/IAS 36 *Impairment of Assets* (see our response to Question 3 in Appendix 1)
- the application of proposed exception in respect of foreign subsidiaries and joint ventures (see our response to Question 4 in Appendix 1)
- the treatment of valuation allowances against deferred tax assets that arise in the context of a business combination (see our response to Question 5A in Appendix 1)
- applying the 'more likely than not' criterion where tax losses, tax credits or anticipated losses are able to be indefinitely carried forward (see our response to Question 6A in Appendix 1)
- guidance on the nature of costs to be taken into account when calculating a valuation allowance against a deferred tax asset (see our response to Question 6B in Appendix 1)
- the recognition and measurement of interest and penalties and the nature of disclosures for uncertain tax positions (see our response to Question 7 in Appendix 1)
- the determination of the appropriate rate to apply in calculating deferred taxes (see our response to Question 9 in Appendix 1)
- differentiating between tax credits, investment tax credits and 'special deductions', and how each of these items should be accounted for (see our response to Question 11 in Appendix 1)
- the requirements around the determination of an 'aggregate' tax rate need to be clarified and limited in scope, and additional guidance provided on when two tax systems are sufficiently related to require the 'aggregate' approach (see our response to Question 12 in Appendix 1)
- guidance on how to determine the split between the current and non-current presentation of deferred taxes (see our response to Question 15 in Appendix 1)
- the usefulness and/or onerous nature of particular disclosures (see our response to Question 17 in Appendix 1).

Appendix 5 – Responses to specific AASB questions

Question 1. Any issues that could arise from applying the proposals in this Exposure Draft to the specific features of Australian income tax laws. Please include in your consideration whether the proposals would resolve existing practice issues and the extent to which the proposals could create new practice issues.

We believe that there are a number of significant issues that arise under the ED in the Australian context. These have been discussed throughout this letter.

In particular, we highlight to the AASB the significance of the proposed removal of the investment recognition exception in relation to tax-consolidated groups discussed in our response to Question 4 in Appendix 1. This is a significant issue for Australian constituents and we strongly recommend the AASB communicate to the IASB:

- the onerous nature of the proposed change in the Australian environment, and
- the resultant need to retain the recognition exception for deferred taxes in relation to domestic subsidiaries.

Question 2. The implications that the proposals could have on Australian Interpretations that currently address Australian-specific income tax accounting issues, including Interpretation 1039 *Substantive Enactment of Major Tax Bills in Australia* and Interpretation 1052 *Tax Consolidation Accounting*, and your views on how those implications should be dealt with

We recommend the AASB consider the need to retain Interpretation 1039 *Substantive Enactment of Major Tax Bills in Australia*, Interpretation 1052 *Tax Consolidation Accounting* and Interpretation 1003 *Australian Petroleum Resource Rent Tax* once any new standard resulting from the ED is made.

In the event that the AASB decides domestic Interpretations are warranted on these or other Australian-specific income tax accounting issues, any such Interpretations must be narrow in scope, deal only with unique Australian issues, be consistent with the new requirements and guidance in any standard resulting from the ED, and be worded in a manner which does not place Australia's full compliance with IFRS at risk.

Question 3. Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(a) not-for-profit entities; and

(b) public sector entities.

For example, whether there are any issues associated with applying the proposals to account for the obligations of public sector entities to pay 'income tax equivalents', noting that paragraph Aus2.1 of AASB 112 currently includes income tax equivalents within its scope

We are not aware of any specific issues in this regard. The interpretational issues faced by not-for-profit and public-sector entities in applying the existing AASB 112 appear to be largely consistent with those arising for the for-profit sector.

Question 4. Whether, overall, the proposals would result in financial statements that would be useful to users

As noted in our covering letter, light of the lack of clear principles, counterintuitive outcomes and the failure to meet the additional objective of achieving convergence with US GAAP, we do not believe the ED, in its current form, is an improvement on existing accounting requirements.

Instead, we would prefer that the IASB does not proceed with the proposals in the ED and instead commences a more thorough and comprehensive project. Accordingly, we believe that the IASB should deal with the more significant issues arising under AASB 112/IAS 12 (such as those outlined in Appendix 2) through the improvements process whilst the more comprehensive project is undertaken.

Question 5. Whether the proposals are in the best interests of the Australian economy.

In light of our response to Question 4 immediately above, we do not believe that the proposals are in the best interests of the Australian economy.

In the event that the IASB proceeds with the proposals, we believe that it is imperative that Australian retains full convergence with IFRS to ensure that Australian entities can compete for funds in global capital markets. The objectives of full convergence with IFRS outweighs concerns about individual standards and from this perspective, we would fully support the adoption of an Australian equivalent standard in these circumstances.