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31 July 2009

Sir David Tweedie
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Dear David

IASB Exposure Draft ED/2009/2 *Income Tax*

The Australian Accounting Standards Board (AASB) is pleased to submit its comments on the abovenamed Exposure Draft. In formulating these comments, the AASB sought and considered the views of Australian constituents. The comment letters received are published on the AASB's website.

The AASB supports the objectives of clarifying IAS 12 *Income Taxes* and US GAAP/IFRS convergence. However, the AASB has concerns with the complexity of the amendments proposed in the ED, some significant technical matters and, in light of recent economic events, also with the project's timing. The AASB thinks that the IASB needs to reconsider whether it is still appropriate for improvements to IAS 12 to be prioritised ahead of other projects.

Given the history of the debates over income tax accounting, the AASB thinks that in due course a more fundamental longer-term review should be considered. In the meantime, and in the context of the short-term convergence project, the AASB thinks the IASB's focus should remain on removing, where appropriate, exceptions from the temporary difference model, so that it is both simplified and relevant to the planned US GAAP/IFRS convergence.

In anticipation of the IASB deciding to proceed with the short-term project, the AASB has outlined in the attached submission its concerns and suggestions for improving the proposals. The AASB's main concerns, and its suggestions for addressing them, relate to:

(a) the appropriateness of the assumption of recovery through sale when different tax rates apply to the consequences of using, compared with selling, where an asset will be both used and sold. The AASB is concerned that the principle underlying the temporary difference model has not been followed, and suggests the IASB address this apparent inconsistency;

(b) the inconsistent application of 'management intent'. The AASB suggests that the IASB reconsiders how it has addressed 'management intent' in light of its debates on financial instruments and the distinction it now seeks to make between 'management intent' and 'business model' and applies whatever notion is adopted consistently;

(c) the manner in which the initial recognition exception has been removed and the manner in which the investments in subsidiaries, associates, joint ventures and branches has been modified. The AASB suggests retaining the IAS 12 approach to the initial recognition exception and either keeping the existing approach to investments or removing the proposed exception entirely;

(d) the apparently inconsistent way in which uncertainty has been treated for asset and liability recognition and measurement. The AASB suggests that the IASB explains the apparent inconsistency or considers using 'more likely than not' as a measurement basis consistently throughout the Standard to be developed from the ED, until the Liabilities project has been finalised, at which point consideration should be given to accounting for uncertainty consistently across all Standards;

(e) that the 'link' between deferred tax assets and liabilities and the transaction that gave rise to them is adopted in the proposals in an inconsistent way. The AASB suggests that the IASB adopts a principles-based approach to the subsequent treatment of deferred tax in relation to whether a 'link' to the initial transaction is maintained; and

(f) that 'income tax' is not clearly defined. The AASB suggests that the IASB develops further guidance on what constitutes an income tax within the scope of the Standard.

The AASB thinks that its suggestions for improving the proposals would result in a less complex Standard that is a significant improvement on IAS 12.

If you require further information regarding any matters in this submission, please contact Jessica Lion (jlion@aasb.gov.au) or me.

Yours sincerely

Kevin Stevenson
Chairman

AASB's Specific Comments on IASB Exposure Draft ED/2009/2 *Income Tax*

The AASB's views on the questions listed in the Invitation to Comment are as follows:

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. (See paragraphs BC17–BC23 of the Basis for Conclusions.)

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

The AASB does not agree with the proposals as it believes the overriding principle of the ED has not been clearly articulated in relation to the role of management intent. As currently drafted, the rule of assuming recovery through sale appears to conflict with the definition of deferred tax and the overriding principle as currently expressed in the ED.

Assumption of recovery through sale is inappropriate

The Board appears to propose mandating the assumption of recovery through sale when determining tax bases, to address a practice issue with IAS 12 *Income Taxes* that arises when management intends to both use (see next point) and then sell an asset. The AASB is concerned the proposal is conceptually flawed. Some jurisdictions (such as New Zealand) have no tax consequences upon sale of an asset. Therefore, depending on how the proposals are interpreted, entities in such jurisdictions might recognise no deferred tax under the proposals. This appears to be in conflict with the overriding principle deferred tax accounting is attempting to achieve, (namely 'recognising tax recoverable or payable in future periods as a result of past transactions or events') and the AASB does not believe it will faithfully represent the financial position of an entity if management has no intention of selling the asset. The AASB therefore thinks the Board should continue to apply an approach based on the current 'management intent' based approach in IAS 12. In relation to the 'management intent' based approach in IAS 12, the AASB notes the IASB's proposal in ED/2009/7 *Financial Instruments: Classification and Measurement* in relation to accounting being based on the 'business model' rather than 'management intent'. The AASB thinks that there is merit in having consistency across projects and that consideration should be given to how the new proposals might apply.

'Recovery through use' needs to be clarified

The ED should define 'recovery through use' (which would help to distinguish 'recovery through use' from 'using an asset without recovering its carrying amount'), as the AASB is aware of two different views on its application. One view is that recovery through use of an asset can only be achieved if the asset is depreciated for accounting purposes, and if it is not depreciated an entity can only assume that it will recover the carrying amount of the asset

through sale (this view is expressed in paragraph BC73). Another view is that non-depreciable assets, such as indefinite life brand names, can be recovered through use as they will generate taxable income in the future. Some see staff examples 14 and 15 as supporting this view. The AASB supports the latter view.

Given the two differing views noted above, some may conclude for example that recovery through use of a particular asset will affect taxable profits (through generation of taxable income) while in relation to the same asset, others may not (as no tax deductions are available on use).

The AASB thinks the two views could be partially resolved by clarifying the meaning of 'depreciated for accounting purposes'. Some argue that both indefinite life assets (e.g. certain brands) and infinite life assets (e.g. certain land) are not depreciated for accounting purposes and therefore not able to be recovered through use. However the AASB is of the view that infinite life assets are not depreciable but indefinite life assets are depreciable and therefore able to be recovered through use.

Management intention is applied inconsistently

The AASB does not believe 'management intention' is applied consistently within the ED as a basis for recognising and measuring deferred tax. For example, a proposed initial step in deferred tax recognition requires management to identify whether it expects a tax consequence on recovery/settlement of an asset/liability based on current intention (with which the AASB agrees, although as noted above the AASB's preference is to base it on the 'business model' similar to that reflected in IASB ED/2009/7), and yet it prohibits having regard to management intent when determining the tax basis. To address this inconsistency, the Board should require the tax basis to be determined based on management intent/business model. However, if the Board goes ahead with this proposal, it should mandate use of the 'sale' tax rate to be consistent with the proposed determination of the tax basis.

The ED is unclear about the treatment of temporary differences with various tax consequences

Appendix A of the ED defines a temporary difference between an asset's carrying amount and its tax basis as a '... difference ... the entity **expects** will affect taxable profit...'. Some interpret this as implying that an entity is required, as part of the deferred tax calculation, to split or allocate a temporary difference into those parts that an entity expects to impact the determination of taxable profit and those that will not. However, this is not explicitly stated anywhere in the ED. The AASB recommends the Board clarifies the requirements, which might include, for example, specifying two additional steps in the deferred tax calculation, 1) to split the temporary difference based on management expectation of those amounts that will affect taxable profit and 2) to multiply each part by the expected tax rate relevant to each, if it is the Board's intention for the calculation to apply to only that part of the temporary difference that the entity expects will affect taxable profit. This would make the steps to be performed when calculating deferred tax clearer to readers.

The AASB also recommends the Board clarifies that the 'difference' referred to in the definition of a temporary difference may not necessarily equal the total difference between an asset and its tax basis, and it could be one component of it. This could also be explained in

paragraph B15 where assets are revalued and the revaluation may or may not be part of the tax basis, but the original cost is.

Furthermore, the ED proposes that the tax rate applied to the temporary difference be based on how management intends to recover the underlying asset, if the deductions available are the same for use and sale. However, it does not consider a situation where there are different tax consequences on different components of an asset as it is recovered (e.g. management might intend to recover the asset through both use and sale) and therefore does not make it clear which rate should apply, nor does it explain whether an entity should break the calculation into components. The AASB notes that illustrative staff example 15 shows a revalued asset being broken down into its 'original carrying value' and the amount of the revaluation to arrive at two temporary differences which are each subjected to different tax rates (30% and nil %) to determine the deferred tax balance. Therefore, for clarity, the ED should provide explicit guidance on the 'unit-of-account' at which temporary differences and deferred tax balances should be calculated, which would help the issue of management having multiple intentions or there being different tax consequences or tax rates applicable to various components of the asset.

Prepayments and income received in advance, taxed on cash payment/receipt

Depending on how it is interpreted, paragraph 10 of the ED may produce a different result from IAS 12 in some instances. This may occur, for example, where a tax deduction or taxable income arises on initial recognition of an asset or liability, even though for accounting purposes income or expense is not recognised until a later period (for example, prepayments deductible on payment of cash, or income received in advance taxable on receipt of cash). The AASB is aware that some are of the view that there is no taxable income or amounts deductible on recovery/settlement of the asset/liability, therefore under the ED no deferred tax arises on initial recognition of the asset/liability. This is different from the current application of IAS 12. However there are those of the view that there is taxable income or amounts deductible on recovery/settlement of the asset/liability and hence these individuals would go on to recognise deferred tax on such items under IAS 12 and the proposals in the ED.

The AASB suggests that, for clarity, guidance is provided that explicitly addresses the tax effect accounting for prepayments and accrued income, taxed on cash payment/receipt, to explain that these items affect taxable profits on recovery/settlement. See also the AASB's comments under the section ''Recovery through use' needs to be clarified' above.

Question 2 – Definitions of tax credit and investment tax credit The exposure draft would introduce definitions of tax credit and investment tax credit. (See paragraph BC24 of the Basis for Conclusions.) Do you agree with the proposed definitions? Why or why not?

The AASB supports the inclusion of definitions for 'tax credit' and 'investment tax credit'. However, the proposed definition of investment tax credit refers only to depreciable assets, even though there may be jurisdictions where investment tax credits are available for non-depreciable assets, such as land, financial assets and intangible assets. Therefore, the AASB

suggests that the definition is expanded to include tangible and intangible, depreciable and non-depreciable assets.

Tax credits, as defined in the ED, may be economically similar to tax deductions forming part of an asset's tax basis, 'special deductions' or other deductions that do not form part of an asset's tax basis. Therefore, the Board should distinguish between different types of tax credits and tax deductions, if in fact they are different for accounting purposes. The AASB would prefer that the Board addresses the accounting for all types of tax credits and deductions, especially investment tax credits, because they are scoped out of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. In practice, the AASB is aware of at least three different ways entities are currently accounting for investment tax credits (by analogy to IAS 12 as a current tax, by analogy to IAS 12 as part of the tax basis of an asset, or by analogy to IAS 20 as a government grant).

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. (See paragraphs BC25–BC35 of the Basis for Conclusions.)

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

In principle the AASB supports the removal of the exception. However, the exception should not be removed in the manner proposed because:

(a) the proposals are unnecessarily complex and would not be understandable to many users and preparers;

(b) the costs would outweigh the benefits in implementing the proposals; and

(c) the proposals would not lead to a significant change in the outcome that would arise from existing IAS 12.

If the proposals proceed, the Board should more clearly explain its rationale for the approach in the Basis for Conclusions. For example, the relationship between transaction price and the initial carrying amount referred to in paragraph BC28(b) needs to be explained, as does the 'problem' referred to in paragraph BC31 and the 'anomaly' referred to in paragraph BC33. If the underlying rationale is aversion to the recognition of day one gains and losses, this should be explicitly acknowledged.

If the Board continues with this proposal, it should also consider providing guidance/examples on how to identify 'entity-specific' tax consequences and whether the

'entity-specific tax effect' referred to in paragraph B10(b) is intended to be recognised (paragraph B11 suggests otherwise), and if so its subsequent accounting treatment.

It is not clear whether the Board's intention in paragraphs B10 and B11 is to deviate from the requirements of other IFRSs. For example, if an IFRS specifies 'cost' on initial recognition, the disaggregation required in paragraph B10 seems to deviate from this measurement requirement. If this is the intention of the Board, it should be explicitly stated in the ED, and the Board should consider consequential amendments to the other Standards.

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. (See paragraphs BC39–BC44 of the Basis for Conclusions.)

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?

Conceptually the AASB agrees with the removal of IAS 12's exceptions to principles. However, the exceptions for investments in subsidiaries, branches, associates and joint ventures should either be removed in its entirety or retained as currently in IAS 12. There is no basis for treating one group of the types of investments referred to in this question differently from others, as complexity in determining tax bases exists for both domestic and foreign investments and it can be difficult to distinguish between foreign and domestic investments. The AASB also notes that despite the proposed exemption from recognition of deferred tax on complexity grounds, the disclosures that are required in relation to foreign investments can be equally complex.

If the Board proceeds with its proposals, guidance should be included on how to assess whether an investment is essentially permanent in duration and how to identify a 'foreign' subsidiary. For example, under the current proposals, it is unclear whether 'foreign' is intended to be considered from a country or regional/union (e.g. Europe) perspective, and whether it is relative to an immediate parent or ultimate parent.

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. (See paragraphs BC52–BC55 of the Basis for Conclusions.)

Question 5A

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

The AASB agrees with this proposal, as it provides useful information about a range of possible outcomes. Although the information could be conveyed in a note, the AASB thinks there is sufficient benefit in capturing it via a measurement requirement that results in converged IFRS/US GAAP.

The AASB suggests that (despite paragraph 24 of IFRS 3), for clarity, the Board considers how valuation allowances against deferred tax assets arising from a business combination should be treated, given paragraph B41 of IFRS 3 states that valuation allowances shall not be recognised separately.

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?

The AASB accepts that this proposed notion of 'more likely than not' is a familiar one in practice and consistent with the treatment of uncertainty in, for example, the existing recognition criteria in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. It is, however, different from the concepts applied to uncertain tax positions in the ED. Accordingly the Board should consider more fundamentally whether uncertainty is a recognition or measurement issue. The AASB also suggests the Board reflects on whether uncertainty should be treated consistently for assets and liabilities. If the Board is of the opinion that assets and liabilities should be accounted for consistently, as mentioned in Question 7, the AASB suggests that consistency is applied throughout the ED regarding the measurement of 'uncertainty' once the Liabilities project is finalised. Alternatively, the Board should explain its rationale for any apparent inconsistency.

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. (See paragraph BC56 of the Basis for Conclusions.)

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

The AASB supports these proposals as the guidance is expected to be useful in helping ensure that the Standard is applied consistently.

Question 6B

The exposure draft adds a requirement on the cost of implementing a tax strategy to realise a deferred tax asset. (See paragraph BC56 of the Basis for Conclusions.)

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

The AASB supports this proposal. However the wording in the ED is unclear on how to account for such costs. Paragraph B18 states, "when tax planning strategies affect the amount of the valuation allowance, the entity shall include in their effect significant expenses or losses to implement those strategies...". Given that this requirement was drawn from US GAAP where the wording in SFAS 109 paragraph 22 is explicit with regards to how to account for such costs, the AASB suggests incorporating the US wording exactly. (SFAS 109 paragraph 22, "Significant expenses to implement a tax-planning strategy…shall be included in the valuation allowance"). The Board should also consider including guidance on how to identify these costs separately from ongoing tax administration costs.

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. (See paragraphs BC57–BC63 of the Basis for Conclusions.)

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

The AASB agrees with the comment in paragraph 26 of the ED, in relation to it being 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 tax.

Although there is conceptual merit with the 'probability-weighted average' approach, the AASB has reservations about this proposal for the following reasons:

(a) the AASB thinks that it would be preferable not to adopt this approach ahead of the Board finalising its Liabilities project. At that point the IASB should consider whether uncertainty should be accounted for consistently across all Standards. (Refer to the comment in Questions 5B). Consistent with the AASB's previous comments to the IASB in its submission on the proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in 2005, unless the measurement basis is clearly defined as being fair value, a probability-weighted average approach would not necessarily provide, without significant disclosure, useful information in situations where normally there are binary outcomes;

(b) the AASB is concerned that the ED does not adequately address the 'unit of account' for which uncertainty is measured, given that uncertainty permeates all aspects of income tax accounting, not just in relation to tax positions. Often individual tax deductions are accepted by the tax authorities on an 'all or nothing' basis and settlements with the tax authorities are made based on an entity's tax position as a whole; and

(c) it does not achieve consistency between IFRS and US GAAP.

However, the AASB notes that this is an area of IAS 12 that particularly needs updating and accordingly considers the 'more likely than not' measurement of uncertain tax positions is preferable as an interim measure (which is consistent with the proposed treatment of valuation allowances in Question 6 and US GAAP), with other pertinent information regarding uncertain tax positions included in disclosures.

If the Board proceeds with the proposals in the ED, the AASB recommends that the IASB considers excluding from the calculation of tax liabilities situations with a 'remote' probability. Guidance should also be included for derecognition of the uncertainty (however, this will be less of an issue if the Board decides to exclude remote probabilities from the calculation).

<u>Question 8 – Enacted or substantively enacted rate</u>

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.

(See paragraphs BC64–BC66 of the Basis for Conclusions.)

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

The AASB agrees with the inclusion in the ED of guidance on substantive enactment, but the existing reference in the ED to the US specific circumstances should be removed because the Board should be developing a global, non-jurisdiction specific, Standard.

Furthermore, the AASB does not agree with paragraph B27, regarding a change in an entity's tax status on the filing date (if approval is not necessary), or on the approval date. This is because, in some circumstances, approval does not necessarily occur on the date the change

in tax status comes into effect (i.e. approval might be obtained for a change in tax status for the following financial year). As such, the Board should make reference to the date the election becomes effective in paragraph B27 (i.e. current taxes should not be measured assuming the change in tax status if the changed status will not be effective until a future period, however, deferred tax should be measured assuming the change in tax status if the status will be effective at the time an entity expects to recover/settle the asset/liability.)

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. (See paragraphs BC67–BC73 of the Basis for Conclusions.)

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

Consistent with the AASB comments in Question 1 relating to the assumption of recovery through sale, the AASB is concerned that the ED does not adequately deal with a dual tax system, i.e. a jurisdiction including both an 'income' and 'capital' tax system. Therefore it is not clear what 'recovery' implies in this situation in the context of the fundamental principle underlying the proposals. The ED should include guidance for circumstances where management intends to (or the business model implies that management will) recover an asset through both use and sale and, as noted in Question 1, consider the 'unit of account' of the temporary difference to which the proposals should be applied.

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. (See paragraphs BC74–BC81 of the Basis for Conclusions.)

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

The AASB agrees with the proposal in the ED, consistent with the argument in the Basis for Conclusions, that this will be the most useful for users.

In some jurisdictions, entities such as trusts act as an agent, paying tax on distributions to the authorities on behalf of their beneficiaries. The Board should clarify that where tax is not levied on the entity itself, distributions should not affect the entity's determination of its tax balances.

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. (See paragraphs BC82–BC88 of the Basis for Conclusions.)

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?

See comments on Question 2.

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?

As commented in Question 9 the ED does not adequately deal with a dual tax system. The AASB agrees that any interaction between the systems should be considered, but is concerned that the ED does not adequately explain how this is to be done. It is unclear whether the proposed requirements would capture arrangements where there are two quite distinct tax systems which are indirectly linked in some way. For example, in Australia 'taxable profits' can be subject to income tax and Australian Petroleum Resource Rent Tax. It is unclear how the proposals would be applied in this case (i.e. would an 'aggregate' rate be determined and applied to the temporary differences arising, or should separate tax calculations be performed for each tax system). The Board should clarify if it intends to require 'aggregated' tax calculations for distinct tax systems and guidance on how to apply the requirement to 'consider the interaction' between them.

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.
(See paragraphs BC90–BC96 of the Basis for Conclusions.)

Question 13A

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

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.

The AASB does not agree with the proposed approach.

The AASB believes the proposal is too rules based and complex and the Board should seek to apply a more principles based approach. In developing the principle, the AASB suggests that the Board considers whether there is any conceptual basis for keeping a link between a deferred tax balance and the original source of the tax if the deferred tax balance is regarded as an asset or liability in its own right. If the Board concludes that there is no link, then subsequent changes in the tax liability should be recognised as part of continuing operations (e.g. as a result of a tax rate change), in the same way that changes in other types of liabilities are recognised.

If the Board proceeds with these proposals, then paragraph 30 should be improved, as it is difficult to comprehend without referring to the guidance in paragraph B35. Guidance should also be included on how to apply paragraphs 31 and 34, in particular defining what constitutes a 'loss item', as referred to in paragraph 34. The AASB acknowledges the Board's reservations about developing a new approach based on principles on this matter, however, the AASB believes there would be benefit in at least articulating an overarching principle that reflects the rules so that a reader of the Standard can better understand the intent behind the rules.

Question 13B

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?

The exposure draft also sets out an approach based on the IAS 12 requirements with some amendments. (See paragraph BC97 of the Basis for Conclusions.)

The AASB is not aware of any material differences between those paragraphs referred to in Questions 13B and the SFAS 109 requirements.

Question 13C

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?

See comment in Question 13A.

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?

See comment in Question 13A.

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. (See paragraph BC100 of the Basis for Conclusions.)

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

The AASB agrees with these proposals; however, it believes there will be a call for further guidance and without such guidance is concerned unacceptable practice will emerge. AASB Interpretation 1052 *Tax Consolidation Accounting* can be freely accessed at http://www.aasb.gov.au/admin/file/content105/c9/INT1052_06-05.pdf. The AASB intends to withdraw this guidance if and when the proposals proceed. The AASB suggests that the Board considers including some guidance based on the matters covered by AASB Interpretation 1052, which are indicative of the issues that arise in practice on the application of the principles set out in paragraph B37 of the ED. The Board should also consider including guidance where an entity in a group is allowed to offset tax assets and liabilities (including losses) with other group entities, but prepares its own tax return.

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. (See paragraphs BC101 and BC102 of the Basis for Conclusions.)

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

The AASB does not support the approach taken in the ED, because the proposal is inconsistent with the ED's proposals relating to backwards tracing, i.e. by removing

backwards tracing it implies that once recognised the deferred tax has no further 'link' to the underlying asset. In contrast, this proposal presumes the deferred tax has an ongoing 'link' with the underlying asset. Therefore, Questions 13 and 15 should be resolved consistently. The AASB agrees with the view deferred tax balances should be classified as current/non-current assets or liabilities in their own right having regard to their own future cash flows.

<u>Question 16 – Classification of interest and penalties</u>

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. (See paragraph BC103 of the Basis for Conclusions.)

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

The AASB notes that although the Board has not reconsidered 'what is an income tax' (see the AASB's first dot point under 'Suggestions for further guidance or clarity' in Other Comments later in this submission), this issue arises frequently in practice and is highlighted by Question 16.

Conceptually, the AASB is of the view that penalties for late payment of tax do not strictly meet the definition of income tax as currently drafted. However, the AASB understands that in some jurisdictions tax is paid inclusive of penalties and it can be difficult to split the amount into its component parts. The AASB therefore can accept giving entities a choice, provided entities are required to disclose their choice.

<u>Question 17 – Disclosures</u>

The exposure draft proposes additional disclosures to make financial statements more informative. (See paragraphs BC104–BC109 of the Basis for Conclusions.)

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. (See paragraph BC110 of the Basis of Conclusions.)

Do you have any specific suggestions for useful incremental disclosures on this matter? If so, please provide them.

The AASB agrees with the proposals, but has the following suggestions:

(a) the AASB considers paragraphs 41(b) and (e), requiring separate disclosure for the tax expense relating to changes in uncertain amounts, unnecessary. The uncertainty would already be contained in the measurement, so showing the income statement charge resulting from any change is excessively detailed and would possibly, in IAS 37 terms, be 'seriously prejudicial'. Furthermore, the Board should be consistent with the requirements regarding disclosure of uncertainty between the proposals and

the requirements of IAS 37. Some are of the view that the proposals go beyond those of IAS 37 unnecessarily and that the two should be consistent.

(b) paragraph 48(g) (regarding disclosure of the differences between an entity's tax bases and carrying amounts if the entity is not subject to tax because its income is included in the taxable income of its owner) is not necessary for the following reasons:

  (i) it would be difficult for an entity to measure its own tax bases as it is not directly subject to tax, and guidance would be required;

  (ii) it would be complex and costly for each individual entity to perform its own tax calculation, and therefore the benefit would not outweigh the costs; and

  (iii) as tax is allocated from the owner of the tax group, these entities would be required under the ED to recognise an allocation of deferred tax in their accounts anyway; and

(c) the proposed disclosure requirements of paragraph 49 could be extended to include the same requirements as paragraphs 91 and 92 of IAS 37 (which refer to circumstances where it is impracticable or seriously prejudicial to disclose certain information).

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. (See paragraphs BC111–BC120 of the Basis for Conclusions.)

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

The AASB agrees with these proposals. However, the AASB suggests that assets and liabilities to which the existing IAS 12 initial recognition exemption has been applied should continue to be exempt.

Although not significant in an Australian context, the Board should consider allowing early adoption of any new tax Standard for entities adopting IFRS for the first time. This would avoid entities that are adopting IFRS after the Standard is issued but before it becomes effective having to comply with the existing requirements of IAS 12 for a short period of time. Adopting IAS 12, then adopting a new tax Standard shortly afterwards may prove a costly implementation exercise for some entities.

Other comments

Items with a carrying value of nil

As currently drafted, paragraph 16 of the ED could cause some confusion, by stating that research costs have a carrying value of nil in the financial statements despite there being no asset recognised. Some might read into this that the carrying amount of nil can be subsequently revalued. The paragraph should be worded to clarify that research costs are

assigned a carrying value of nil for the 'purpose of performing deferred tax calculations' (even though research costs are not recognised as assets).

Structure of ED

As stated in Appendix B of the ED, the Application Guidance in Appendix B is integral to the Standard. The AASB thinks that some of the material is critical for an understanding of the requirements (e.g. recognition exemptions and the initial recognition procedures), and that it would be more useful to the readers of the Standard to have it included in the main body of the Standard, rather than the large volume of cross referencing currently employed.

Suggestions for further guidance or clarity

The AASB recommends that the Board considers the following other issues if it progresses the project:

- The Board should seek to clarify and provide more guidance as to what constitutes an income tax and is therefore within the scope of the Standard, as this issue frequently arises in practice. For example, government taxes on 'income' amounts are becoming more frequent and hence discussions are arising in practice as to whether these are covered by the current scope of IAS 12. In Australia there is the Australian Petroleum Resource Rent Tax. As the number of these types of taxes increases around the world, the question arises as to whether tax accounting should be applied to all of them. The AASB suggests that the Board reconsiders the scope of tax accounting, given the broad range of taxes currently employed, and clarifies the principle as to which taxes are included or excluded.

- The ED does not contain illustrative examples, and the AASB suggests including the staff examples as an appendix to any final IFRS as they would help promote consistent interpretation and application of the proposed requirements.

- The ED provides no guidance on how tax elections should be treated and accounted for. The AASB suggests that the Board develops 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. The AASB notes that some elections can be conditional or freely chosen.

- The average effective tax rate (described in paragraph 43 of the ED as 'tax expense recognised in profit or loss divided by pre-tax profit or loss') should be defined consistently across Standards (for example it is also referred to in paragraph B12 of IAS 34 *Interim Financial Reporting* as 'the tax rate that would be applicable to expected total annual earnings').