

DRAFT COMMENT LETTER

Comments should be sent to commentletters@efrag.org by 6 November 2010

IASB
30 Cannon Street
London EC4M 6XH
UK

7 October 2010

Dear Sir/Madam

**Exposure Draft Deferred Tax: Recovery of Underlying Assets –
Proposed amendments to IAS 12**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Amendments to IAS 12 Income Taxes* ('the ED'). This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

EFRAG agrees that the existing IAS 12 lacks guidance on the accounting for income tax in relation to assets for which the tax consequences depend on the way the carrying amount of the underlying asset is recovered. We therefore support the IASB in its efforts to address the issue.

However, we disagree with the use of an exception to the measurement principles in IAS 12 to resolve the issues being addressed in the ED. In our view, the issues should be addressed by extending application guidance on the measurement principle, because we believe that it would be clearer and would produce the right answer based on the 'manner of recovery' of the underlying asset.

Putting aside our disagreement with the proposed approach, our detailed comments on the ED are set out in the Appendix to this letter. Our other major concerns are:

- We do not believe that the rebuttable presumption is operational for the reasons set out in paragraph 18 of the Appendix.
- We believe that the scope of the exception is overly broad and that property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38, respectively, should continue to be accounted for in accordance with the principles underlying IAS 12.

Should the IASB proceed with the proposed amendments, we would recommend that the rebuttable presumption be redrafted. As explained in paragraph 19 of the Appendix, the IASB could require an entity to account for the tax consequences of recovery of the

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carrying amount of the asset entirely by sale when the entity can prove that it is impracticable to determine the expected manner of recovery. We believe that this could reduce the costs of implementation and ongoing application quite considerably

If you would like further clarification of the points raised in this letter, please do not hesitate to contact Alessandro Turris, Isabel Batista or me.

Yours sincerely

Françoise Flores

EFRAG, Chairman

Appendix

Question 1 – Exception to the measurement principle

The Board proposes an exception to the principle in IAS 12 that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. The proposed exception would apply when specified underlying assets are remeasured or revalued at fair value.

Do you agree that this exception should apply when the specified underlying assets are remeasured or revalued at fair value?

Why or why not?

Notes for constituents

- In some jurisdictions, the applicable tax rate depends on how the carrying amount of an asset is recovered. Under IAS 12 Income Taxes, the measurement of deferred tax liabilities and deferred tax assets will depend on whether an entity intends to recover an asset by using the asset in its business or by selling it, which may have significantly different tax consequences. Depending on the facts and circumstances, under the current IAS 12 an entity would base the measurement of deferred tax on the tax consequences of recovering the carrying amount of the underlying asset (1) entirely by sale, (2) entirely through use or (3) partially by sale and partially by use. The ED proposes to amend this aspect of IAS 12.*
- IAS 12 does not provide specific guidance on how to apply ‘expected manner of recovery’. However SIC-21 Income Taxes – Recovery of Revalued Non-Depreciable Assets provides some limited guidance on this issue in relation to non-depreciable assets under IAS 16.31 (for example land).*
- As explained in paragraph BC3 of the ED, the IASB was informed that in some jurisdictions where the applicable tax rate depends on how the carrying amount of an asset is recovered, determining ‘recovery’ of the carrying amount is difficult or subjective. This is particularly so in respect to investment properties that are measured using the fair value model under IAS 40 Investment Properties and are held by an entity both to earn rental income and capital appreciation.*
- The ED seeks to provide relief in such cases and in other similar cases where assets are measured at fair value or a revalued amount, by proposing an exception to the measurement principle in IAS 12. The proposed exception states that, for certain assets remeasured or revalued at fair value, the measurement of deferred tax liabilities and deferred tax assets should reflect a rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale, unless the entity has clear evidence that it will recover the carrying amount of the asset in another manner.*

EFRAG’s response

EFRAG does not support the proposed exception to the measurement principle in IAS 12. Instead, we would recommend that the IASB provide additional application guidance. However, should the IASB proceed with an exemption, we would recommend changing the drafting of the rebuttable presumption along the lines suggested in paragraph 19 below.

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- 5 EFRAG is generally in favour of principles-based standards. For that reason we believe that IASB should provide application guidance on how to determine the expected manner of recovery of an asset under IAS 12.52, rather than proposing an exception to the measurement principles.
- 6 EFRAG notes that the accounting treatment proposed in the amendments – to base the measurement of deferred tax on the tax consequences of recovering the carrying amount of the asset entirely by sale – can be achieved under the existing IAS 12, when the entity expects this outcome. We agree that at present IAS 12 is not sufficiently self-explanatory to lead to a satisfactory implementation of the measurement principle in all circumstances, i.e. to ensure that tax liabilities represent what tax entities expect to pay. Therefore, it is not necessary to introduce an exception to the measurement principle. In our view, having application guidance is a more appropriate way to resolving the issue, as entities could apply the principles in IAS 12 in a consistent manner and thereby enhance comparability of information. At the same time, this would avoid the creation of a ‘bright line’ distinction and ensure that the accounting reflects an entity’s best estimates. In this case, it would not be necessary to define the scope of the amendment by reference to the type of underlying asset.
- 7 We do not believe that the IASB should introduce an exception to the general principle in IAS 12 – that the measurement of deferred tax assets and liabilities should reflect the tax consequences that would follow from the manner in which an entity expects to recover or settle the carrying amount of its assets and liabilities. This principle applies when the specified underlying assets are remeasured or revalued at fair value, because the exception:
- (a) results in financial reporting that does not necessarily reflect an entity’s expectations or best estimates. Therefore, such information is less likely to be relevant or decision-useful;
 - (b) gives rise to significant internal inconsistencies with the approach underlying IAS 12, which is based on the expected manner of recovery or settlement. Therefore, we are concerned about the unintended consequences this may have;
 - (c) introduces a rule that adds complexity to the standard; and
 - (d) assumes that the carrying amount of assets will be entirely recovered through sale. That means that in mixed-use (or dual-use) scenarios (e.g. an investment property that is rented out, with the intention to sell it after 10 years), it would not be permitted to account for income tax on the temporary differences that arise and are expected to reverse within the initial (10-year period).
- For these reasons, we believe that there are significant drawbacks in creating an exception to the measurement principles in IAS 12.
- 8 Should the IASB proceed with its proposal to introduce an exception, we would recommend the IASB consider changing the drafting of the rebuttable presumption along the lines suggested in paragraph 19 below.

Question 2 – Scope of the exception

The Board identified that the expected manner of recovery of some underlying assets that are remeasured or revalued at fair value may be difficult and subjective to determine when deferred tax liabilities or deferred tax assets arise from:

- a) investment property that is measured using the fair value model in IAS 40;
- b) property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38;
- c) investment property, property plant and equipment or intangible assets initially measured at fair value in a business combination if the entity uses the fair value or revaluation model when subsequently measuring the underlying asset; and
- d) other underlying assets or liabilities that are measured at fair value or on a revaluation basis

The Board proposes that the scope of the exception should include the underlying assets described in (a), (b) and (c), but not those assets or liabilities described in (d).

Do you agree with the underlying assets included within the scope of the proposed exception?

Why or why not? If not, what changes to the scope do you propose and why?

Notes for constituents

- 9 *Paragraphs BC14-BC17 of the ED, explain why the IASB believes the above categories of assets should be addressed by the amendments. As explained in paragraph BC18 of the ED, the IASB believes that the significant practice issues lie with the categories of assets mentioned under (a), (b) and (c) in the question above. Therefore, the IASB does not believe that the amendments should be extended to other assets. The IASB supports the ‘restricted’ scope by stating that it is concerned about the possibility of unintended consequences of expanding the scope to other assets and liabilities that are measured on a fair value basis.*

EFRAG’s response

EFRAG does not agree with the scope of the proposed exception. We believe that the scope of the exception is overly broad and that property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38, respectively, should continue to be accounted in accordance with the principles underlying IAS 12.

- 10 As mentioned in paragraph 6 above, if the IASB were to develop application guidance then it would not be necessary to define the scope of the amendment by reference to the type of underlying asset.
- 11 It is our understanding that when the IASB initially discussed the issue, it only considered introducing an exception regarding income taxes on investment

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properties measured at fair value under IAS 40 *Investment Property*. During its deliberations, the IASB decided to extend the proposed exception to temporary differences on other types of assets that are measured at a revalued amount under IAS 16 or IAS 38, including temporary differences on those same assets if those differences arose in a business combination.

12 We agree that determining the way in which the carrying amount of investment properties is recovered, can be complex and often is subject to a degree of judgement because it may not clear in advance how much is recovered through rentals and how much through sale. However, we have various concerns about expanding the proposed exception beyond the accounting for income taxes on investment properties held at fair value:

- (a) *Property, plant and equipment* – Property, plant and equipment (PPE) are defined in IAS 16 as those ‘tangible items that: (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one period’. Given that the carrying amount of PPE is expected to be recovered mainly through use of the PPE rather than through a sale, we believe that the accounting for income tax should reflect the expected manner of recovery;
- (b) *Intangible assets* – The use of the revaluation model for intangible assets is limited in practice because of the restrictive definition of an active market in IAS 38. However, we believe that, for example, emission right certificates that are revalued may fall within the exception as proposed. In such cases, it is likely that the underlying intangible assets will be recovered through use rather than through sale. In our view, the IASB has not yet consider the full impact of extending the scope of the exemption to intangible assets.
- (c) *Temporary differences arising in a business combination* – We understand that the requirements of paragraph 51C of the ED are intended to ensure that all temporary differences on assets subject to the proposed exception are treated the same way. However, we are not convinced by the justification given in the Basis for Conclusions for including these temporary differences within the scope of the exception:
 - (i) Paragraph BC19 of the ED states ‘...the unit of account applied in determining the manner of recovery in the Standard is the underlying asset as a whole, not the individual temporary differences.’ However, this seems to be contradicted by Example C in the ED, which illustrates that the temporary differences related to one asset may well need to be split as they are subject to two different tax regimes. In addition, paragraphs 24 and 44 of IAS 12 seem to rely on a unit of account that encompasses the temporary differences on large groups of assets.
 - (ii) There are also some unintended consequences. For example, entity A acquires a property in a business combination and subsequently accounts for it under IAS 40. If entity B acquires an identical property in a business combination, but subsequently accounts for it under the IAS 16 cost model, it would be required to recognise a higher deferred tax liability and corresponding goodwill. It is not clear to us why this should be the case. Furthermore, it is not clear what ought to happen

if entity A (entity B) subsequently changed the use of the acquired property and had to account for it on a cost basis (fair value basis).

- 13 Should the IASB proceed with these proposals, we would recommend that:
- (a) the scope of the exception be limited to investment property that is measured using the fair value model in IAS 40; and
 - (b) the Basis for Conclusions explain in more detail the rationale underlying the selection of the items to be included in the scope of the ED.

Question 3 – Measurement basis used in the exception

The Board proposes that, when the exception applies, deferred tax liabilities and deferred tax assets should be measured by applying a rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely through sale. This presumption would be rebutted only when an entity has clear evidence that it will consume the asset’s economic benefits throughout its economic life.

Do you agree with the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale when the exception applies?

Why or why not? If not, what measurement basis do you propose and why?

Notes for constituents

- 14 *Paragraph BC21 of the ED concludes that when an asset held under IAS 16, IAS 38 and IAS 40 is measured on a fair value basis, the tax consequences that reflect recover by sale are more relevant than a presumption of recovery in another manner. In addition, paragraph BC22 of the ED explains that the IASB decided to make the presumption of realisation through sale a ‘rebuttable’ one, because it believes it is not appropriate to assume the recovery of an asset by sale when the entity has clear evidence that it will use the asset.*

EFRAG’s response

We disagree with the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale. In addition, we do not believe that the rebuttable presumption is operational.

Should the IASB proceed with these proposals, we would strongly recommend that the rebuttable presumption be redrafted.

- 15 As stated in paragraphs 5 and 6 above, we believe that the IASB should resolve the issue by developing application guidance, in which case a rebuttable presumption would not be necessary.
- 16 However, should the IASB proceed with the proposals, we disagree with the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale. Instead, we believe that the accounting for income taxes should reflect the tax consequences that would follow from the manner in which the entity expects to recover the carrying amount of an asset, rather than require entities to rebut the presumption that the asset will be sold.

Recovery exclusively through sale

- 17 We are not convinced that an approach based on a *presumption that an asset is recovered entirely through sale* (unless the entity can demonstrate that recovery will occur in another manner) results in useful and meaningful information. In fact, consistent with the concerns we expressed on the Exposure Draft *Income Taxes* that the IASB published in March 2009, we think the proposed amendments will obscure the real tax consequences that arise when the carrying amount of assets is recovered and therefore will make the income tax information less relevant. Instead, we believe that when an entity has the intention to operate an asset and then to sell it, the accounting for income taxes should always reflect the expected use of the asset.

Rebuttable presumption

- 18 We believe that the rebuttable presumption as drafted in the ED is not operational for the following reasons:
- (a) the ED sets a fairly high threshold by requiring the existence of ‘clear evidence’, which it does not define. We believe that this could easily lead to diversity in practice;
 - (b) by definition all assets accounted for under IAS 16 are held for use. It is not clear to us what would constitute clear evidence – other than the entity reasserting that the asset is *really* held for use – that would allow an entity to rebut the presumption that such an asset is held for use; and
 - (c) the presumption is only rebutted when an entity *has* clear evidence that it will use an asset. Given that the ED does not require an entity to collect ‘clear evidence’, an entity that has an undocumented expectation not to sell investment properties appears to have a *de facto* option to account for deferred taxation or not. Also, it is not clear what would happen if an entity stopped collecting clear evidence.
- 19 Should the IASB proceed with these proposals, we would strongly recommend that the rebuttable presumption be redrafted. The IASB could require an entity to account for the tax consequences of recovery of the carrying amount of the asset entirely by sale when the entity can prove that it is impracticable to determine the expected manner of recovery. This approach would have the added advantage that the burden of rebutting the presumption would lie with entities that have difficulty applying the principles underlying IAS 12. This would minimise the impact of the amendments on entities that until now could apply IAS 12 without problems (see also paragraphs 28 to 30 below).

Arguments in the ED

- 20 We do not agree with the arguments presented in the Basis for Conclusions in support of the proposed exception:
- (a) *Practical approach* – Paragraph BC20 of the ED argues that the proposals result in a practical approach that avoids subjective estimates. We disagree with this argument as it does not take into consideration the impact of the proposals on the relevance and decision-usefulness of the resulting information;

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- (b) *Fair value reflecting tax effects* – Paragraph BC21(a) of the ED argues that in some cases, fair value will include the tax effects arising from recovering the underlying asset. However, we do not believe that the tax effects are always fully reflected in the fair value. In any event, IAS 12 requires income taxes to be accounted for based on the undiscounted tax rate applicable to the reporting entity and does not allow income taxes to be accounted for based on their fair value as determined by reference to market participants.

EFRAG understands that there is divergent practice in this area of income tax accounting, specifically in relation to whether ‘fair value’ includes or excludes the related tax effects, and whether the related tax effects are those of a market participant or are those of the entity. We think this is a broad measurement issue that would require a more fundamental debate about whether tax effects should or should not be reflected in the fair value measurement of an underlying asset.

- (c) *Consistency* – Paragraph BC21(b) of the ED argues that presuming a sale is consistent with measurement of the underlying asset on a fair value basis. IFRSs permit, or even require, certain assets to be measured at fair value absent an intention to sell. In addition, fair values are often determined using an income approach, which does not assume a sale. Therefore, we are not convinced by this argument.

Disclosure of rebuttal

- 21 Paragraph 81(l) of the ED only requires disclosure when an entity has rebutted the presumption that an asset will be recovered by sale. This implicitly assumes that users are not interested in understanding whether an entity holds any assets for which it did not rebut the presumption. We expect that users would like to have fuller understanding of the assumptions underlying the calculation of deferred taxes. Therefore, we would encourage the IASB to consider a disclosure objective that focuses on the reasons that have lead the preparer to rebut or not rebut the presumption that certain assets are recovered through sale.

Question 4 – Transition

The Board proposes that the amendments should apply retrospectively. This requirement includes retrospective restatement of all deferred tax liabilities or deferred tax assets within the scope of the proposed amendments, including those that were initially recognised in a business combination.

Do you agree with the retrospective application of the proposed amendments to IAS 12 to all deferred tax liabilities or deferred tax assets, including those that were recognized in a business combination?

Why or why not? If not, what transition method do you propose and why?

Notes for constituents

- 22 *Paragraph BC29 of the ED explains that in the IASB’s view, it would not be unduly burdensome for entities to apply the proposed changes to IAS 12 retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.*

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- 23 *Although the IASB acknowledges that it may add some administrative burden if the amendments apply to assets acquired in a business combination that occurred in a previous reporting period, they do not require judgment and do not require disclosure of complex information. For these reasons, the IASB concluded that the cost of requiring retrospective application is outweighed by the benefit of consistent application of the amendments by entities to all periods presented in the financial statements.*
- 24 *In some cases retrospective application might be impracticable or involve a degree of judgement and/or hindsight. For example, in relation to assets acquired in a business combination undertaken in a prior period, an entity would need to determine which deferred tax assets and deferred tax liabilities it would not have recognised had the amendments always been in place. An entity might not have the required information readily available or determining the required information might require significant judgement or involve undue hindsight. However, IAS 8 addresses such concerns because it limits the retrospective application of an accounting policy if it is impracticable.*
- 25 *In addition, the proposals assume that an entity would have ‘clear evidence’ in relation to a prior period in order to rebut the presumption.*

EFRAG’s response

EFRAG agrees that the amendments should be applied retrospectively.
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- 26 EFRAG supports retrospective application because it enhances comparability of information.
- 27 In our view, there might be some concerns in relation to the use of judgement or ability to obtain the necessary information to implement the amendments retrospectively. However, we believe that such concerns would be addressed by IAS 8, which limits the retrospective application of an accounting policy if it is impracticable.

Question 5 – Other comments

Do you have any other comments on the proposals?

Cost of implementation

- 28 The amendments, as currently drafted, put the burden of rebutting the presumption on entities that until now have been able to comply with the principles underlying IAS 12. At the same time, the amendments require no additional effort on the part of those entities to which it aims to provide relief.
- 29 According to paragraph BC3 of the ED, the issue that the amendments try to address arises in ‘some jurisdictions’ in ‘some circumstances’. We believe that the entities that do not benefit from the proposed exception significantly outnumber those entities that are expected to benefit.
- 30 We would therefore recommend that the IASB consider redrafting the rebuttable presumption along the lines suggested in paragraph 19, as this could reduce the costs of implementation and ongoing application quite considerably.

Entity-wrappers

- 31 We note that the proposed amendments propose no explicit guidance on the treatment of so-called single asset entities or 'entity-wrappers' (i.e. those cases where a single asset is held within a corporate 'wrapper'). In some tax jurisdictions, the tax consequences will depend on whether the asset is sold by selling the shares of the 'entity-wrapper' or directly disposed by the entity. The ED does not explain why the IASB decided not to address this issue, which in our view is similar to the issues the amendments aim to address.