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Sir David Tweedie
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30 Cannon Street
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on Exposure Draft ED/2009/2 Income Tax. Principal authors of this comment letter were Josef Arminger, Peter Geyer and Gerhard Prachner.

General remarks

The IASB's Income Tax project is intended to close the gap between IFRS and US GAAP. It does not, unfortunately, involve any fundamental rethinking of the accounting for income taxes. We therefore consider that the proposals in the ED do not represent an improvement on the existing IAS 12. We do not support convergence that does not bring improvements to IFRS.

Certain proposals are extremely rules-based. The US GAAP rules are based on the US tax systems and can therefore not necessarily be applied in other jurisdictions around the world. Before introducing such rules, field tests should be carried out, to provide a better understanding of the implications of the proposals.

In summary, we do not see the necessity for the proposals, and therefore we can in principle not support most of the proposed rules.

Specific comments

Q1. Definitions of tax basis and temporary difference

The proposal to change the tax basis from amounts that are expected to be recovered or settled based on management's intentions to the recoverable amounts that would result in case of a sale or settlement at period end would generally lead to more uniformity at this stage of deferred tax calculation. However, as tax consequences in many tax jurisdictions depend on aspects of how assets or liabilities are used, we see here the advantages of the existing IAS 12 definition, as it being better capable of reflecting the individual tax position.

However, since the definition of temporary differences is changed in such a way that deferred taxes are to be calculated only on temporary differences that are expected to affect taxable profit, the disadvantage of the new tax basis definition – which is not able to reflect the individual tax situation – is compensated for.

Assuming the tax regulations of the 'old' regime are consistently and reasonably applied, we do not expect material differences from the changeover from the 'old' to the 'new' regime.

On basis of the above analysis we agree with the proposed changes, however we are less convinced that an approach based on sale will always lead to appropriate, meaningful and decision-useful information in all tax jurisdictions.

Q2. Definitions of tax credit and investment tax credit

We do not agree with the adoption of the proposed definitions.

The ED proposes to define (in Appendix A) a tax credit as a tax benefit that takes the form of an amount that reduces income taxes payable and an investment tax credit as a tax credit that is directly related to the acquisition of depreciable assets.

As explained in BC24, investment tax credits are excluded from the scope of IAS 12 (no change proposed in ED). BC24 mentions different treatments of tax credits and tax deductions and other aspects that give rise to discussions about how tax benefits should be classified.

The existing position (investment tax credits excluded from scope, no definitions of tax credits or investments tax credits) has different impacts in different tax jurisdictions. For certain tax jurisdictions adequate solutions may have been found using only the existing limited rules. The proposed definitions could have negative impacts in some situations by introducing additional restrictions preventing adequate solutions for certain types of tax credits and investment tax credits. (In certain tax regimes there is no clear distinction between tax credits and investment tax credits.)

We propose deferring the introduction of definitions for tax credits and investment tax credits until after comprehensive reconsideration, particularly with respect to the interaction of IAS 12 and IAS 20.

Q3. Initial recognition exception

We agree in principle with the proposal to eliminate the initial recognition exception in order to make the standard more principles-based and to achieve more consistent deferred tax treatment. We also agree with the rejection of the EITF 98-11 approach, since this approach tends to result in overstated (grossed up) assets and liabilities (BC27).

However, we are not convinced that the proposed treatment makes the issue easier to understand and apply, as suggested in BC26.

Furthermore we do not see a clear conceptual objective in the proposed multistage procedure.

The first step in the new process is the disaggregation of asset or liability amounts into asset or liability amounts excluding any entity-specific tax effects (i.e., carrying amounts in accordance with other applicable IFRSs) and those entity-specific tax effects. We agree with the comment in BC29 which states that there “may be difficulties in assessing what the amount measured in accordance with applicable IFRSs would have been had the same tax basis been available to the entity as to a market participant”. In our opinion disaggregation is not sufficiently clearly defined, and we see too much scope for interpretation in estimating the entity-specific tax effects. The disaggregation step suggests something like a ‘pre-tax’ presentation, without leading finally to this result in the ‘normal cases’.

In the next step a deferred tax asset or liability is recognised for the difference between the carrying amount and the tax basis of the asset or liability (BC30). The conclusion in BC30 that the resulting deferred tax asset or deferred tax liability is consistent with the other tax assets or liabilities in accordance with IAS 12 is true if the calculation is based on the provisions of ED paragraph 20. B12 of the ED requires recognition of a deferred tax asset or liability for ‘any resulting temporary difference’. In the case of non-taxable and non-deductible temporary differences, the treatment would not be consistent with that of other tax assets and liabilities.

As the final step, if the total carrying amount of the recognised asset or liability (including deferred tax) differs from the consideration paid, the difference is to be treated as allowance against or premium to the deferred tax asset or liability.

BC34 points out that if the same tax basis is available to the entity and to market participants, no difference occurs in respect of the initial recognition compared to the initial recognition exception of IAS 12. The allowance or premium in the last stage is not however be taken into consideration when determining the need for or the measurement of a valuation allowance for the purposes of B16–25 of ED 12.

As a result, the tax effects (temporary differences, deferred taxes, others) possibly identified in the first stages of the procedure are ultimately all priced into the amount of the asset or liability via the allowance or premium adjustment in the last stage. However, the consideration paid or received with priced-in tax effects also represents the starting point of the issue under discussion. Therefore, we see no improvement in terms of more uniform treatment compared with other deferred taxes in accordance with IAS 12.

We would propose either substantially reworking the proposed method, or staying with the initial recognition exception.

Q4. Investments in subsidiaries, branches, associates and joint ventures

We do not agree with the proposals.

In our opinion the practical usefulness of the existing regulations and the proposed exceptions is entirely dependent on the group structure and the tax jurisdictions involved. We are not convinced that the criterion for application or non-application should be the place of residence (domestic, foreign).

In principle we agree with the judgment that it is often not possible to measure reliably deferred taxes arising from temporary differences on investments in foreign subsidiaries and joint ventures that are essentially permanent in duration. In any case, we agree with exceptions for cost/benefit reasons. However, the complexity argument and the argument that the costs of complex calculation may outweigh the benefits can also be valid for domestic investments, joint ventures and branches.

The conclusion in BC42 that the IAS 12 exceptions should not be carried into the new IFRS because they have no conceptual basis is at least partly valid even for the proposed new regulation, where the existence or absence of temporary differences would depend on the assessment of essentially permanent duration and residence.

We agree however with the exclusion of the investments in associates from the exception.

Q5. Valuation allowances

Q5A. Do you agree with the recognition of a deferred tax asset in full and an offsetting valuation allowance? Why or why not?

We totally agree with the full recognition and offsetting valuation allowance approach. The full recognition approach gives a much clearer picture of the tax assets.

Q5B. 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 see much difference between the terms 'probable' and 'the highest amount that is more likely than not to be realisable'. We therefore agree. Formally, there is a difference, as the first is expected value – and in line with IASB concepts; the second a single amount taken out of the distribution—in line with US GAAP.

Q6. Assessing the need for a valuation allowance

Q6A. 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 are not convinced that the comprehensive and prescriptive language of the guidance is appropriate. We would propose establishing guidance based on the existing contents, focusing on principles and avoiding repetitions and redundancies.

BC56 suggests that all the guidance on the realisability of deferred tax assets in the two standards is useful. We agree with this statement to the extent that the information provided in paragraphs B16 to B25 is educational and an aid to better understanding of the risk assessment aspects of deferred tax assets. For purposes of regulation, however, we reject the proposal as being too rules-based.

Q6B. 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?

BC56 provides no information or supporting arguments on this issue. We are not convinced that simply taking over the rules-based US GAAP provision is the best solution. We would therefore propose that IAS 12 remains silent on this issue until alternatives have been carefully discussed and reviewed.

Q7. Uncertain tax positions

We have several concerns in connection with the rules for uncertain tax positions, and we therefore disagree with the proposal.

We cannot see any improvement in precision in basing the measurement of an uncertain tax position on 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. This is a rules-based calculation with respect to a specific tax position, but the information on which it is based is still a matter of management judgment. We agree with BC63 in saying that in some – we would say most – cases, adopting a probability-weighted average of possible outcomes could be unduly onerous.

Providing a detailed calculation of the probability-weighted average of all possible outcomes would in our opinion influence discussions with tax authorities and could lead to a worse outcome in a tax review.

In our opinion, adoption of the measurement principle of the ‘best estimate’ would lead to the same level of precision as a complex calculation using input based on management judgement.

We would also recommend field-testing to get a better understanding of the issue and possible consequences of the proposed changes. Convergence cannot be the only argument for changing regulations.

Q8. Enacted and substantively enacted rates

In our opinion it makes sense to adopt the US GAAP rules, because this would result in increased clarity and leave no scope for interpretation.

Q9. Sale rate or use rate

We do not agree with the proposal, because using the rate that is consistent with the expected manner of recovery leads to more reliable measurement of the tax position than using the sales rate, which does not necessarily reflect management intentions.

Q10. Distributed or undistributed rate

We do not agree with the proposal 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. In our opinion the IASB should retain the existing rules of IAS 12.

In many countries the legally binding decisions about distributions are made in the annual general meeting. Management proposals may influence the decision, but are not binding. In our opinion, tax effects of distributions should not be recognised before the date of the binding decisions.

Additional information on potential tax consequences of proposed distributions should be disclosed in the notes.

Q11. Deductions that do not form part of a tax basis

We agree with the Board's decision not to list specific items from various tax jurisdictions. If there is no issue in practice, convergence cannot be an argument. In our opinion IFRSs should not move towards rules-based accounting but remain principles-based.

Q12. Tax based on two or more systems

We agree with the proposal, because consideration of any interaction between applicable tax systems should clarify the measurement principles and lead to more consistent application.

Q13. Allocation of tax to components of comprehensive income and equity

Q13A. Do you agree with the proposed approach? Why or why not? The exposure draft deals with allocation of tax to components of comprehensive income and equity in paragraphs 29–34. The Board intends those paragraphs to be consistent with the requirements expressed in SFAS 109.

We do not support the proposed tax allocation requirements. We believe backward tracing is the better allocation method in that it provides more useful information. The SFAS 109 approach is very complex and does not result in a significant overall advantage. We favour the more principles-based approach of IAS 12.

Q13B. Would those paragraphs produce results that are materially different from those produced under the SFAS 109 requirements? If so, would the results provide more or less useful information than that produced under SFAS 109? Why? The exposure draft also sets out an approach based on the IAS 12 requirements with some amendments. (See paragraph BC97 of the Basis for Conclusions.)

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. This is because the alternative approach retains backwards tracing while the SFAS 109 approach does not.

As discussed 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 continuing 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.

Q13C. Do you think such an approach would give more useful information than the approach proposed in paragraphs 29–34? Can it be applied consistently in the tax jurisdictions with which you are familiar? Why or why not?

As explained above, 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. In our view, the requirements in the ED will result in an allocation method that is more complicated than we believe is necessary. For that reason, we favour retaining IAS 12’s more principles-based approach.

Q13D. 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?

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, because of the complicated set of prescribed allocation steps and procedures involved. Unlike in the case of recognition and measurement issues, we do not believe it is a priority for an allocation method to be exactly the same in all entities, particularly in light of the complexity introduced. In our view, the proposal risks introducing too much complexity without providing corresponding benefits to users.

Q14. Allocation of current and deferred taxes within a group that files a consolidated tax return

B37 of the ED gives methods that are not consistent with the broad principles of the proposed standards. These exceptions have the exact wording of the related US GAAP regulations. In some tax jurisdictions, however, such methods are allowed, provided the agreements result in an economically and legally reasonable application of income tax expense between the members of the tax group. We would therefore prefer not to exclude these methods from application under the standard.

We agree in principle with the allocation of tax expense to the individual entities of the group. But in a situation where the group does not charge or pay the entity for the allocated tax expense – where this is permitted by a tax jurisdiction – tax assets should only be recognised where there is provision for compensation in the agreement between entities of the tax group. Under such circumstances, however, the recognition of a theoretical tax expense and an equal amount of capital contribution or distribution leads to a false picture of the financial situation of the individual entity.

Q15. Classification of deferred tax assets and liabilities

We do not agree with the proposal, since we do not see why the proposed classification will provide information that is more useful. BC102 does not explain why it would be more useful.

Q16. Classification of interest and penalties

We agree with the proposal, because disclosure in accordance with an accounting policy will provide consistent information.

Q17. Disclosures

We welcome 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.

Q18. Effective date and transition

We agree with the proposal, as we do not support retrospective application.
Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman