IASB
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

31 July 2009

Dear Sir or Madam,

RE: BUSINESSEUROPE RESPONSE TO IASB EXPOSURE DRAFT ON INCOME TAX

BUSINESSEUROPE welcomes the opportunity to comment on the proposals set out in the Exposure Draft (ED.)

We understand that one of the two primary objectives of the project is to clarify various aspects of IAS 12 *Income Taxes* in response to requests. From their regular contacts with investors and other active users preparers are well aware of dissatisfaction among the recipients of financial reports in respect of tax information under IAS 12. In particular, information on deferred tax is regarded by very many active users as so opaque and incomprehensible that they simply eliminate the amounts in their analysis.

Given such dissatisfaction on the users' side, it is rather disappointing that the Board has apparently not taken the opportunity to seek more dialogue with active users (and preparers) to find out their perceived needs. This is a great pity, not only because the tax elements in financial reporting are generally very material components of income and cash flows. It is also a pity because, we believe, a proper understanding of the tax effects of transactions reported in the period – even if the actual tax bill is only affected in another period - is essential to a full understanding of financial performance as a whole.

We are rather puzzled as to how the Board can see the changes proposed in the ED as contributing to "accounting standards ... **to help participants in the world's capital markets and other users to make economic decisions**." Users would remain as perplexed as now (perhaps even more so in some instances) by the technical intricacies. We would strongly recommend that the Board should get out among active users and preparers and identify what is practically needed before undertaking further work on this project. There is no point in developing theoretical principles if the users are just going to ignore the product. For instance, we understand that active users' interest focuses clearly on real tax cash flows, tax loss carry-forwards and tax effects of "unusual items", not on theoretical balance-sheet numbers.

The other primary objective of the project is to amend IAS 12 in ways that will reduce the existing differences between IFRS and US GAAP in accounting for income tax.

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BUSINESSEUROPE has always tried to be supportive of the Board's convergence efforts, as a road to having a single set of global accounting standards, and welcomes the project in this sense. However, we do not support convergence at any price and in particular would not generally support changes to IFRS that would result in convergence but, in our view, would not at the same time improve financial reporting for companies applying IFRS.

The Board has claimed that, in its convergence work, it would adopt the better of US GAAP and IFRS alternatives or, if necessary, develop something better. So we are disappointed that many of the proposals seem to adopt the worse solution of the two standards and would, in our view, fail to improve financial reporting. One must also question the wisdom of the convergence undertaking in this specific area where there is no corresponding change commitment on the part of the FASB. This is quite apart from more general concerns about the overall convergence process given the recent cooling of interest in IFRS in the US. Most IFRS preparers are in any case not US-listed and do not see that US GAAP should be driving the development of IFRS.

In addition, we regret that the Board has found it necessary to make the proposed standard extremely rule-based in many places, contrary to the declared aim of IFRS. We also have considerable doubts about the practicality of several proposals. Further, the demotion of the qualitative characteristic of relevance as well as the apparent disregard of the going concern principle raise severe doubts about the proposals on our side.

Finally, we are concerned with some of the detailed requirements in the ED - in particular in relation to tax uncertainties and allocation and presentation of deferred tax assets and liabilities - and question whether their application will involve undue effort without commensurate benefits. We especially have serious doubts on the following points:

- definition of the tax basis in terms of recovery through sale,
- elimination of the exemptions for initial recognition and investments in foreign subsidiaries,
- guidance on setting the valuation allowance,
- approach on uncertain tax positions,
- tax on intra-group transfers of assets,
- tax rate reflecting expected future distributions,
- intra-period tax allocation,
- current/non-current split of deferred tax in the statement of financial position.

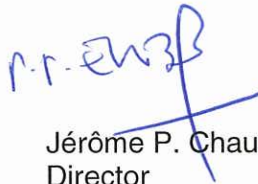
In short, we strongly believe that the proposals in the ED do not represent an improvement to the existing IAS 12 and therefore think that any revision to IAS 12 should not be based on the ED. Neither do we believe the topic a pressing one, in this form it is purely a convergence matter with little point otherwise. If the ED is the best

the IASB can offer at present, then IAS 12 should be left as it is unless and until a more thorough review of the whole topic of deferred taxation is made.

Please see Appendix 1 for our detailed comments.

Should you wish any supplementary comments or explanation, please do not hesitate to contact us.

Yours sincerely,



Jérôme P. Chauvin
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APPENDIX 1—COMMENTS ON SPECIFIC QUESTIONS IN INVITATION TO COMMENT

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?

In its initial definition of the tax basis the ED does indeed provide, in one sentence, a succinct and understandable principle. However, as we progress through the further refinement and qualification of that principle in subsequent paragraphs, we become less convinced that the principle is indeed more straightforward than that in IAS 12 and, in particular, that it leads to correct, meaningful and decision-useful information. For instance the Board is apparently seeking a single approach to determining the tax basis of an asset and a liability. However, this cannot be the only objective if its application leads to irrelevant and, in some cases, quite misleading information.

We have particular difficulty with the proposed tax basis of an asset. The IASB argues (BC21) that requiring the tax basis of an asset to be determined based on the tax effects of selling the asset at the reporting date will help resolve the uncertainties that have arisen in practice. Unfortunately, although this may well eliminate the need to determine whether an asset's value will be recovered through sale or through use, it would in many cases result in an untrue and unfair view of the entity's financial position and performance and in a false view of expected future cash flows being presented in the statement of financial position. Industrial firms, for instance, will generally recover the value of their tangible and intangible fixed assets through use, not through sale. It is not realistic to base the standard on the assumption that an industrial entity could or would recover all its production facilities through sale. The calculation of tax effects as if this were the case would lead to quite misleading results. While determination of whether assets will be used or sold does indeed rest on management's intentions, in the overwhelming majority of cases that determination can be readily checked against history and any deviations from "normal" patterns justified in the audit process. We also see absolutely no justification at all for effectively dispensing with the going concern principle in this respect – especially where it is based on a rejection of management intentions which, in other instances in the ED, are openly accepted. Our objections are not limited to industrial firms' situations. In insurance, for instance, obvious distortions would arise on deferred tax relating to long-term investment portfolios in jurisdictions where the taxation of gains and losses on sales of investments differs from that of (unrealised) gains and losses arising from holding the investments.

For these reasons, we believe that requiring the tax basis to be determined on the basis that the asset will be sold would very often result in an unfaithful reflection of the deferred tax consequences to which the entity is exposed. We would therefore urge the Board to retain the current approach of having the tax basis reflect the expected method of recovery. At the same time, the opportunity should be taken to improve the current wording of IAS 12 in this area to prevent some of the anomalies which today occasionally arise in practice through too literal interpretation. One example is the tax basis where a company cannot recover for tax purposes the acquisition cost of an asset through (tax) depreciation during its use but can recover it on sale or destruction at the end of it useful life, e.g. deduction for capital gains tax purposes. Such a solution might foresee a quasi-dual asset approach with a single tax basis for an asset determined not only by the tax effects of depreciation but also by the tax effect of selling the asset in such cases.

Finally, we also have doubts on the proposed approach on own equity instruments in paragraph 16. The absence of a recognition threshold (as for assets and liabilities) means that management's expectations would never be considered in determining the instrument's tax consequences, and its tax basis is defined as a future deduction without further precision (deduction on sale? on cancellation? on value decrease?) Should a deferred tax asset be recognised as soon as an entity purchases its own equity instrument even if no tax impact is expected?

In general we are anyway of the opinion that the whole process proposed for determining the deferred tax amounts to be recorded is excessively complex and should either be substantially simplified (are all of the individual steps absolutely necessary, for instance?) or left as at present in IAS 12. Similarly we find B29 in any case rather unclear: it should be made more comprehensible.

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?

We agree with the proposed definitions. However, we regret that the Board has not taken the opportunity to comprehensively reconsider the accounting for tax credits and investment tax credits: the practical recognition issues encountered on investment tax credits from capital expenditure for oil-industry exploration and production contracts would still remain, for instance. However, the definition is a step in the right direction.

Question 3 – Initial recognition exemption

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?

We believe that this current exception is one – like goodwill – where a more pragmatic, common-sense solution without any disadvantage in the form of less meaningful and decision-useful information would be to leave the present approach unchanged. What is proposed in its place is extremely complex, and we do not think that it would produce better information. The present requirements in IAS 12 are far clearer and easier to apply. Also we do not share the Board's view that tracking of subsequent changes in initial temporary difference is a very significant issue, given the circumstances under which such situations arise.

There is also a concern here about deciding on the tax rate to apply. Para 11 refers to the rate at which an entity expects to recover; what does "entity" mean in respect of intangibles arising on consolidation. In addition, the requirement to use a 'for sale' tax basis adds a considerable level of uncertainty; where there is no intention to sell, this must be a hypothetical situation. Possibilities include an asset sale, sale of the company itself, or sale of an intermediate holding company. These may have different tax rates/exemptions available. Para 11 implies that we can choose the expected manner of sale and thus, effectively, to choose our tax rate.

The complexity of the proposed approach is in any case exacerbated by the introduction of the treatment of "entity-specific" effects as an integral part of the discussion. We believe that greater clarity could be achieved if this aspect were considered separately from that of "normal" divergences between book and tax on initial recognition (as in Example 7.) We would even go further and suggest that this specific aspect should be dropped from the proposals: we would foresee considerable problems of judgment in arriving at what would be available to "other market participants" and in having to assess the tax positions of others. The Board's "There may be difficulties" (BC29) is a good summary!

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?

This is a further exception which we believe the Board would be well advised to retain – in its entirety - in respect of subsidiaries.

In our view the financial information generated would be at best meaningless, at worst misleading and distortive, which indicates that perhaps the underlying principles are themselves faulty. The proposal does not fit in with the going concern assumption, and the numbers generated would only make more difficult users' attempts to form a view on likely future tax outflows. Also, under the going concern assumption, we have grave doubts whether the amounts involved even meet the definition of a liability. Users are sufficiently confused on deferred tax already, without being distracted by tax amounts which, to all intents and purposes, would rarely if ever fall due. (Recognition only when e.g. a disposal has been firmly decided, or when some other likely event would cause the potential liability to crystallise, would be a more sensible solution, applying the conditions in B5 to all, not just foreign, subsidiaries.) In addition there would be severe practical problems at each reporting date as subsidiaries' individual values - for comparison with the investment - , once finalised, would then have to be pushed up through the various levels of consolidation and the process repeated at every stage. This is not an ideal situation in a "Fast Close" world. The Board should also be aware that the participation exemptions which are available in the US and which therefore facilitate the operation of FAS 109 there are by no means available in all jurisdictions worldwide. In many jurisdictions the considerable complexities met with in the US in respect of foreign subsidiaries are met with also in respect of domestic subsidiaries. This US import would therefore by no means work globally.

The suggested foreign/domestic differentiation carries with it many difficulties:

- We think such a differentiation would be fairly confusing for many users

- There seems no conceptual justification for it.

- We wonder whether it is in any case clear what is meant by "domestic". E.g USA/Puerto Rico, UK/Jersey? And is it viewed on a direct or indirect (drill-down) basis? E.g Is a Swiss subsidiary of a UK sub-holding which itself is owned by a Swiss ultimate parent "domestic" in the parent's consolidation?

- Where IFRS financial statements are prepared at the intermediate holding level, different numbers may well be involved. This could quickly become very complex.

Currently, we do not have to provide for deferred tax on reserves where we can control the timing of any reversal. The proposal would require us to provide, in the case of foreign subsidiaries, unless we can demonstrate that the investment is "essentially permanent in duration". The definition of "essentially permanent in duration" requires us to demonstrate plans for reinvestment. To obtain documentary evidence for this for every subsidiary (and intermediate company) would be an enormous task. If we could not demonstrate such plans, we would need to provide tax at the distributed rate. The ED is silent on whether we could take advantage of planning opportunities to reduce the rate, but these would presumably need to be documented also.

Another point is that the standard concentrates on reinvestment. It ignores the possibility that amounts which are technically distributable may be required for working capital or to demonstrate good financial standing to customers

Finally, we find no explicit justification for the exclusion of investments in associate companies from the treatment proposed for subsidiaries and joint ventures, which seems unsatisfactory.

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?

We agree with the proposal. We did, nonetheless, have some questions about whether the gross asset actually meets – and will continue to meet - the Framework criterion

for recognition, especially in the (generally unwelcome) eventuality that the Framework project moves standard-setting away from a risks-and-rewards to a control approach.

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 do not really see any need to change present IAS 12 arrangements in this respect as we believe that they work well.However, we can accept the proposal but would like to ask the Board to consider a best estimate approach as being much more practical (entities do not usually consider lots of scenarios) and giving more useful information.

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?

We see the proposals as excessively and unnecessarily complex and rule-based, in no sense a significant improvement on IAS 12 guidance. They would increase the complexity of the whole process, and we would be concerned lest they led to a rule-based audit exercise.

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?

While we can overall accept this change, we would suggest that the idea of "the cost of implementing a tax strategy" and how it should be reflected in the valuation allowance need to be expanded on for the sake of clarity and understandability. The proposal seems to introduce extra complexity without any benefit other than convergence.

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?

We decidedly reject the proposals. We are concerned at the level of precision implied by the specific "rules" in the ED (e.g. para. 26.) It is probably unrealistic to expect a high degree of precision in accounting for uncertain tax positions. The assessment is generally a matter of professional judgment and discussion with tax experts, auditors, etc. Hence these specific rules would in many cases be unnecessarily prescriptive. The statement in BC63 is right that in some cases the requirement to adopt a probability-weighted average of possible outcomes could be unduly onerous and not produce any more useful results though giving an unwarranted illusion of accuracy. Also, the situations are generally of a binary nature, so outcomes will only be the full tax amount or zero: a probability-weighted number will never be the actual cash outflow. We suggest instead that IAS 12 should not be made more theoretical but only go as far as laying down general principles based on a most-likely-outcome approach, permitting entities to interpret those principles in relation to deferred tax accounting and apply these principles to their particular tax situations.

We note the similarity of the proposed approach to that contained in the ED on Non-financial Liabilities. We would like to remind the Board that that approach received considerable criticism from ourselves and other respondents, and we would still not support it in any way.

In any case, we would have found it helpful to have a thorough analysis of US experience with FIN 48 in this area. Did it bring information which was decision-useful? What were the major implementation issues? We would be surprised if the Board was able to form a responsible judgment on the appropriateness of the proposals without such an analysis.

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

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

We can accept the proposal, though we do feel it inappropriate the references in BC 66 that an IFRS principle should be determined in terms of practice in one particular jurisdiction.

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, ie 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?

We have already expressed our strong objection to the ED's proposals on the determination of the tax basis (see Q. 1 above.) Here we find it incongruous that the Board accepts the relevance of management intention in determining the tax rate, having rejected this in respect of the tax basis. We strongly believe that, to avoid the presentation of meaningless and potentially misleading information, management intention should be reflected in the determination of both tax basis and, consistently with that, the tax rate. Furthermore, there is perceived to be a logical inconsistency between the use of a tax rate reflecting sale together with a tax basis determined under Q1 on a recovery assumption. The Board would have to ensure that the wording of the ED is improved in this area to make the logical relationship between tax basis, recovery assumption and tax rate clearer.

We are particularly puzzled by the assertion in BC 70 that "the tax basis is a matter of fact". This does not always accord with our actual experience. In what way exactly is it a "matter of fact"??

We would like at this point to raise the matter of the tax rate to be applied to consolidating adjustments for intra-group transfers of assets and liabilities, in particular that for unrealised profits in inventories. We had hoped that this "convergence" project would have provided the Board with the opportunity to change an approach in IAS 12 which has long perplexed preparers and users alike through its effects in the consolidated income statement, which can only be described as unhelpful, to put it mildly. Described in BC45-49 the Board's strange decision, to opt for the (not better) IAS 12 approach of applying the buyer's rate rather than FAS 109's seller's rate, seems again to give preference to metaphysical concepts than to providing meaningful decision-useful information. We expand on this point in appendix 2 with an example of the effects of this choice. We hope that the Board will reconsider its decision. If the Board believes that its choice accords with the proposed general principles on deferred tax, it may wish to consider whether the meaningless, misleading and decision-unuseful result may not suggest that those principles themselves need further review.

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?

On balance, we believe that the proposed change should not be made. Apart from the practical difficulties of estimating future distributions and consequent tax rates in some circumstances, we see the triggering event for the tax effect of the distribution as being the (later) distribution itself, rather than the earning of taxable income with the applicable tax rate being a measurement issue.

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?

We agree.

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?

The proposals seem rather complicated, and the change would bring no significant improvement or benefit. The IAS 12 approach, i.e using what is likely to apply, seems to work fine in practice and should remain.

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

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.

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

As a principle, adjustments should always be presented where the original transaction was presented. In our experience, backwards tracing may require a little effort but not so much as to outweigh the benefit of following this principle and thus being able to present more meaningful, understandable information. Backward tracing avoids distortion of the tax relating to continuing activities, the most important element for active users. Either approach will in any case often involve arbitrary allocation judgments. The IAS 12 solution should be retained.

On the proposals for detailed guidance on intra-period allocation, we think that they would add excessive complexity to an allocation process which is in any case, of its nature, often somewhat arbitrary. They would simply give a misleading aura of accuracy. The guidance in IAS 12 seems to us quite adequate for industrial and commercial firms and should be retained. Furthermore, it appears to us that, for the financial industry, the proposed change would be extremely onerous. Many banks and insurance companies classify most of their investments as available-for-sale financial assets, with changes in value recorded in OCI net of tax. The impact of a tax-rate

change should follow this into OCI, as is the case at present. We would regard it as inconsistent, anomalous and misleading for the deferred tax to be initially recorded in OCI but the impact of changes in the tax rate to go into net income.

Question 13B

The exposure draft also sets out an approach based on the IAS 12 requirements with some amendments. (See paragraph BC 97 of the Basis for Conclusion).

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?

See Q. 13A. We prefer to retain backwards tracing because we believe it provides more useful information and does not distort tax related to continuing activities in the income statement.

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 Q. 13A. We prefer to retain backwards tracing.

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?

Bearing in mind the extent to which arbitrary allocations affect the process in most practical circumstances, it seems to us that adding the complex rules proposed would not be likely to result in better or more consistent information. Users tell us that, in any case, the tax information on OCI items is not of any particular interest to them, so setting up complex procedures would in any case result in wasted efforts. We recommend the retention of current arrangements,

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?

We agree with the proposals.

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?

We strongly disagree with this proposal. Firstly, we would vigorously contest the Board's assertion (BC102) that its proposal would "provide more useful information" than the current IAS 12. From what we know of users' requirements and the use to which they put – or rather do not put – the corresponding information in the USA, we see no justification for this assertion. The Board does not explain it, or why other ways of classifying deferred tax assets and liabilities were rejected. Indeed, the proposed change would cause substantial work for no discernible real benefit, and it would also make it even more difficult to see the overall tax position as balances would be even more fragmented over the statement of financial position. We would recommend that the practical approach used in IAS 12 (non-classification) is by far the most sensible.

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

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

Though a specific determination would enhance comparability, we can agree with the proposal as it at least makes the situation transparent.

Question 17 – Disclosures

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.

Within the usual bounds of cost/benefit constraints (including the potential deleterious effects of increased disclosures on the position of the reporting entity vis-à-vis tax authorities), we are generally very much in favour of a new look at the *disclosures which are actually most needed by active users* (see also the opening paragraph of our covering letter.) This may of course not be the same as simply "informative" if no specific need is served by the information. We have the impression that present, fairly voluminous disclosures do not meet needs in every case – they often seem more directed to satisfying accountants and auditors. A joint zero-base review of needs and the practical possibilities of meeting them between IASB staff, preparers and active users would be warmly welcomed.

The proposal in para. 43 of the ED that the numerical tax rate reconciliation should take as the applicable rate the rate in the country of domicile appears to us unhelpful in many cases. While it may work in the US, Swiss groups with a basic holding-company tax rate in single digits, for instance, would have to put in a second step to come up with an average applicable tax rate which better reflects the tax effects of worldwide income – a step which would not be particularly helpful. Similarly, a double-headed group like Unilever would be faced with the choice of whether the starting point should be the British or the Dutch tax rate or some amalgam of the two.

Several of the proposed disclosures depend on the principles amendments proposed in the ED, to several of which we have objected above. The following disclosure proposals consequently need reconsideration:

- Para. 41(b) and (e), Para. 49 – Effect of the possible outcome of a review by, or dispute with, the tax authorities

- Para. 48(a) – Use of tax rate on undistributed income

- Para. 48(c) – Temporary differences on investments in subsidiaries

We particularly object to the requirements under para. 49, including the qualitative information involved, which go substantially beyond what US GAAP require. We would in particular like to remind the Board of the practical difficulties involved in disclosures which could jeopardise the entity's position vis-à-vis tax authorities and, in respect of tax planning strategies, vis-à-vis competitors. We insist that the Board must take a realistic approach to what is feasible in this area, in a similar way to its accommodation in IAS 37.92 with regard to provisions. A quantification of the amounts involved in material items and some information on the possible timing of additional liabilities would be a more acceptable approach.

We assume that the proposals in para. 48(d) concerning disclosures on inter-company transfers of assets and liabilities are included to assist users in adjusting for the distorting effects of the unhelpful approach to determining the tax rate to be applied to

consolidating adjustments (see Q. 11 above.) We strongly believe that users would be better served by applying a more sensible and meaningful approach to the tax rate than to trying to correct unhelpful accounting treatments by disclosures.

BC 108 is rather disturbing to us. If we understand correctly, the Board is accepting additional disclosure requirements as a way to avoid potential manipulation of earnings. We do not believe that unsupported assertions about potential earnings manipulation should form the basis on which IFRS disclosure standards are set.

Finally, we would like to underline the amount of effort (and cost) associated with deriving all of these disclosures, which in many cases will, we think, generate more confusion than decision-useful 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?

We agree with the proposals and with the justification given in the ED.

ADDITIONAL POINTS

- We are rather disappointed that it was decided not to re-examine the question of deferred tax on share-based payments as part of the project. In contrast to the US GAAP approach, the IFRS approach is extremely complex and cumbersome and results in considerable variability in the effective tax rate which is very difficult for users to grasp and to take account of in their forecasting. We strongly recommend the Board not to let slip the opportunity to help the capital markets by suggesting a more pragmatic, practical and understandable solution.

- We note from C6 that the Board intends to change IAS 34 in a consequential amendment. No explanation is given in the Basis of Conclusions and, as we fail to see any need for change, would require the Board at least to explain their intention.

- The Illustrative Examples, while in some cases helpful, seem to duck many difficult issues and include many items not relevant to the new proposals. No example is given for the "entity-specific tax advantage" case, nor is anything to be found on the approach the Board has in mind for temporary differences on investments in subsidiaries. We would strongly recommend the Board to improve and incorporate them selectively for them to really be of help if it decides to proceed with these proposals as they stand – which we nevertheless hope will not be the case. We believe that the principles and requirements of a standard cannot be clear enough if 23 pages of examples are necessary to explain them and recommend that the Board improve the clarity of

drafting in finalising any standard in order that extensive implementation guidance is unnecessary. We do not believe that staff examples should be a feature of the final standard, as their status is unclear under IFRS; any essential examples should only be included in implementation guidance that has been approved by the Board.

- If, contrary to our preference, the ED were in fact taken forward to a standard, we would strongly recommend the Board to try to improve its understandability. The ED is often opaque and could definitely be improved by the inclusion of some of the explanatory material from the Basis for Conclusions.

APPENDIX 2—INTRA-GROUP TRANSFERS OF ASSETS

IAS 12 requires that the tax rate borne by the receiving, rather than supplying, subsidiary should be applied to intra-group eliminations for calculating the corresponding deferred tax asset/liability.

The Board has decided to retain this approach, in the light of the fact that the entity has paid tax in one jurisdiction in exchange for a higher or lower tax benefit in another and should reflect that fact in its financial position. While we understand that argument and the Board's desire to adhere to the principles which lead to it, we firmly believe that the Board should reconsider the decision. This is first and foremost because the Board has the responsibility to publish standards which "help participants in the world's capital markets to make economic decisions", and we consider that the information produced in this way, while perhaps theoretically correct from the viewpoint of the principles proposed in the ED, is actually decision-useless: far more relevant for most users is information on tax *in relation to the profit produced* in a given period, which is often seriously distorted by the IAS 12 approach.

As an example, in a Swiss pharmaceuticals group sales of product with production cost of 60 are made by a Swiss manufacturing subsidiary to the Japanese selling subsidiary at a transfer price of 160. At year end the product is still in stock in Tokyo but is sold in the following January for 200. The respective tax rates are: CH 25%, JPN 45%.

The current year's consolidated results will be derived under IAS 12 as follows:

	CH	JPN	Consol.adj.	Group
Sales	160	0	-160	0
Cost of sales	-60	0	60	0
Gross profit	100	0	-100	0
Tax	-25	0	45	20
Net income	75	0	-55	20
Inventories		160	-100	60
Tax assets, net (current and deferred)	-25	0	+45	+20

Thus, although the group, reporting "as if it were a single entity", has realized no sales or gross profit in the current year, it (or, better said, IAS 12) has actually managed to create a net profit.

Similar distortions of income flows are to be found in the oil industry where the higher tax rates in jurisdictions where upstream activities are often carried out result in the converse situation of losses being shown where no realisations have actually taken

place from a “single entity” perspective, and the tax expense recorded bears no relationship to the margins shown in the pre-tax income.

It appears that the Board has realised that users might not be satisfied with the financial statement information generated by the required approach and so have included in para. 48(d) a disclosure of the effect of the distortion. We strongly believe that it would be much more helpful to participants in the capital markets if the situation were reversed and the more useful seller's-rate approach were adopted for the financial statements. At most a disclosure requirement for the buyer's-rate effect might be considered if it is demonstrated that active users deem it decision-useful. If the principles proposed fail to produce decision-useful information, the principles are inadequate and must be revised to ensure that they do provide decision-useful information.

Some further considerations on this point:

- It should be clear that there is no temporary difference in the receiving company itself: in the above example, the Japanese subsidiary itself has both a tax basis and a carrying amount of 160. The temporary difference arises in the consolidation process of showing the group “ as if it were a single entity”. The applicable tax rate is not immediately obvious from that viewpoint.

- We are not at all convinced that the deferred tax asset actually meets the recognition criteria for an asset. What is the likelihood of the product being sold by JPN at its carrying amount to a subsidiary with a different, perhaps lower tax rate, so that no “benefit” will actually be available?

- It is unclear how it can be said that the IAS 12 deferred tax adjustment meets, from the consolidated perspective, the objective of “accounting for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves.” The group – nor any part of it – will ever pay tax at 50% on the 100 gross profit made in Switzerland.

In conclusion, we warmly recommend the Board to reconsider its position on this point and to ensure that the principles imposed achieve the objective of providing decision-useful information. This would also obviate the necessity for an entity to resort to non-GAAP information to explain the development of its tax charge in meaningful terms.