XX August 2009

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

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 3 July 2009

Dear Madam/Sir

IASB Exposure Draft *Income Taxes*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on Exposure Draft 2009/2 'Income Taxes' (the ED). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The IASB's Income Taxes project is in fact a joint project with FASB, and it was originally described as a short-term convergence project. That means that the primary objectives of the project are to amend IAS 12 *Income Taxes* in ways that will reduce the existing differences between IFRS and US GAAP on the accounting for income tax and to address some aspects of existing IAS 12, and, does not involve a fundamental re-think of the accounting for income taxes. EFRAG is a supporter of having a single global accounting language.

We are not convinced that the proposals in the ED represent an improvement to existing IAS 12 and therefore we think that the ED should not be used as a basis for a revised standard on income taxes. As we have said before on other occasions, we do not support convergence simply for the sake of convergence and in particular, would not generally support changes to IFRS that would not improve financial reporting. It also concerns us that, in our view, many of the proposals are not supported by material in the basis for conclusions that clearly explain why the IASB thinks that the proposed changes are an improvement to financial reporting.

We are also very concerned that certain proposals are excessively rules-based and lack underlying conceptual rationale. In other words, we think that the ED forsakes the benefits of having an amended income tax standard that is based on clearly articulated principles that are workable in "real life", and which entities can apply to their particular tax situation. Perhaps a further problem might be that the IASB is trying to align aspects of existing IAS 12 with a totally different tax jurisdiction without first having carried out a field-test exercise to better understand the implications of the proposals and assess the usefulness of the information that the ED will produce when applied to a non US environment. To this end, we believe that a thorough field-test exercise would be very helpful to bring to light the implications of the proposals and place the IASB in a better position to reach a conclusion on whether the proposals can be operational and effective in meeting its objectives.

Our detailed comments are set out in the appendix to this letter, but our main concerns can be summarised as follows:

(a) We disagree with the proposal to define the tax basis of an asset or a liability to be determined based on a consequence of sale or settlement at the reporting date. While we believe that the approach in the ED could bring some consistency to the way entities determine the tax basis of an asset or a liability, we also believe that the outcome of the proposed approach may result in meaningless and sometimes confusing information.

(b) We are very concerned that the ED looks at the notion of management expectations in a way that is internally inconsistent with other aspects of the ED. For instance, the guidance in respect to the 'tax basis' is contrary to the way deferred tax assets and liabilities are measured under the ED. We find it odd that the ED requires management expectations to determine the tax rate, yet rejects it in respect to the tax basis.

(c) We believe that the proposals in the ED aimed at eliminating the "initial recognition" exception, are overly complex. In addition, we do not think they will produce information that is more meaningful than that required by the current IAS 12. We say this because, despite the various complex steps involved, the end result will in most cases be the same as under IAS 12.

(d) The ED retains an exception for temporary differences that arise on *foreign* subsidiaries and joint ventures (when the temporary difference is essentially permanent in nature) but removes the existing exception for all *domestic* subsidiaries. Again, we disagree with this proposal. While we agree that the calculation of the amount for deferred taxes for permanently reinvested unremitted earnings of foreign entities might require a fairly high degree of complexity, we believe that a similar argument can sometimes apply to domestic ones. Furthermore, developing a principle based on a where an entity is located is an unacceptable approach. In our view, the existing exceptions in IAS 12 should be retained.

(e) We think the requirements on the allocation of tax expense/benefit are overly prescriptive, add undue complexity to the way tax allocation is carried under IAS 12, and will not significantly improve the information that will be provided. In addition, we do not support the proposal to eliminate "backwards tracing", because we think the improved information it provides justifies any minor incremental effort the approach involves.

(f) We believe that the detailed rules for recognising and measuring tax assets are overly complex and rules-based. We would recommend a more principle based approach.

If you would like further clarification of the points raised in this letter, please contact Isabel Batista, Jeff Waldier or me.

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

APPENDIX—EFRAG'S RESPONSE TO 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?

Background notes to EFRAG constituents

1 *IAS 12 has a definition of tax basis that is based on amounts that will be deductible for tax purposes against any economic benefits that will flow to an entity when it recovers or settles an asset at a future date. This generally means the tax basis is in effect the value attributed to an asset by the tax authorities for tax purposes. Because the tax basis of an asset or liability depends on the expected manner of recovery or settlement, under IAS 12 management intent is important to determine the tax basis and consequently the amount of deferred tax to recognise. As explained in IAS 12, the recovery of an asset can be done through sale, through use, or through use and subsequent sale. However, IAS 12 does not offer much guidance on how to determine 'expected manner of recovery or settlement'.*

2 *Paragraph 1 of the ED explains that the core recognition principle on deferred tax is that an entity shall:*

> *"recognise tax liabilities, tax assets and tax expense..., for which tax is payable or recoverable on taxable profit for future periods as a result of past transactions or events. Such tax arises from the difference between the amounts recognised for the entity's assets and liabilities in the statement of financial position and the recognition of those assets and liabilities by the tax authorities, and the carryforward of currently unused tax losses and tax credits."*

3 *The ED is based on the principle that no deferred tax arises if an entity expects to recover an asset or settle a liability without causing any effect on taxable profit. This is explicitly stated in paragraph 10 of the ED. The ED slightly amends the definition of a temporary difference to reflect this principle, and defines a temporary difference to be the difference between the carrying amount of an asset, liability or other item in the financial statements and its tax basis that the entity expects will affect taxable profit when the asset or liability is recovered or settled (in case of other items, when they affect taxable profit).*

4 *Paragraph 15 of the ED proposes to provide specific guidance on how an entity should determine the tax basis of an asset and a liability. For an asset the tax basis equals the amount deductable at sale (at the end of the reporting period) rather than deductable through use. For a liability the tax basis is calculated based on settlement at the reporting date (rather than settled according to the term) and it is the tax amount deductable or taxable if the liability was settled at the book value at the reporting date. There are specific guidance for deferred income including revenue.*

5 *The IASB explains that one of the objectives underpinning this proposed change is to try to ensure that a single approach is applied in determining the tax basis of an*

asset and a liability. A second objective is to align the notion of tax basis in IFRS with US GAAP.

EFRAG's response to Question 1

Tax basis of an asset and a liability

6 We recognise that the proposal is a simple one and is likely to involve a lower degree of judgement. However, we have significant concerns with the proposed definition of the tax basis of an asset and a liability.

7 First, we disagree with this proposal on a conceptual level. In our view, in its definition of a tax basis, the ED provides, in one sentence, an understandable principle as to what a tax basis might represent in a particular tax jurisdiction. This definition states that the tax basis is the "measurement, under applicable substantively enacted tax law of an asset, liability or other item". However, as we progress to the more detailed aspects of how the principle is to be applied, we become less convinced that an approach based on sale will always lead to appropriate, meaningful and decision useful information in all tax jurisdictions.

8 In relation to the 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. We disagree with this argument.

9 In our view, entities will often acquire assets for use or consumption in their day-to-day operations, and may not necessarily recover their operational assets through sale. We think that requiring a simplistic fit-for-all 'sale' approach to determine the tax basis of an asset, will mean that in some cases the actual tax cash flows that are likely to arise from the recovery of an asset will be different - and sometimes very different - from the deferred tax effects recognised in the financial statements. The tax basis of an asset will often depend on how an entity recovers it, which may vary from entity to entity. Some entities may recover an asset through sale whereas others may recover it through use and other entities may recover some assets, for example real-estate, through sale and some assets through use. Therefore, we are not convinced that determining the tax basis of assets based on a single 'sale' notion, is the right conclusion.

10 In addition, in some tax jurisdictions an asset may have no tax basis or a different tax basis while it is being used, whereas on sale there is a tax basis arising under the capital gains tax laws. In other tax jurisdictions, the opposite can happen. In a third situation, an entity may intend to recover an asset partly through use and partly through sale, and the tax basis might depend on the manner in which the asset will be recovered (The tax basis can be different or might comprise of a combination of two or more values attributed by the tax authorities). In these cases, it is clear to us that having information based on the tax basis determined on sale will most likely produce information that is meaningless, and thus more likely to confuse users.

11 Similar to the definition and related guidance on the tax basis of an asset, the ED proposes that the tax basis of a liability be determined based on how it is settled at the reporting date. Again, we disagree with the single approach being proposed, as we believe that in some circumstances the tax basis of a liability might depend on whether the liability is settled or transferred at the reporting date and on another date.

12 Second, paragraph BC19 of the ED explains that SFAS 109 does not explicitly define a tax basis. Nevertheless, the IASB argues (BC21) that the proposals in the ED (i.e. determining the tax basis based on the "sale" of an asset) will in most cases result in a tax basis that is consistent with that used under US GAAP, except when the deductions available on sale differ from the cost of the asset less deductions received so far plus any tax indexation allowance. In other words, the proposals in the ED will achieve convergence in some circumstances but will not ensure convergence in other circumstances. We think the requirements in IAS 12 are already converged in that 'tax basis' is undefined currently in SFAS 109. If there is diversity in practice where tax basis differs on sale, that diversity in practice is likely to exist under both IFRS and US GAAP.

13 In a third point, we note that in some tax jurisdictions the tax basis of an asset or liability, when based on sale, may be subject to periodic adjustment - such as indexation adjustments - by the tax authorities. In such situations, entities will be faced with an added burden of having to determine the tax basis of each asset and liability at each and every reporting period, and preparers might be faced with a disproportionate degree of additional costs that are unlikely to be compensated by benefits it might bring to users. In fact, we believe that the ED will result in 'fluctuating' deferred taxes numbers. As we have argued in the above paragraphs, accounting for the deferred tax effects based on sale, will not always represent the actual tax effects an entity is likely to face when it recovers an asset or settles a liability. The added volatility might confuse users and make the deferred tax numbers even less useful.

Management expectations

14 The ED further says (BC22) that the tax basis does not depend on management's expectations of how the carrying amount of an asset will be recovered. Again we disagree with this point of view. As explained in the above paragraphs, an asset may have more than one tax basis and in some tax jurisdictions the tax basis of an asset may depend on how an entity recovers it. In such cases, we strongly believe that the tax basis of an asset should be determined based on the way management expects to recover it, because it will provide the most useful information for users.

15 As a second point, we are concerned that the ED looks at the use of judgement by management or management expectations in an inconsistent way in relation to various aspects of the proposals in the ED. For example, the ED disregards management expectations in the way it determines the tax basis of an asset and a liability, but considers management expectations:

(a) when an entity decides whether to recognise a deferred tax asset or a liability(paragraph 10 of ED),

(b) when measuring deferred tax assets and liabilities including the deferred tax implications that arise on the subsequent re-measurement of assets and liabilities (paragraph 25 of the ED),

(c) when an entity considers whether a temporary difference arises on the re-measurement of assets to fair value (B15 of the ED),

(d) in relation to the exception to investments in other entities (B6 of the ED).

16 It is clear to us that the notion of management expectations is firmly entrenched in the way deferred taxes are accounted for in accordance with the ED. The proposal

to remove it from the determination of the tax basis is thus contradictory to other aspects of the ED.

Recognition core principle and the definition of a temporary difference

17 We recognise that the ED maintains the existing temporary difference approach in IAS 12, and hence any changes it proposes have been made with this approach in mind. However, we have some concerns about whether the revised core principle is sufficiently clear when read together with the definition of a temporary difference and paragraph 10 of the ED.

18 We think the link between the core recognition principle, the proposed guidance about the definition of a tax basis of an asset or a liability and the proposed definition of a temporary difference, is somewhat circular. The guidance in paragraph 10 is based on the difference between an asset's or a liability's carrying amount in the financial statements and its tax basis - which is based on the tax consequences arising on sale of the asset or settlement of the liability. We interpret the ED to say that if an entity expects to recover an asset through use without affecting taxable profit, then no deferred tax arises. However, this is somewhat contradictory to the way the ED defines a tax basis of an asset - that definition is based on selling the asset - and also contradictory to the definition of a temporary difference, which refers to "the tax basis that the entity expects will affect taxable profit".

EFRAG's overall conclusion

19 To conclude, we believe that requiring the tax basis to be determined on the basis that an asset will be sold, or a liability settled, is not the conceptually correct approach and may not always result in a faithful reflection of the deferred tax consequences an entity is exposed to.

20 In our view, the way an asset is recovered and a liability is settled is a decisive factor in determining its tax basis and consequently the amount of deferred tax that an entity will recognise. We strongly believe that an entity should not be bound to determine the tax consequences on sale only, as the outcome in some circumstances might be tax numbers that are meaningless and more so potentially misleading to users. We would argue that leaving the tax basis - as it currently is in IAS 12 or making it undefined as it is in SFAS 109 – would result in IFRS and US GAAP being converged. Alternatively, we think the IASB should develop a clearly articulated principle that is operational and that supports the basic definition of a tax basis as defined in the ED that, will permit entities to interpret that principle and apply it to their particular tax situation.

21 We think the inconsistency in the ED on the use of management expectations should be resolved by requiring the way management expects to recover an asset or settle a liability to play a role when an entity estimates what the tax basis of an asset or a liability at the reporting date. We see no reason at all as to why the IASB has decided to dispense with the going concern principle in respect to the tax basis, more so because it is based on a rejection of management intentions which, in other instances in the ED are openly acceptable. In developing its thinking further, we encourage the IASB to carry out a series of field tests across the global tax regimes to explore the possible consequences of the proposal and of the impact of ignoring management intent when establishing the tax basis of an asset that addresses "real life" situations in relation the way assets are recovered. We strongly encourage the IASB to do this if it decides to go ahead with the ED. Another point is that if the IASB intends to eliminate the use of management

expectations or management intent in general a more comprehensive debate on its use and application is needed.

22 We think the linkage between recognition of deferred taxes in the ED and the proposed definition of a temporary difference would benefit if made clearer in the ED and encourage the IASB to review the drafting.

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?

Background notes to EFRAG constituents

23 *IAS 12 does not define a tax credit and an investment tax credit (ITC). The ED proposes to define a tax credit and an (ITC) as follows:*

> *Tax credit: A tax benefit that takes the form of an amount that reduces income taxes payable.*
>
> *Investment tax credit: A tax credit that is directly related to the acquisition of depreciable assets.*

24 *IAS 12 excludes ITCs from its scope and provides no specific guidance on how to account for ITC's. However, guidance is available in paragraph 34 of IAS 12 on the accounting for unused tax credits, which are recognised as deferred tax assets to the extent that it is probable that future taxable profits will be available. In practice, entities often find themselves considering whether a tax benefit or incentive granted by the tax authorities represents in substance an unused tax credit (in which case it will account for that "incentive" in accordance with IAS 12), a reduction in the applicable tax rate or an ITC. We understand that, if an entity considers such a benefit to be an ITC, it generally will apply existing IFRSs by analogy and either account for ITCs by analogy to IAS 12 or by analogy to IAS 20 Accounting for Government Grants and Disclosure of Government Assistance*.

25 *The ED proposes to define a tax credit and an ITC based on the definitions applicable under US GAAP. The ED explains that the definitions focus on the way in which the tax authorities express the benefit. However, the IASB decided not to provide guidance on the accounting for tax credits and ITCs as it believes this would require a more comprehensive debate on the accounting for such tax benefits.*

EFRAG's response to Question 2

26 Generally speaking, tax credits (including investment tax credits) are interpreted to be a form of tax incentives granted to entities in certain circumstances and when certain conditions are met. We are somewhat troubled with having a specific definition of a tax credit and ITC, because we believe that such incentives can be implemented by tax jurisdictions in different ways which may in fact be different to the way the ED defines such incentives.

27 We note that in some European tax jurisdictions, a tax credit can be associated with investments in assets. In our view, it is difficult to differentiate between a simple tax credit and an ITC, and we think that IAS 12 should remain silent in this

respect, until such time as a thorough understanding is obtained about the types of tax incentives to stimulate investments and their implications. We believe that the IASB should either be silent on this issue or define and set the accounting within the standard.

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?

Background notes to EFRAG constituents

28 *IAS 12 prohibits recognition of a deferred tax liability or deferred tax asset for temporary differences that arise from the initial recognition of an asset or liability in a transaction that (a) is not a business combination, and (b) at the time of the transaction affects neither accounting nor taxable profit. IAS 12 also prohibits an entity from recognising subsequent changes in such an unrecognised deferred tax asset or liability. SFAS 109 does not include an exception from the temporary difference approach for temporary differences that arise on the initial recognition of an asset or liability.*

29 *The IASB explains that in practice there are several aspects of this exception that has lead to difficulties in its application and also to uncertainties as to when it is appropriate to apply the exception and when it is less appropriate.*

30 *Our understanding of the proposals in B10-B12 and B13(c)) of the ED in respect to the transactions it intends to address can be summarised as follows:*

(a) *Step 1(B10): When a temporary difference arises on the initial recognition of an asset or a liability, the entity shall disaggregate the asset or liability into (a) an asset or liability excluding entity-specific tax effects and (b) any entity-specific tax advantage or disadvantage.*

(b) *Step 2 (B11): Recognise and measure (a) in accordance with other IFRSs.*

(c) *Step 3 (B12): Recognise a deferred tax asset or liability for any resulting temporary difference between the initial carrying amount of the asset or liability and the tax basis.*

(d) *Step 4 (B13c): If the consideration paid or received differs from the total recognised amounts of the acquired assets and liabilities (including deferred* *tax), the difference is recognised as an allowance against, or premium on, the deferred tax asset or liability.*

31 *B13(c) of the ED also requires that subsequently the allowance or the premium recognised in step 4, be reduced pro rata with changes in the related deferred tax asset or liability (step 5).*

32 *B10 requires an entity to estimate the value of the asset or the liability on the basis that it has the tax basis that is available to market participants in a transaction for the individual asset or liability (other than in a business combination) in that tax jurisdiction. B11 requires an entity to recognise that value (which will exclude entity-specific tax effects) in accordance with other IFRSs.*

33 *The ED explains that when an asset or a liability has a single tax basis that is available to market participants, the outcome of the proposal is to recognise the asset or the liability at an amount that equals the consideration the entity paid or received. In such situations the entity that acquires the asset or assumes the liability does not benefit from entity-specific tax benefits, so the amount it pays for it will be the same as the amount that assumes a tax basis equal to that available to other market participants.*

34 *In B12, the ED proposes to recognise a deferred tax asset or liability for any resulting temporary difference between the amount recognised initially for the asset or liability and its tax basis.*

35 *At the same time, B13(c) proposes to recognise any difference between the consideration paid and the amount recognised for the asset or liability (net of deferred taxes) as an allowance or a premium against the deferred tax asset or liability. In others words, the allowance or premium will be netted-off against the deferred tax asset or liability.*

EFRAG's response to Question 3

36 We welcome the efforts the IASB is making to address this exception and its attempt to eliminate it; we are, as a general rule, in favour of eliminating the exceptions in IAS 12 because we think that it will result in a more principle-based standard.

37 However, we have several concerns with the requirements in this proposal and do not believe that the IASB has made a sufficiently persuasive case to convince us that the proposals are an improvement to IAS 12 and, more so, we question whether the proposal does eliminate the existing exemption in IAS 12 or whether it simply redefines it in a different and more complex way. It is also our understanding that the proposals will not result in convergence with US GAAP on the tax accounting for these transactions. Our more specific concerns are discussed below.

Entity-specific tax effects and recognition under IFRSs (steps 1-2)

38 We have several concerns about this proposal. Our first concern is the rules-based nature of the proposal and the fact that we find those 'rules' to be unclear. For instance, we think it is unclear what "entity-specific tax effect" means and who the "market participants" referred to in the ED might be. We think that entities are likely to have difficulty in assessing tax positions of others to determine whether there were, in fact, entity specific impacts. We think that this aspect of the requirement may entail significant use of judgement and impose considerable amount of effort

on entities. For example, it is unclear to us whether "entity-specific" is the result of an entity's own tax planning exercise, an exclusive tax structuring opportunity offered by the seller of the asset, a unique status with taxing authorities or something else. Further, we suspect that in many situations, it might be extremely difficult, if not impossible, to obtain the information necessary in order to assess the tax implications of other entities that might be market participants. The IASB has acknowledged (in BC29) that "there may be difficulties" in this respect. We totally agree this will be the case.

39 Our second concern is whether the requirements in the ED are consistent with the way assets and liabilities are recognised in other IFRSs. BC29 explains that recognising an asset or a liability as described in B11 and B12 results in a carrying amount for that asset that will be consistent with the carrying amount of other assets and liabilities that are not affected by any entity-specific tax effects. We are not convinced this is the case and note the following:

(a) Under the ED, if a tax basis of an asset or liability that is assigned to an entity is different to that assigned to other market participants (because an entity is granted an entity-specific tax advantage), the amount recognised initially as an asset or a liability will <u>not equal</u> the consideration paid or received by the entity for the asset or liability. In this case, B10 of the ED requires an entity to recognise an amount that assumes a tax basis equal to that available to all other market participants – in other words a semi "grossed-up" or "grossed-down" number that removes any tax advantages or disadvantages that are specific to that entity. In our view, such an approach is not consistent with the way assets and liabilities are recognised and measured initially under other IFRSs.

(b) The notion of whether the amounts recognised for assets and liabilities are pre-tax or post-tax has created some debate in other IFRSs, particularly when they are measured initially or subsequently at fair value. The pre-tax/post-tax concept has not been fully debated in IFRSs, and we think it should be because it is valid to ask whether it is more appropriate to present assets and liabilities using a pre-tax presentation with a corresponding deferred tax liability or tax asset versus a net of tax presentation where the tax effects are included in the valuation of the respective assets and liabilities. We recognise though that this question is not unique to the "initial recognition exception"; it arises in numerous other cases. Nonetheless, we think it might be a worthwhile aspect for the IASB to explore further in the context of this 'exception' and how to address the accounting for it and the underlying tax effects.

40 An alternative approach considered by the IASB (BC29) would be to account for the assets and liabilities at fair value. This approach would, we believe, in principle be analogous to the method in US GAAP where the consideration paid or received for an asset or a liability is 'grossed-up' so that it presents a pre-tax number. The IASB rejected this approach on grounds that it did not want to introduce new fair value measurements in this ED. We believe the IASB should have explored this further before rejecting it.

Net-off approach on deferred tax effects (step 4)

41 The *o*utcome of the proposal in the ED will, in most cases, result in the same end result on initial recognition as the current exception in IAS 12 – a zero deferred tax

balance in the financial statements. In some cases, when the tax basis of an asset or liability that is assigned to an entity is different to that assigned to other market participants, the deferred tax balance might not be zero. The same might be the case in some other limited cases. In our view, the ED does not clearly explain how to deal with such situations.

42 The ED explains (BC33) that the allowance or premium that arises from adopting the proposals is an anomaly that arises because the approach in IAS 12 does not measure deferred tax assets and liabilities at fair value or at a price established by an exchange transaction for the tax asset or tax liability. Therefore, the IASB concluded that the anomaly should be recognised as part of the underlying deferred tax asset or liability. In other words, the anomaly should be dealt with using a 'net-off' approach. The IASB's reasoning (BC34) eludes to that this approach makes tracking subsequent changes of the temporary difference easier. While we agree that the resulting allowance or premium is an anomaly, we do not agree that the solution to resolve this anomaly lies in the net-off approach proposed, because as we say above, the alteration being proposed, albeit more complex and likely to involve disproportionate undue cost to preparers, will normally produce a similar answer to that in IAS 12.

43 We agree with the ED that "tracking" of the subsequent changes in the initial temporary difference is not always straightforward - particularly if a new temporary difference arises from the same asset or liability at a later date (for example due to re-measurement of the asset or liability) - but we are not convinced that it is a significant issue. That is because we believe that, when an entity is involved in transactions that involve such specific tax effects, it generally will have the necessary tax systems to address such situations.

EFRAG's overall conclusion

44 Overall, we believe that the proposals in the ED in this area are overly complex and we do not think they will produce information that is meaningful. In our view, the IASB should consider whether it is more appropriate to retain the present requirements in IAS 12 on grounds that they are clearer and easier to apply or find a more principle based approach than the one proposed in the ED.

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?

Background notes to EFRAG constituents

45 *The objective of the proposal is to eliminate part of the exception in IAS 12 in relation to the accounting for temporary differences that arise from investments in other entities. The ED proposes (in B5) an approach that is based on the accounting under US GAAP - it retains the exception for investments in foreign subsidiaries and joint ventures, but removes the exception available to domestic investments in subsidiaries and joint ventures and all associates.*

46 *The ED explains in BC43 that the reason the IASB decided to retain the exception for foreign subsidiaries and joint ventures is because it understood from experts that it is sometimes not possible to measure reliably the tax effects of undistributed earnings from those investments.*

EFRAG's response to Question 4

47 We disagree with this proposal. While we agree with the argument in BC43 - that the calculation of the amount for deferred taxes for permanently reinvested unremitted earnings of foreign subsidiaries and joint ventures might sometimes require a fairly high degree of complexity - we also believe a similar argument can sometimes apply to entities that are domiciled locally. Therefore, our logical reaction is to think that if the IASB is to permit an exception for the tax effects arising on certain investments as described in IAS 12, it should also permit entities to apply that exception to all their subsidiaries and joint ventures, irrespective of where the entities are domiciled.

48 As a second point, we believe that developing an accounting model based on where an entity is located, as is done in the ED, is in our view an inappropriate way of developing global accounting standards, as it may produce information that is meaningless and perhaps even confusing. The basis for conclusions is not very helpful in this sense.

EFRAG's overall conclusion

49 Although we support convergence between IFRS and US GAAP, we think that convergence should be to the standard that is deemed to be most appropriate and not the other way round, which we believe is the case here. For the reasons cited above, we believe the existing exceptions in IAS 12 should be retained.

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?

Background notes to EFRAG constituents

50 *The proposal requires a valuation allowance to be set up if, based on available evidence, it is more likely than not that all or some portion of the deferred tax asset will not be realised due to the inability to generate sufficient taxable income to realise the benefit of the deferred tax asset. Once a valuation allowance is determined and offset against the deferred tax asset, the net deferred tax asset will represent the tax benefits that are more likely than not of being realised. The IASB argues in BC53 that this approach is more consistent with the underlying concepts in the IASB's Framework in relation to the recognition of assets.*

<u>EFRAG's response to Question 5</u>

51 Although we think that the net outcome under the ED's proposals will be consistent with that achieved under IAS 12, we believe that the information presented will be enhanced as users will be able to obtain more transparent information about how the net deferred tax amount has been determined. We also agree with the IASB's arguments in BC53. We therefore agree with the proposal.

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?

Background notes to EFRAG constituents

52 *Under IAS 12 deferred tax assets are recognised in respect of deductible taxable differences only to the extent that is probable that taxable profit will be available against which the deductible temporary differences can be utilised. The ED proposes to replace the term "probable" used in IAS 12 with the term "more likely than not", which is consistent with the term in US GAAP when referring to the recognition threshold for deferred tax assets.*

53 *The proposal to require the net amount recognised to be the <u>highest</u> amount that is more likely than not to be recovered through future taxable profit seems to be driven by the desire to converge IAS 12 with FIN48 (as explained in BC57).*

EFRAG's response to question 5B

54 We agree that the net amount recognised should be the highest amount that is more likely than not to be realisable. In our view, the highest amount that is more

likely than not is broadly similar to the term 'probable' in existing IAS 12 and is already understood as it is used elsewhere within IFRS. For example, as explained in paragraph 16 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the term "probable" is intended to mean "more likely than not".

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?

Background notes to EFRAG constituents

55 *B16 to B25 provide rules for tax asset valuation allowances. B17 provides rules for the sources of taxable income that may be available to realise a tax benefit for temporary differences and unused tax losses and tax credits, which can include tax planning strategies. B18 provides rules for what comprises a tax planning strategy. B20-B25 give rules for the various sources of evidence that an entity can use to demonstrate the existence of sources of taxable profit that support the recognition of a deferred tax asset (positive sources) and also discusses the various sources of evidence that indicate that a valuation allowance might be needed to reduce the net deferred tax asset to the highest amount that is more likely than not to be realisable against future taxable profit (negative sources). As explained in the basis for conclusions, the guidance combines existing guidance in IAS 12 and guidance under US GAAP on this matter.*

EFRAG's response to Question 6A

56 Overall, we question whether the detailed rules provided in B17-B25 are necessary. At the same time we acknowledge that IAS 12 is already fairly prescriptive in its guidance in relation to when an entity can recognise a deferred tax asset. Having said that, we cannot accept that such rules be part of an amended IFRS standard on the accounting for income tax. In our view, the IASB should have laid out the principles and considered adding some brief implementation guidance, if they were of the view that added guidance was needed to improve IAS 12. In our view, convergence should mean improved standards not more detailed rules to facilitate convergence with a US standard.

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?

Background notes to EFRAG constituents

57 *B18 proposes that, when tax planning strategies affect the amount of the valuation allowance, the entity shall include significant expenses or losses incurred to implement those strategies in the measurement of the valuation allowance.*

58 *IAS 12 is silent on this topic.*

EFRAG's response to Question 6B

59 We think that this is yet another very ruled-based requirement which we believe will not be an improvement to IAS 12, which presently permits entities to evaluate whether they should capitalise the costs they incur when implementing a tax strategy, or expense such costs when they are considered to be insignificant.

60 A second concern is that the proposal is once again giving preference to a US GAAP requirement and simply adopting that existing requirement, without the IASB having considered other possible alternatives to the accounting. We are concerned with the precedent that the ED seems to be setting – when IFRS is silent on something it is US GAAP that prevails. We find this approach simply unacceptable. The ED does not explain why the IASB believes that the guidance under US GAAP is preferable to something else. In our view, it is fundamental that the IASB give sufficient thought to the changes proposed to IFRS and justify those changes clearly in the basis for conclusions.

61 Finally, we believe that IAS 12 should remain silent on this topic, until such time as the IASB can evaluate the other possible alternatives in the accounting for such costs, and of those alternatives select the more appropriate one.

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?

Background notes to EFRAG constituents

62 *As the question explains, IAS 12 is silent on the treatment of uncertainty over whether the tax authority will accept the amounts reported to it (uncertain tax positions). EFRAG understands that the lack of specific guidance has lead to this type of "uncertainty" being accounted for in different ways. The ED proposes to provide guidance to address this uncertainty.*

63 *Our understanding of present practice is that entities need to makes estimates and assumptions in relation to the tax effects that they are exposed to, and it would seem reasonable for an entity to consider a number of possible outcomes in cases that involve uncertain tax positions and estimate the final outcome based on those possible outcomes.*

64 *Paragraph 26 of the ED proposes that current and deferred tax assets and liabilities 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. Changes in the amount initially measured should be based on new information that the entity receives, and not on revisions to the original estimate.*

EFRAG's response to Question 7

65 We have several concerns with this proposal.

66 First, we are concerned with the level of precision implied by the specific "rules" in the ED (see paragraph 26 for example); we think it is unrealistic to expect a high degree of precision in accounting for uncertain tax positions, and that it follows that these specific rules are unnecessarily prescriptive. In our view, BC63 is probably right in saying that in some cases the requirement to adopt a probability-weighted average of possible outcomes could be unduly onerous.

67 Second, we are not aware of any field testing that has been carried out to explore the practical consequences of the increased rigidness proposed in the requirements, and to support that it is indeed the most appropriate way of computing a so-called precise tax number. With this in mind, we suggest that the IASB carry out some field tests to better understand the implications of this proposal, if the IASB intends to retain it. We also believe there will be concerns of reporting entities that the prescribed approach may provide unduly transparent tax information to tax authorities. Once again, field tests would be helpful in this respect.

68 Third, we are not aware of a significant issue in practice under IFRS, and therefore it seems to us unduly onerous to require an entity to apply such degree of precision, which in our view is not really precise anyway.

EFRAG's overall conclusion

69 We have considered what approach we believe could be acceptable, if the IASB decides that IAS 12 ought to have guidance on this topic. In our view, the probability approach that the ED suggests is unlikely to produce a precise tax figure, despite the onerous requirements that an entity is likely to adopt to get to that number.

70 We think that another way to get to an reasonable tax number, when uncertain elements exist, is for an entity to simply adopt an approach based on the most likely outcome. This would be consistent with the spirit of the measurement principle set out in paragraph 25 of the ED, as it requires entities to measure deferred tax assets and liabilities based on tax rates that are likely to apply. We therefore fail to see the need for the detailed guidance proposed by the ED. We further note that the use of a 'best estimate' notion would be consistent with other IFRSs and with the way the IASB is developing other forms of guidance for topics that are subject to uncertainty of information. We encourage the IASB to further explore our suggestions as discussed in this paragraph, when finalising the ED.

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?

EFRAG's response to question 8

71 We agree with the clarification in the ED 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. In our view, the proposal is also

consistent with the way many entities interpret "substantive enactment" at present in the absence of specific guidance.

72 IAS 12 already requires measurement of deferred tax assets and liabilities to be based on "substantial enactment", which is slightly different to US GAAP which looks at the "enacted" tax rate. As explained in BC65 the IASB rejected the US GAAP approach on the grounds that in some tax jurisdictions it would be inappropriate to have to wait until the actual formal announcement of the enacted tax rate is made. We support the line the IASB has taken on this issue.

73 A more detailed point is the reference in B26 to the US specifically. We find such a reference unacceptable considering that the US does not use IFRS and the US is only one nation compared to many other nations in the world that actually use IFRS.

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?

Background notes to EFRAG constituents

74 *As previously discussed, the ED changes the definition of a tax basis of an asset and a liability so that it is based on the consequences of sale or settlement. In addressing the situations where more than one tax rate might apply depending on how an asset is recovered, the ED tries to propose guidance that is consistent with the way it proposes to determine the tax basis of an asset and a liability.*

75 *The IASB concludes that the measurement of deferred tax liabilities and assets it might depend on the manner of recovery or settlement of the related asset or liability.*

(a) *First, the ED proposes the use of a tax rate that is consistent with the deductions that determine the tax basis, if those deductions are available only on sale of the asset.*

(b) *However, if the same tax deductions are also available if the asset is used, the ED proposes the use of a tax rate that will apply when the asset is recovered – i.e. in this case the tax rate to be used should depend on how the asset is expected to be recovered.*

76 *In relation to (a), the IASB argues (BC69) that its aim was to ensure that the tax rates used to measure a deferred tax asset or liability is consistent with the tax basis. The IASB states that the use of an inconsistent tax rate would not provide useful information.*

EFRAG's response to Question 9

77 As mentioned in our response to question 1, we strongly object to the way the ED describes the way the tax basis is determined because we believe that the tax basis of an asset or a liability should depend on how an entity will recover an asset or settles a liability. We further believe that the way deferred tax assets and liabilities ought to be measured should be based consistently on the way the related asset or liability will be recovered or settled. For instance, if an asset is to be recovered via sale both the tax basis and the tax rate should be related to the sales recovery. We find it odd that the IASB accepts the relevance of management intent in determining the tax rate to be applied to the measurement of deferred tax assets and liabilities, but rejects this notion in respect to the tax basis.

78 We would like to note that we find B29 confusing and have struggled to understand fully its intended meaning. According to B29 the tax rate on sale should be used if the deductions are available "only" on sale. We are unsure whether this means exactly the same amount of tax deduction or partly the same deduction. We are also unsure whether it means the same deduction at the point in time of initial recognition or whether it must be the same deduction at all times through use or sale. If it is meant to be the same amount of deduction at all times throughout the period of ownership regardless, the possibility to use a "non-sale" tax rate is likely to be extremely remote in many circumstances. If that is so, the IASB ought to have required the use of the tax rate on sale, in all circumstances. Having said that – and as mentioned earlier in this letter - it seems meaningless to us to provide a deferred tax figure based on a sales approach if an entity will recover the asset through use.

EFRAG's overall conclusion

79 As explained above, in our view the way an asset or a liability is recovered or settled is a fundamental factor in determining whether there is a temporary difference and consequently whether deferred tax needs to be recognised in the financial statements.

80 We also believe that getting the measurement principle right is largely dependent on getting the tax basis of an asset or a liability right. As we have said earlier in this letter, we think the IASB should further explore the relevance of management intent – in order to establish a clearly articulated principle that addresses "real life" scenarios and which entities can apply to their specific tax situation.

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***?***

Background notes to EFRAG constituents

81 *The ED proposes that an entity should estimate the part of a distribution that it expects to distribute in a future period and recognise the tax effects of that future distribution.*

EFRAG's response to question 10

82 EFRAG members were divided on this issue.

(a) Some EFRAG members support the proposal on the bases that they believe that a distribution may result in a temporary difference in which case a deferred liability will need to be recognised. These EFRAG members agree with the proposal on the basis that it better reflects the overall expected tax outflows. They recognise that it could be argued that the tax consequences arising from settling a liability cannot be recognised without the liability being recognised and that the event which actually triggers the income tax consequence is the distribution itself. However, in their view, the obligation event is the earning of the taxable income and that the rate is merely a measurement issue, with the expected rate being the realistic basis for the expected tax outflow.

(b) Other EFRAG members are less supportive of the proposal. These EFRAG members, share the views expressed in BC79 of the ED that the tax consequences arising from the settling of a liability cannot be recognised without the liability being recognised. The event that triggers the income tax consequence of the distribution is the distribution itself.

83 We note that the ED is proposing to require an entity to consider management expectations in order to determine the tax consequences that are expected to arise if an entity makes a distribution at a future date. Again, we reiterate the point that we think that it is fundamental to eliminate the inconsistency in the ED in relation to the way the role of management expectations.

Question to EFRAG's constituents

84 Which of the above two views do you support and why?

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?

EFRAG's response to question 11

85 EFRAG is not aware of any existing problems in practice related to deductions that do not form part of part of the tax basis of an asset or liability. We agree with the board that it would be impractical to list specific items from various tax jurisdictions as special deductions in developing a global standard, and think the existing principle of the standard provides adequate guidance. As a result, EFRAG agrees

that the ED should be silent on the treatment of tax deductions that do not form part of a tax basis. However we would like to mention that it seems a bit odd to ask the question without explaining what the issue is.

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?

EFRAG's response to question 12

86 EFRAG agrees with the proposal that an entity should consider the interaction between tax systems. We believe entities that are subject to tax based on one of two systems are in a similar economic situation being subject to graduated tax rates. The level of tax levied by taxing authorities can vary under a two tax system because deductions or rates may differ depending on taxable income. Under graduated tax rates, only the rate differs. In both cases, we think it is necessary to consider the tax rate or system in measuring tax assets and liabilities.

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?

Background notes to EFRAG constituents

87 *The objective of the proposed allocation in the ED is to converge with US GAAP. This proposed convergence would make two basic changes to the allocation approach under IAS 12. First, it would eliminate the use of backwards tracing for*

tax allocation. The second change would provide additional allocation guidance to address specific situations that are silent in IAS 12.

88 *In explaining the first proposed change (the elimination of backwards tracing), the ED (BC93) argues that in certain cases backwards tracing under IAS 12 is difficult or results in arbitrary allocation. Consider the following example:*

> *Consider loss carryforwards that arose from losses recognised in different components of comprehensive income or equity. The tax authority does not distinguish between the different loss carryforwards. At the time the losses arose, 100 per cent valuation allowances were recognised in relation to the resulting deferred tax assets because the likelihood of their realisation was low. In a subsequent period, the assessment of the realisation of the total deferred tax assets changes and the total valuation allowance is reduced. There is no non-arbitrary way of allocating the benefit arising from the reduction in the total valuation allowance to the different components of comprehensive income or equity in which the losses were originally recognised.*

89 *The ED also proposes to address tax allocation situations that are not addressed in IAS 12. For example, IAS 12 does not state whether tax benefits from tax losses should be allocated to the source of the loss or the source of the taxable income that utilises the tax benefit. IAS 12 acknowledges that in practice tax allocation can be difficult in some situations and simply requires a reasonable pro rata allocation. The ED proposes to provide guidance to address these situations.*

EFRAG's response to question 13A

90 The IASB has not argued that prohibiting backwards tracing would result in an improvement to financial reporting. Also, EFRAG is not convinced that backwards tracing is as difficult in practice as the IASB seems to be suggesting. We agree that it can be arbitrary, but we think all allocation methods are in some way arbitrary. (The IASB seems to accept this in BC93 when it states that there is no non-arbitrary way of allocating tax in certain situations.) But most important of all, we think the financial reporting will be better – in other words, the information provided will be more useful - if the allocation of tax continued to follow the underlying – in other words by applying 'backward tracing'. We think the improved information backward tracing provides justifies any minor incremental effort the approach involves.

91 The additional detailed guidance is attempting to address some very complicated tax situations, which indeed some entities may encounter in practice and aims at enhancing consistency of information. While this guidance might indeed address those situations, it does entail a fair amount of very detailed and prescriptive rules. In our view, those rules add unnecessary complexity to the allocation process in these already complicated tax situations. We are also concerned that the prescriptive nature of the proposed allocation method seems likely to result in greater complexity for even the less complicated tax allocation situations.

EFRAG's overall conclusion

92 Overall, we do not support the ED's proposed tax allocation requirements. We believe backward tracing is the better allocation method by providing more useful information, and we are very concerned about the added complexity resulting from the additional allocation guidance. We do not think the greater consistency promised by the detailed rules will be a significant overall advantage, and therefore favour the more principle based approach of IAS 12.

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?

Background notes to EFRAG constituents

93 *The IASB considered an alternative allocation approach to the one discussed in Question 13A that would retain the backwards tracing method under IAS 12 and add guidance to address the tax allocation situations that IAS 12 is silent on. The rationale for this alternative is explained in BC 97:*

> *"However, the Board is aware that that the SFAS 109 requirements are complex, can be difficult to use and, as noted above, can seem to give counter-intuitive results. The Board has simplified the requirements as much as possible without changing the basic approach. In order to explore the issue fully in the exposure draft and get as much information as possible from respondents, the Board has also developed an approach based on the IAS 12 requirements with additional guidance to cover the gaps described in paragraph BC94 (see paragraphs 29A–34A and B34A–B36A). The invitation to comment asks questions on both approaches. "*

EFRAG's response to question 13B

94 We think the results under the alternative approach would be different from those produced under SFAS 109 when a tax event occurs that involves backwards tracing. That is because this alternative approach retains backwards tracing while the SFAS 109 approach does not.

95 As discussed above in our response to the previous question, we prefer retaining backwards tracing because we believe it provides more useful information. In particular, if a tax amount is recognised in the current year that relates to a prior period transaction recognised outside continued operations, we believe it is more useful to present the tax amount recognised on the same basis as the transaction that gave rise to the tax rather than the outcome under SFAS 109.

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?

EFRAG's response to question 13C

96 As previously mentioned, we prefer retaining backwards tracing because we believe it provides more useful information. However, we do not support the alternative approach because it retains the additional rules-based guidance in the ED to cover the 'gaps' in IAS 12, which we expressed significant concerns with in our response to Question 13A. In our view, the requirements in the ED will result in an allocation method that is more difficult than we believe is necessary. For that reason, we favour retaining IAS 12's more principle based approach.

97 Having said that, our view is that the proposal can be applied consistently in the tax jurisdictions with which we are familiar, albeit with a high degree of implementation cost for preparers.

Question to EFRAG's constituents

98 We would appreciate your views on whether you believe the alternative approach could be applied consistency, and, if it could do you think it would represent a better approach than the one in existing IAS 12, and if so why ?

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?

EFRAG's response to question 13D

99 We think the proposed additions in the ED, under either the proposed approach or the alternative approach, would probably help provide greater consistency of information between entities in respect to tax allocation; namely because of the complicated set of prescribed allocation steps and procedures involved. However, unlike recognition and measurement matters, we do not believe it is a priority for an allocation method to be exactly the same between entities, particularly in light of the complexity introduced. In our view, the proposal risks introducing too much complexity without providing corresponding benefits to users.

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?

Background notes to EFRAG constituents

100 *The ED requires an allocation of consolidated tax expense to entities that prepare separate financial statements and are within a group that files a consolidated tax return. The does not provide detailed guidance, and instead states that the allocation shall be 'systematic, rational and consistent' with the standard's principles. The ED further gives examples of methods that are not consistent with the standard's principles.*

EFRAG's response to question 14

101 EFRAG agrees with the proposal.. We also support the use of a systematic and rational methodology to allocate tax expenses between those entities, as we believe this guidance is both principle-based and encourages consistency in its application.

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?

Background notes to EFRAG constituents

102 *IAS 1 (revised 2008) requires an entity to present a classified statement of financial position (by classifying assets and liabilities either as current or non-current), except when a presentation in order of liquidity provides information that is more relevant and reliable. However, the standard prohibits an entity from classifying deferred tax assets and liabilities as current assets and current liabilities.*

103 *The ED proposes to require the classification of deferred tax assets and deferred tax liabilities as either current or non-current based upon the classification of underlying asset or liability that gave rise to the temporary difference. For example, a deferred tax asset related to a temporary difference created by a current accrual would be classified as a current deferred tax asset. Whereas a deferred tax asset related to a temporary difference created by a provision classified as non-current would also be classified as non-current. .*

EFRAG's response to question 15

104 We do not agree with this proposal. We think the way assets and liabilities are classified in the statement of financial position should depend on which classification will provide information that is most useful. Although the IASB argues (BC102) that its proposal will "provide more useful information" than the current IAS 12, it does not explain why that it is so nor why other alternative ways of classifying deferred tax assets and liabilities were rejected.

105 In our view, probably the best presentation would be to base the current and non-current classification on the expected timing of settlement or recovery of the tax cash flows, because classification is based on a liquidity notion. Classifying deferred taxes under the proposal based on the underlying item that gives rise to the deferred tax amount will not always reflect the expected timing of tax payments and potential tax benefits. For example, significant deferred tax liabilities associated with property, plant and equipment may reverse in the current year and trigger current tax payment, yet these deferred tax liabilities would not be classified as current. To this end, a model based on scheduling the turnaround of deferred tax would most likely produce the more accurate information. However, since deferred taxes are not actually settled or recovered but instead reverse, even though this approach would not be completely accurate. Therefore, we believe that classifying current tax amounts as 'current' and deferred tax amounts as 'non-current' is a reasonable approach. In our view, any alternative attempt at greater precision would require not only detailed scheduling of the future reversals of temporary differences but also forecasting subsequent tax payments and we are not convinced that such an approach is at all practical.

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?

Background notes to EFRAG constituents

106 *In most jurisdictions, interest and penalties may be charged when an entity underpays or delays the payment of its income tax obligations. Under IAS 12 such interest and penalty charges are generally deemed by practitioners and do not to meet the definition of an "income tax" – which is defined to be a tax based on taxable profit. In practice, the interest or penalty is generally presented either as a finance cost (interest) or operating expense (penalty), and is not presented as part of the tax expense in the statement of comprehensive income.*

107 *EFRAG notes that the IFRIC has previously considered whether to give guidance on which taxes are within IAS 12's scope, and decided not to so. More recently the IFRIC received a similar request in relation to the presentation of taxes arising on "tonnage". Again the IFRIC opted not to carry out a project on the issue although its reasoning for not doing so was stated to be that such taxes are not income taxes as defined by IAS 12 and are therefore outside the scope of IAS 12.*

108 *The ED does not require a specified classification of interest and penalties and is similar to IAS 12 on this point; it will continue to leave it to practitioners to use the definition of 'income tax' to decide whether interest and penalty charges - and indeed things like tonnage – are within the scope of the standard. Indeed, our understanding is that scope was not an issue that was specifically addressed as part of the project. However, the ED does require an accounting policy decision and disclosure for the classification decision for interest and penalties*.

109 *Unlike US GAAP, the ED does not require the amounts of interest and penalties to be disclosed. The ED implies that a specific requirement in IAS 12 to disclose such information is unnecessary because paragraph 97 of IAS 1 already requires separate disclosure of items of income or expense that are material*.

EFRAG's response to question 16

110 We are broadly in agreement with the proposed approach because disclosure as an accounting policy helps ensure the classification is consistently applied by entities.

111 We also agree with the IASB's decision not to require disclosure of the amounts of interest and penalties to be disclosed because IAS 1 *Presentation of Financial Statements* should in principle "capture" this type of information when the amounts involved are material.

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.

Background notes to EFRAG constituents

112 *As explained in BC104 of the ED, when the IASB considered disclosures from the standpoint of convergence so that users would have comparable information under*

each standard that was cost-beneficial to prepare. In doing this, it looked at (a) the existing disclosures under both standards, which in some cases are different, and (b) new disclosures that might be necessary as a result of the decisions reached in the project.

113 *While the ED proposes to delete some of the existing disclosure requirements in IAS 12, it adds other disclosures, some of which are intended to reflect the changes in the ED to existing IAS 12.*

114 *The following disclosures are proposed to be added to IAS 12, and which are currently required in US GAAP (BC 107):*

(a) *adjustments for a change in the tax status of an entity and tax benefits allocated directly to capital or goodwill.*

(b) *for entities not subject to income tax because their income is taxed directly to their owners, a requirement to disclose that fact and the net difference between tax basis and carrying amounts.*

(c) *for an entity that is a member of a group that files a consolidated tax return, disclosure in its individual or separate financial statements about the allocation of the consolidated tax effects.*

115 *The ED also proposes to change the reconciliation of the tax expense recognised by eliminating the existing IAS 12 option of either using the parent entity's domestic tax rate or aggregating separate reconciliations and rates for each tax jurisdiction to compute an average tax rate. The ED proposes to require an entity to use the parent's entity's domestic tax rate.*

116 *The ED proposes some new disclosures that are not currently required in either IAS 12 or US GAAP. These new disclosures would include:*

(a) *deferred taxes arising on transfers of assets and liabilities within a consolidated group between taxing jurisdictions with different tax rates and the net effect on tax expense.*

(b) *a numerical reconciliation of the opening and closing deferred taxes for each type of temporary difference*

117 *BC110 explains that the IASB considered whether different disclosures to those in IAS 12 would be useful in relation to undistributed foreign earnings. The IASB is asking constituents for suggestions on what disclosure in relation to the effect effects of distributions might be useful to users. Presently paragraph 82A of IAS 12 requires an entity to disclose the potential income tax consequences that may arise from the payment of dividends to its shareholders and if such consequences are not practicable determined, an entity is required to state that. The ED (paragraph 48a) retains the requirement to require an entity to provide information about the potential tax effects relating to future distributions to shareholders and the effect, if any, that future distributions might have on the tax rate used to measure deferred tax assets and liabilities.*

118 *The ED proposes to change the disclosure in respect to uncertain and unresolved disputes with the tax authorities. Paragraph 49 of the ED requires more transparent information in respect to tax uncertainties than is currently required in IAS 12.*

EFRAG's response to question 17

119 EFRAG welcomes the approach taken by the ED to take a fresh look at which disclosures might be provide useful information to users, without adding unnecessarily to the voluminous amounts of information required by IAS 12.

120 EFRAG broadly agrees with the additional disclosures proposed in the ED generally for the reasons stated in the IASB's basis for conclusion.

121 However, we note that in existing IAS 12, the IASB explains that if an entity operates in various tax jurisdictions, it may be more meaningful to use the 'aggregate' method by using the domestic tax rate in each individual jurisdiction, instead of the parent company's domestic rate. We generally support the elimination of options from standards because we believe it provides more consistency. We further believe that it is important to adopt whichever is the better of the two options. The Basis for Conclusions in the ED does not provide any convincing rationale as to why the parent's rate is preferable to the aggregate tax rate. That said, we believe that some users may better relate to the parent's tax rate, and, the information on the aggregate rates will still be available in the tax reconciliation. In other words, when using the parent's tax rate the impact of aggregate rates is not lost. Instead this information is reflected as an item that reconciles to the parent's tax rate. For this reason, EFRAG supports the proposed change.

122 A second concern we have relates to the potential effects of the increased disclosures on the position of the reporting entity. In this respect, we would like to point to the practical difficulties involved if the disclosures provided by an entity which could jeopardise its position vis-à-vis the tax authorities. For this reason, we encourage the IASB to select a realistic approach that is feasible in this respect.

123 The ED (paragraph 46 and 48(d)) adds to this disclosure requirement by proposing that a numerical reconciliation be presented to reflect the changes to the deferred tax assets and liabilities itemised by type of temporary difference and proposing additional tax information arising on the transfers of assets and liabilities within a consolidated group. The ED in BC109 states that it believes this type of analysis and additional disclosure will provide users with more useful information so that they can better reconcile and understand the tax expense for the reporting period. We agree with the proposed change in paragraph 46 and 48(d) of the ED and the rationale supporting this change.

124 We note that paragraph B32 of the ED changes the requirement to account for the tax effects arising on future distributions (see Question 10 of this letter). The IASB is seeking views from constituents on what information would be useful to users in relation to the potential future tax effects of undistributed reserves. Irrespective of this change in the accounting, it is our understanding from the discussions we have had with users of financial statements that information about the potential future tax effects of undistributed reserves is important to them.

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?

Background notes to EFRAG constituents

125 *The ED proposes prospective application. The IASB considered some of the information that would be needed for retrospective application and also considered whether retrospective application could be affected by hindsight in making judgements. In BC 112 the IASB identifies information that would be required for retrospective application:*

(a) *The elimination of the initial recognition exception will change the carrying amount of some assets and liabilities that were subject to the exception.*

(b) *The proposed amendments include changes in the allocation of tax between profit and loss, other comprehensive income and equity.*

126 *In BC 113 the IASB identifies two issues that could require judgements that could be affected by hindsight:*

(a) *the proposal relating to uncertainty over the amounts and rates underlying the tax amounts.*

(b) *The need to assess whether a valuation allowance is needed for any deferred tax asset that could be recognised under the proposals but are not recognised in accordance with IAS 12.*

EFRAG's response to question 18

127 We would like to point out that EFRAG does not support some of the ED's proposed changes that make retrospective application impracticable such as the proposed change to the tax allocation methodology. EFRAG's general policy is to argue for retrospective application of IFRS. Furthermore, if the choice is between prospective application now or retrospective application with a longer lead time, EFRAG's general policy would still be to favour retrospective application.

128 Some EFRAG members agree that some of the amendments would require the use of judgement and hindsight to obtain some of the information needed. These EFRAG members believe that, provided the amendments that cause difficulties for retrospective application are in a final standard, in this case prospective application might be fairest for those amendments.

129 Other EFRAG members argue that IASB should require full retrospective application of all the proposals. These EFRAG members think that entities ought to have the information needed to apply the proposals retrospectively.

Question to EFRAG's constituents

130 We would appreciate your views on the type of transitional provisions you would prefer to apply when adopting the proposals and why you prefer that approach.

Other comments

131 We are concerned that the changed structure of the ED will make applying the requirements more difficult compared to the existing standard, mainly because although the ED describes the principles in the standard itself, it forces the reader to refer continuously to the application guidance as it is actually the latter that contains the fundamental requirements that the ED proposes to be adopted.