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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

United Kingdom

Berlin, 31. July 2009

Dear David,

Exposure Draft ED/2009/02 'Income Tax'

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Exposure Draft ED/2009/02 'Income Tax' (herein referred to as 'the ED'). We appreciate the opportunity to comment on the Exposure Draft.

The GASB welcomes the completion of the short-term convergence project on 'income taxes'. Although this welcome aspect, we do not support the new regulations of ED/2009/2 in general. Especially on the topics of

- tax basis,
- internal recognition exemption,
- outside basis differences and
- intraperiod allocation

we disagree with the proposals.

Due to the FASB not intending to pursue the idea of a separate standard on accounting for income taxes in the USA, convergence is no longer the primary objective for issuing new rules for accounting for income taxes. Our understanding is that the IASB and the FASB intended to create a principle-based regulation for income taxes. In our opinion, further aims of new rules should be feasibility, simplification and the reduction of complexity.

Taking into account that we disagree with the above mentioned major changes in ED/2009/2 from our perspective an amended IAS 12 should have fulfilled the major aims for new rules in the area of accounting for income taxes.

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Please find our detailed comments on the questions raised in the ED in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

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Appendix 1

GASB comments on the questions set out on the IASB's Exposure Draft ED/2009/02
'Income Tax'

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.)

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

We do not support the Board's attempt remove management's intention from the calculation of the tax basis, once the initial threshold for recognising deferred tax assets and liabilities in paragraphs 5(b), 10 had been established, because the rule is not consistent to other IFRS and within the ED.
We assume that for most of the cases management should be aware of their intention to treat assets and liabilities. If not, the intention should be used that is more likely than not.

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.)

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

We support the definition of a tax credit and an investment tax credit, as both were not in the scope of any standard before. But, we do not understand why the standards gives no guidance on the accounting treatment for these two areas. We would recommend to add the additional guidance.

Question 3 – Initial recognition exception

The exposure draft proposes eliminating the initial recognition exception in IAS 12. Instead, it introduces proposals for the initial measurement of assets and liabilities that have tax bases different from their initial carrying amounts. Such assets and liabilities are disaggregated into (a) an asset or liability excluding entity-specific tax effects and (b) any entity-specific tax advantage or disadvantage. The former is recognised in accordance with applicable standards and a deferred tax asset or liability is recognised for any temporary difference between the resulting carrying amount and the tax basis. Outside a business combination or a transaction that affects accounting or taxable profit, any difference between the consideration paid or received and the total amount of the acquired assets and liabilities (including

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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.)

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

Basically we support the attempt to eliminate exceptions from the standard. Nevertheless we would like to point out that any new rule should be a practicable and better rule.

We considered the discussion during the convergence project to take over the rules of EITF Issue 98-11. We understand the Board's concerns to defer a credit in cases with a material difference between the carrying amount and the tax basis even though these cases are very rare. The deferred credit does not fulfil the criteria for a liability under the IFRS framework.

We also analysed the new proposition in ED/2009/2 with – from our perspective – more complex rule as EITF 98-11. The main reason is that the new rules expect to find a fair value that does or does not include the tax advantage or disadvantage of the asset/liability. This may lead to difficulties concerning practical application and to different interpretations by the preparers.

As obviously neither the proposed new rule nor EITF 98-11 lead to a better accounting for initial differences we would suggest to keep the exemption of IAS 12.

We agree with the retention of the exception for the initial recognition of goodwill.

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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?

We do not agree with the proposals of the Board. We do so as we acknowledge that an exception in the case of outside basis differences limited to foreign subsidiaries and joint ventures lacks an underlying conceptual basis. This is obviously based on the complexity of a reliable computation of tax effects in certain countries. But the tax effect in certain countries should not be the reason for an exemption.

We understand that it would often not be possible to measure reliably the deferred tax asset or liability arising from Outside Basis Differences. But we do not see a conceptional difference between domestic and foreign companies as the complexity depends on the tax law of every single country. We would like to add that the Board should think about how to separate foreign and domestic companies. Under existing FAS 109 for example two subsidiaries in the UK of US parent are treated as domestic. This is not in line with IAS 21 that treats both subsidiaries in the UK as foreign subsidiaries.

Additionally, we think that complexity for this whole topic must be considered. One example is the definition of the term ‘carrying value’. On the one hand this pertains to goodwill, which unquestionably forms part of the carrying value. In practice it tends to be difficult to reliably allocate goodwill to a corresponding tax basis as soon as a cash generating unit comprises more than one independent legal entity. A modified allocation that might arise if a rearrangement of segments is required in accordance with IAS 36, however, can have significant tax consequences. A second example shows that it remains questionable if all consolidation activities have to be considered in order to determine the carrying value. This particularly relates to the elimination of liabilities and intercompany profits that decrease the carrying value of a subsidiary, but (except in the case of consolidated tax returns) do not affect the tax basis. Thus, they fulfil the criteria of assets and liabilities that are not recognised within a financial statement but have a tax basis and therefore give rise to deferred taxes in accordance with section 16. However, if the subsidiary was disposed, these items would not be eliminated by a third party and thus would have an impact on the selling price. Both examples show that the calculation of deferred taxes for Outside Basis differences is complex.

Thus, we consider to keep the existing exception for complexity reasons including domestic and foreign subisidiaries, associates and joint ventures.

Question 5 - Valuation allowances

The exposure draft proposes a change to the approach to the recognition of deferred tax assets. IAS 12 requires a one-step recognition approach of recognising a deferred tax asset to the extent that its realisation is probable. The exposure draft proposes instead that deferred tax assets should be recognised in full and an offsetting valuation allowance recognised so that the net carrying amount equals the highest amount that is more likely than not to be realisable against taxable profit. (See paragraphs BC52–BC55 of the Basis for Conclusions.)

Question 5A

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

We support the two-step approach for the recognition of deferred tax assets as included in current SFAS 109, i.e. recognition of all deferred tax assets and recognition of a valuation allowance to the extent that the deferred tax assets will not be realisable against taxable profit. This procedure would also be consistent with the recognition and measurement requirements in other existing IFRSs/IASs, e.g. IAS 16 regarding accounting for property, plant and equipment or IFRS 3/IAS 36 regarding accounting for goodwill.

But, the Board should consider that this two-step approach is not consistent with the recognition and measurement of tax uncertainties where no recognitions threshold takes place.

Question 5B

Do you agree that the net amount to be recognised should be the highest amount that is more likely than not to be realisable against future taxable profit? Why or why not?

We 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. In our view, the criterion ‘more likely than not’ is more precise than the term ‘probable” used in current IAS 12 and therefore reduces existing judgement and improves comparability of IFRS financial statements.

BC 54 mentions that in some jurisdictions that currently apply IFRSs, the term ‘probable’ is currently understood to denote a different likelihood than the term ‘more likely than not’. The final IFRS should be aware that on first-time adoption of the ‘more likely than not’ criterion adjustments could take place from the past different understanding of the expressions. From our understanding the adjustments are changes in accounting principles.

Regarding a current/non-current classification of valuation allowances, please also refer to our answer to Question 15.

Question 6 – Assessing the need for a valuation allowance

Question 6A

The exposure draft incorporates guidance from SFAS 109 on assessing the need for a valuation allowance. (See paragraph BC56 of the Basis for Conclusions.)

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

We support the incorporation of additional guidance on assessing the need for a valuation allowance. The guidance on the realisation of deferred tax assets included in B16 to B19 of ED/2009/2 is comprehensive and appropriate.

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?

We do not agree to add the implementation costs to realise deferred taxes. First step should be that the Board should clarify which costs are meant (internal and external cost). Additionally, it should be avoided that such costs are included somehow in the income tax line of the P&L as these are partly costs from the ongoing operating business and not in the definition of income taxes.

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.)

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

We disagree with the proposals as explained further below, without curtailing the positive effect in general that the Board focuses on this issue and proposes rules in the ED concerning the accounting for tax uncertainties.

In terms of the measurement of current and deferred taxes, the proposed rule requires that all possible outcomes of a tax audit should be taken into account. As described in the ED, the measurement shall be based on a probability-weighted average approach. In theory, such a measurement method can be preferable as if it is based on a sufficiently large population of outcomes which inherently assumes that the normal (Gaussian) distribution applies. Without an appropriate population the probability-weighted average approach could result in a misleading amount. It might be helpful if the standard acknowledges that in some circumstances there may only be a single best outcome which the uncertainty should be recognised at.

Whereas, recognised liabilities concerning uncertainties for not finished tax audits should be measured used the best estimate of the expenditure required to settle the present obligation at the balance sheet day. We are convinced that this measurement is the most appropriate way to measure the economic substance of the underlying uncertainty of tax issues that have to be reported in the financial statements.

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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.)

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

We support the requirement for an entity to measure deferred tax assets and liabilities using the tax rates substantively enacted by the reporting date.

Nevertheless we like to stress out that we do not support the implementation of solutions of specified jurisdictions like in B26 or BC66 of the ED. We believe that the general principle (last sentence in BC65) of the ED covers the US procedure even though.

Question 9 – Sale rate or use rate

When different rates apply to different ways in which an entity may recover the carrying amount of an asset, IAS 12 requires deferred tax assets and liabilities to be measured using the rate that is consistent with the expected manner of recovery. The exposure draft proposes that the rate should be consistent with the deductions that determine the tax basis, i.e. the deductions that are available on sale of the asset. If those deductions are available only on sale of the asset, then the entity should use the sale rate. If the same deductions are also available on using the asset, the entity should use the rate consistent with the expected manner of recovery of the asset. (See paragraphs BC67-BC73.)

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

We do not welcome the proposal in the exposure draft. With reference to our answer on question 1 we support the retention of the management intention for consistently reasons. That means we prefer the use of a tax rate that depends on the expected manner of recovery.

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 entities past practices and expectations of future distributions. (See paragraphs BC74–BC81.)

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

We disagree with the proposal and suggest changing paragraphs B31 and B32 ED from a practical point of view. The basic principle should be that the income tax

effects of distributions should not be recognised before the distribution has to be shown in the financial statements as a liability.

Especially in cases of an expected partial distribution to shareholders practical computation problems will be triggered if the proposed expectations are considered. The application guidelines (paragraphs B31 and B32) are not clear enough and add more complexity to the process. Due to this there will be no consistent treatment.

Obviously, the situation is different for specific entities like e.g. real estate investment trusts (flow-through entities) which pursue a policy of distributing almost all of their available reserves. Nevertheless these specific entities do not represent the vast majority of preparers. Therefore from a cost-benefit view, it is not appropriate to derive a general rule from minority requirements and thus to compel all entities to provide complex documentations.

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 recognised no earlier than the year in which those special deductions are deductible on the tax return’. SFAS 109 is silent on the treatment of other deductions that do not form part of a tax basis.

IAS 12 is silent on the treatment of tax deductions that do not form part of a tax basis and the exposure draft proposes no change. (See paragraphs BC82–BC88 of the Basis for Conclusions.)

Do you agree that the exposure draft should be silent on the treatment of tax deductions that do not form part of a tax basis? If not, what requirements do you propose, and why?

We agree that the exposure draft should be silent on the treatment of tax deductions that do not form part of a tax basis. There is no need for a seperate rule for deductions.

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?

We agree that an entity should consider any interaction between tax systems when measuring deferred 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.)

13A: Do you agree with the proposed approach? Why or why not?

We do not agree with the proposed approach over all. Although we support the Board's initiative and welcome the convergence, as articulated in our previous correspondence to the Chairman of the IASB dated October 20, 2005 (Appendix 3), we would like to confirm our serious concerns with respect to the IASB's and FASB's decision to amend IAS 12 to adopt the FAS 109 requirements for purposes of accounting for the allocation of tax to components of comprehensive income and equity.

We continue to consider the current IAS 12 guidance of recognising the effects of tax changes in the income statement except to the extent that they relate to items previously recorded in equity to be both conceptually superior to the FAS 109 approach and, all aspects considered, easier to apply. We therefore strongly recommend adopting the alternative approach of allocation of tax to comprehensive income and equity that the Board proposes not to adopt.

As discussed further in question 13C below, the application of the proposed accounting requirement produces misleading and illogical results in the financial statements, especially as it relates to securities available for sale.

Our discussions below also detail the accounting treatment currently followed by constituents. Hopefully this will remove uncertainty as to how constituents are applying the existing IAS 12 guidance.

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.

13B: Would those paragraphs produce results that are materially different from those produced under the SFAS 109 requirements? If so, would the results provide more or less useful information than that produced under SFAS 109? Why?

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

Following our proposal set out in the previous paragraph, a detailed assessment of any potential differences has not been performed.

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?

In our view, the alternative approach will provide more useful information. It complies with the temporary approach not only as on the first time recognition but also in subsequent periods. Therefore, it leads to more intuitive results. The alternative approach, similar to the proposed approach, does not completely eliminate arbitrary results. Nevertheless, we consider applying a pro rata or other appropriate method in cases where ‘backwards tracing’ is not practicable, a reasonable approach which makes it possible to allocate tax expense in a way consistent with the applicable tax jurisdiction. We have explained our opinon in the appendix 2.

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?

The current IAS 12 acknowledges that in exceptional circumstances it may be difficult to allocate the current and deferred taxes among the categories, but allows for a pro rata or other method that achieves a more appropriate allocation in the circumstances. This requirement allows one to make an appropriate allocation when faced with that problem. This was found not to be a significant area of concern. We believe the additional guidance given will improve the consistency of the application in practice.

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?

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We agree with both, the accounting method and disclosures, as proposed in the exposure draft. From our perspective financial statements become more comparable as under the existing IAS 12.
But, anyway we would like to point out that push down accounting is not a general accounting principle within IFRS.

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 related non-tax asset or liability. (See paragraphs BC101 and BC102 of the Basis for Conclusions.)

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

We do agree with the proposed current / non-current classification of deferred taxes as they are consistent with other standards. Although we know that the simplification rule is only a approximation of the real situation (except tax losses carryforwards which must be analysed regarding their scheduling) we think for complexity reasons (avoiding a detailed scheduling for every asset and liability) the new rule is acceptable.

Assuming that the boards approve the proposed classification requirement, we agree to allocate the valuation allowance for deferred tax assets (please refer also to our answers to Question 5) to the current and the non-current portion of deferred tax assets as well. For practical reasons, this allocation should be performed in general on a pro rata basis in accordance with the guidance included in current SFAS 109, i.e. based on the actual ratio of the recognised current and non-current underlying assets or liabilities. But, in contrast to a mandatory allocation on a pro rata basis as included in SFAS 109, we prefer a direct allocation to the current or non-current portion of deferred tax assets to the extent that the valuation allowance definitely affects certain identifiable underlying assets and liabilities classified as current or non-current.

Additionally, we seek clarification regarding the offset of deferred tax assets and liabilities at entities which do not present a classified balance sheet and, therefore, would neither classify deferred tax assets and liabilities. Our understanding is that, in such a case, all deferred tax assets and liabilities which meet the requirements of paragraph 37(c) and (d) shall be offset (i.e., paragraph 37(a) and (b) do not apply.)

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?

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We agree 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.

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.

We disagree with some of the proposals and propose to reconsider the following issues:

Tax Uncertainties (Paragraphs 41(b); 41(e); 49)

We like to reference to the Board that any additional tax uncertainty related disclosure may further increase the level of information about the tax uncertainties in favour of the tax auditor. That could turn a provision for uncertainties into a liability as 'self-fulfilling prophecy' which might not be in the interest of the shareholder.

Above all the Board should be undertaking to be aware of being ensure that no one is at a disadvantage by providing the information (considering tax audits from the financial authorities).

'Roll Forward' of deferred tax assets and deferred tax liabilities (Paragraph 46(b))

We disagree with the disclosure requirement of paragraph 46(b).

Paragraph 46(b) requires a detailed 'roll-forward' of deferred tax liabilities and deferred tax assets for each type of temporary difference and for each type of unused tax losses and tax credits.

Basically, main components of this information are already included in other disclosure requirements, even if on a higher level of aggregation. So, paragraph 41 requires a separate disclosure of deferred taxes recognised in the income statement and, according to paragraph 46(a), deferred tax liabilities and deferred tax assets for each type of temporary difference, unused tax losses and tax credits must be disclosed. Eventually, paragraph 45 results in a disclosure of taxes recognised in other comprehensive income and equity.

Beyond that, roll forward required by paragraph 46(b) takes up a roll forward of the underlying positions.

Hence, in our view, a further disclosure of a detailed 'roll-forward" of deferred tax liabilities and deferred tax assets would provide a very limited additional value to the user of the financial statements or, due to an increased flood of information, even decrease the benefit of the users. Moreover, this requirement would increase the administrative cost at the preparers.

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Therefore we believe that the costs of generating this information would not be commensurate with the resulting benefit for users of the financial statements.

Analysis of valuation allowance (Paragraphs 47)

We think the proposed analysis of valuation allowance is redundant. A disclosure of the amount and the change of valuation allowance is reasonably covered in the disclosure required under paragraph 41(g).

Intercompany Sales (Paragraph 48(d))

We do not endorse the disclosure requirement of paragraph 48(d).

In BC108 the Board notes that this disclosure is a response to concerns about possible perceptions of earnings management. We do not see this in the scope of ED/2009/12 and there is no conceptually reason for implementing a special disclosure under the income tax standard. If the Board feels that management abuse is not covered in detail, a general rule should be developed.

Aggregate amount of temporary differences with respect to Outside Basis Differences (Paragraph 48(c))

We propose that the disclosures for Outside Basis Differences should be changed to the FAS 109 disclosures. Even if we propose that the existing exemptions in IAS 12 for the recognition of deferred taxes should be kept, we think that there are certain situations in which temporary difference could not be calculated.

FAS 109.44c states that 'the amount of the unrecognised deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable' should be disclosed 'or a statement that determination is not practicable'. We think that this disclosure is useful even under the existing IAS 12. The company should disclose the fact if the determination is not practicable.

Question 18 – Effective date and transition

Paragraphs 50–52 of the exposure draft set out the proposed transition for entities that use IFRSs, and paragraph C2 sets out the proposed transition for first-time adopters. (See paragraphs BC111–BC120 of the Basis for Conclusions.)

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

We do not agree with the proposals.

We prefer a prospective application of the standard and, if there is need for, an allocation of catch-up effects within retained earnings.

Appendix 2

Similar to the Board's acknowledgement in the basis for conclusions that in some situations backwards tracing seems the obvious treatment and prohibiting it seems to produce counter-intuitive results, in support of our request we provide the following arguments and comments that supports the alternative approach suggested in the exposure draft:

(1) The proposed approach distorts, in the period of the tax change, the income tax expense reported in the income statement for changes in other comprehensive income (OCI) deferred taxes on gains and losses that were never recognised in net income, which produces an illogical result in both net income for the period of the tax change and retained earnings. This does not appropriately reflect the economic substance of a tax change;

(2) Consequently, this approach leaves the tranche of OCI deferred taxes accrued immediately preceding the tax change fixed until the securities are sold, at which point the underlying gains or losses may or may not exist anymore;

(3) The proposed approach results in an economic misstatement of OCI from the date of the tax change;

(4) The allocation of tax changes to income and equity as provided by IAS 12 does not impose additional record keeping requirements. This allocation merely requires an entity to collect and keep track of information that it is already required to disclose under FAS 130.25 and IAS 1.90; allocation should therefore not pose any practical problems. In contrast with the alternative approach, the proposed approach requires additional recordkeeping in a separate tranche for OCI deferred taxes on the unrealized gains and losses subsequent to the tax change;

(5) The proposed approach misstates income statements for the subsequent periods when the gain or loss on the underlying transaction is realised by including income tax expense different from the actual tax expense on the gain or loss recognised in net income for the period; in some cases, recording income tax expense when there is none in reality.

(6) The distortions and misstatements mentioned above have a direct impact on the effective tax rate in the period of the tax change and in subsequent periods when the gain or loss on the underlying transaction is realised. The effective tax rate, among other ratios, is a measure used by analysts to forecast future post tax returns.

(7) To overcome the income statement effect of the release of the tax change in subsequent periods, diversity has developed in practice due to a lack of specific guidance under FAS 109. OCI deferred taxes are released using either the 'specific identification' or the 'portfolio' approach. The latter approach defers the release until the whole portfolio is sold.

(8) The proposed approach is a rule based approach whereas the proposed alternative is more principle based.

(9) The Board does acknowledge in BC92 that it seems simpler to allocate a change in the valuation allowance relating to an item recognised outside continuing operation in a prior period, to the component of comprehensive

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income or equity in which the taxable gain is recognised in the current period, but this process requires detailed calculations and is considered more onerous than the efforts required under the proposed alternative. Although this may appear to be simpler to do, the often counter-intuitive results that the proposed method produces, makes analytical review of these numbers more difficult and the information about the aggregated tax effect needs to be kept for the recognition of the reversal through continuing operations. We do acknowledge that this can happen under the alternative approach, but the occurrence thereof is expected to be less frequent

(10) Under the alternative, the accounting for subsequent changes in the amounts previously recognised is simplified because it follows the original recording of the deferred taxes: for example, if the original income taxes were recorded in OCI, the change in those deferred taxes in respect of unrealized OCI gains and losses is recorded as an adjustment of the original OCI deferred taxes. The effect of the subsequent changes is not reflected in the income statement until the underlying items are realised in the income statement. When the underlying items affected by the subsequent change are realised, the gain or loss is tax effected in the income statement at the then current tax rate.

(11) The Board noted in BC93 that in some cases, backwards tracing would be difficult, or result in arbitrary allocations. The following examples illustrate that the current IAS 12 requirement of a pro rata allocation or another method that achieves a more appropriate allocation in the circumstances, used to allocate taxes among categories within comprehensive income and equity achieves relatively consistent results.

(12) In support of our proposal, we have included examples of how constituents are currently accounting for the allocation of tax related to an item that was recognised outside continuing operations in a prior year, under IFRS. These are supplemented with numerical examples in Appendix 2. We have illustrated the following examples that the Board identified as being the major difference between IAS 12 and SFAS 109 in BC90:

1. Changes in tax rates,
2. Changes in the taxable status,
3. Changes in assessments of recovery of deferred tax assets,
4. Changes in the effect of uncertainty over the amounts reported to the tax authorities.

GASB examples on the questions 13C

Changes in tax rates

IAS 12 requires the allocation of a rate change outside continuing operations, which related to an item that was previously recognised outside continuing operations. IAS 1 already requires the disclosure of items recognised outside continuing operations together with their tax consequences [IAS 1.90]. The 'backward tracing' comes at no additional effort and the deferred taxes recognised on items outside continuing operations is easy to keep track of.

Draft

The rate change is allocated to deferred taxes in each component of comprehensive income and equity where the pre-tax item is recognised. These are one-time events and will be accounted as such. Recognition through continuing operations in current year, as currently proposed, requires an entity to track the amount for the recognition of the reversal in subsequent year.

Example 1 - Changes in the tax rates

An entity recognises a loss of CU100 relating to a security classified as available for sale in other comprehensive income (OCI). The security is not considered to be impaired. The tax rate is 30 per cent. The loss of CU100 is taxed on a realised basis and consequently cannot be taken into account in determining taxable profit. The entity assesses that it is more likely than not that there will be sufficient taxable profits in the future and does not recognise a valuation allowance against the deferred tax asset. In the next year, the entity recognises no further gains or losses in continuing operations or OCI. The entity now reassesses the need for a valuation allowance and concludes that it is not needed because the entity still expects further future taxable gains. At the end of the second year a statutory rate change to 20per cent for the following years is substantively enacted. The entity therefore recognises a tax expense of the tax rate reduction of CU10 in OCI.

In the third year the entity sells the asset, for which losses of CU100 had been recognised in OCI for fair value. The cumulative loss on the available-for-sale financial asset, previously recognised directly in equity, through the statement of changes in equity, is recognised in profit or loss upon derecognition in accordance with IAS 39.55(b) and derecognises the deferred tax expense arising at the time of disposal from the same component of OCI in accordance with ED.29A. The realised loss is deductible in determining taxable profit. The entity recognises deferred tax arising from carry forward losses in continuing operations.

Draft

	Year 1	Year 2	Year 3
Continuing operations	**0**	**0**	**(100)**
Tax	**0**	**(0)**	**20**
Current	0	0	0
Deferred – gross	0	0	20
– change in rate	0	0	0
Other comprehensive income	**(100)**	**0**	**100**
Tax in OCI	**30**	**(10)**	**(20)**
Current	0	0	0
Deferred – gross	30	0	(20)
– change in rate	0	(10)	0
Memo: carry forward losses	0	0	(100)
Balance sheet	**30**	**20**	**20**
Deferred tax asset – gross	30	20	20
– valuation allowance	0	0	0
Effective tax rate for continuing operations	0%	0%	20%

Draft

Changes in the taxable status

Similarly to the accounting for changes in tax rates, the effect of the change in an entity's tax status, which relates to an item that was previously recognised outside continuing operations, is also recognised in the component of comprehensive income or equity, where the pre-tax item is recognised. Similarly to changes in tax rates, 'backward tracing' comes at no additional effort because change in tax status is a one-time event.

Example 2 - Changes in the taxable status

An entity recognises a loss of CU100 relating to a security classified as available for sale in OCI. The security is not considered to be impaired. The tax rate is 30 per cent. The loss of CU100 is taxed on a realised basis and consequently cannot be taken into account in determining taxable profit. The entity assesses that it is more likely than not that there will be sufficient taxable profits in the future and does not recognise a valuation allowance against the deferred tax asset. In the next year, the tax status of the entity is changed from fully taxable at the statutory rate to a non-taxable entity. In the year the entity recognises no further gains or losses in continuing operations or OCI. The entity therefore derecognises a tax benefit of CU30 previously recognised in OCI.

In the third year entity sells the asset, for which losses of CU100 had been recognised in OCI for fair value. The cumulative loss on the available-for-sale financial asset, previously recognised directly in equity, through the statement of changes in equity, is recognised in profit or loss upon derecognition in accordance with IAS39.55(b). No further tax consequences are recognised.

	Year 1	**Year 2**	**Year 3**
Continuing operations	**0**	**0**	**(100)**
Tax	**0**	**0**	**0**
Current	0	0	0
Deferred – gross	0	0	0
Other comprehensive income	**(100)**	**0**	**100**
Tax in OCI	**30**	**(30)**	**0**
Current	0	0	0
Deferred – gross	30	(30)	0
Memo: carry forward losses	0	0	0
Balance sheet	**30**	**0**	**0**
Deferred tax asset – gross	30	0	0
– valuation allowance	0	0	0
Effective tax rate for continuing operations	0%	0%	0%

Draft

Changes in assessments of recovery of deferred tax assets

A valuation allowance could relate to temporary differences, operating losses carried forward or tax credits. An entity would recognise the effect of a change in the valuation allowance, in the category within comprehensive income or equity, where the pre-tax item is recognised. As mentioned in 1 above, IAS 1 already requires the disclosure of items recognised outside continuing operations together with their tax consequences and the 'backward tracing' comes at no additional effort.

If it is difficult to determine the amount of current and deferred tax that relates to items recognised outside profit and loss, a pro rata allocation or another method that achieves a more appropriate allocation in the circumstances is used to allocate taxes among categories within comprehensive income and equity.

Although the Board is of the view that there is no non-arbitrary way of allocating the benefit arising from a change in the valuation allowance, the numerical example provided in Appendix 1 example 3 illustrates an acceptable method which produces results that achieves an appropriate allocation.

Example 3 - Allocation of tax benefits – allocation of change in valuation allowance between elements of comprehensive income

An entity recognises a loss of CU100 from continuing operations which includes a loss on disposal of an asset it previously classified as available for sale of CU210 and a loss relating to another security classified as available for sale, of CU150 in OCI. The tax rate is 30 per cent. The loss of CU150 recognised in OCI is taxed on a realised basis and consequently cannot be offset against any profit from continuing operations in determining taxable profit. The losses from continuing operations and OCI give rise to a deferred tax asset of CU75. The entity assesses that it is more likely than not that there will not be sufficient taxable profits in the future to support the whole deferred tax asset and recognises a valuation allowance of CU25.

The entity allocates the valuation allowance to transactions and events on a last-in-first-out basis as trades giving rise to incremental losses contribute to the increase in the valuation allowance. The loss created by the undisposed security was generated after the loss generated on disposal. Consequently, the change in the valuation allowance is firstly allocated to OCI.

In year two, no further gains or losses are recognised in continuing operations or OCI and the entity assesses that it is more likely than not that there will not be sufficient taxable profits in the future to support the whole deferred tax asset and recognises a valuation allowance of CU60. The loss created by the undisposed security was generated after the loss generated on disposal and the increase is firstly allocated to OCI until the whole deferred tax asset is reduced to zero. The residual of CU15 is then allocated to continuing operations.

In year three, the entity recognises a gain of CU70 from continuing operations and a gain of CU60 in OCI. The entity expects similar future profits and assesses that it is more likely than not that there will be sufficient taxable profits in the future and no longer requires a valuation allowance against the deferred tax asset. The reversal of the valuation allowance is also applied on a last-in-first-out basis and in this example would reverse firstly against continuing operations and secondly against OCI until the balance on the valuation allowance account is zero.

Draft

In the fourth, year the entity recognises a profit of CU310 from continuing operations and sells the asset, for which losses of CU90 had been recognised in OCI for fair value. The cumulative loss of CU90 previously recognised directly in equity, is recognised in profit or loss upon derecognition in accordance with IAS 39.55(b) and the entity derecognises the cumulative deferred tax benefit of CU27 arising at the time of disposal from the same component of OCI in accordance with ED.29A. Concurrently the entity recognises current tax of CU57 arising from the loss on disposal of the available for sale security and the profit from other continuing operations in continuing operations where both events are recognised and reverses the deferred tax asset of CU9 relating to the utilisation of the carry forward losses which related to items previously recognised in continuing operations.

	Year 1	**Year 2**	**Year 3**	**Year 4**
Continuing operations	**(100)**	**0**	**70**	**220**
Tax	**30**	**(15)**	**(6)**	**(66)**
Current	0	0	0	(57)
Deferred – gross	30	0	(21)	(9)
– valuation allowance	0	(15)	15	0
Other comprehensive income	**(150)**	**0**	**60**	**90**
Tax in OCI	**20**	**(20)**	**27**	**(27)**
Current	0	0	0	0
Deferred – gross	45	0	(18)	(27)
– valuation allowance	(25)	(20)	45	0
Memo: carry forward losses	(100)	(100)	(30)	0
Balance sheet	**50**	**15**	**36**	**0**
Deferred tax asset – gross	75	75	36	0
– valuation allowance	(25)	(60)	0	0
Effective tax rate for continuing operations	30%	0%	9%	30%

Draft

Changes in the effect of uncertainty over the amounts reported to the tax authorities

Similarly to the accounting for changes in tax rates, the effect of the change in an uncertainty over an amount previously reported recognised outside continuing operations, is also recognised in the component of comprehensive income or equity, where the pre-tax item is recognised.
Regularly, tax uncertainties are under separate review by the companies. Therefore, ‘backward tracing” is not expected to lead to major additional effort.

Example 4 - Changes in the effect of uncertainty over the amounts reported to the tax authorities

An entity recognises a gain of CU100 relating to a security classified as available for sale in OCI. The security is not considered to be impaired. The tax rate is 30 per cent. Gains of this nature are taxed on a realised basis and consequently taken into account in determining taxable profit however, the entity believes that this gain will be deemed non-taxable and does not recognise the gain as a taxable profit reported to the tax authority. There is some doubt over this treatment and the entity assesses the possible outcomes of the uncertainty and calculates a liability of CU3.

Following the outcome of a court case in the following year, the uncertainty is removed as the ruling determined that the gain would not be taxable. The entity therefore derecognises the tax accrual of CU3 previously recognised in OCI. The gain is recognised in profit or loss upon derecognition in the third year in accordance with IAS 39.55(b) without any tax consequences.

	Year 1	**Year 2**	**Year 3**
Continuing operations	**0**	**0**	**100**
Tax	**0**	**0**	**0**
Current	0	0	0
Deferred – gross	0	0	0
Other comprehensive income	**100**	**0**	**(100)**
Tax in OCI	**3**	**(3)**	**0**
Current	3	(3)	0
Deferred – gross	0	0	0
Memo: carry forward losses	0	0	0
Balance sheet			
Current tax liability	**3**	**0**	**0**
Effective tax rate for continuing operations	0%	0%	0%

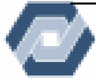
Draft

Appendix 3

Letter to IASB:

Short-term convergence – Income taxes – Adoption of the FAS 109 allocation requirements for a change in tax laws or rates

Draft



Deutsches Rechnungslegungs Standards Committee e. V. ®
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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Berlin, 20 October 2005

Dear David

Short-term convergence – Income taxes – Adoption of the FAS 109 allocation requirements for a change in tax laws or rates

In view of the IASB FASB Joint Meeting on 24, 25 October 2005, the undersigned companies jointly with the GASB would like to express their serious concerns with respect to the IASB's decision to amend IAS 12 to adopt the FAS 109 requirements for purposes of accounting for a change in tax laws or rates (henceforth collectively: "tax changes").

We support the Board's convergence efforts and their overall approach to adopt the current FAS 109 guidance for intraperiod tax allocations – with one important exception: We consider the current IAS 12 guidance of recognising the effects of tax changes in the income statement *except to the extent that they relate to items previously recorded in equity* to be both conceptually superior to the FAS 109 approach and, all aspects considered, easier to apply. We therefore strongly recommend adopting the current IAS 12 guidance for both US-GAAP and IFRS purposes, and emphatically appeal to the IASB to reconsider its earlier decision dating 21 April 2005 to adopt the FAS 109 requirements for intraperiod tax allocation in their entirety. In support of our request we provide the following arguments and comments (which are set down in more detail further below):

1) The FAS 109 approach distorts both net income and other comprehensive income (OCI)[1] reported in equity, and does not appropriately reflect the economic substance of a tax change.

2) We concur with the FAS 109 allocation requirement to record the total effect of tax changes related to gains or losses reported in the different components of

[1] Or a similar component of equity under IFRS. Henceforth we will continue to refer to "OCI" although this US-GAAP term is not part of IFRS terminology.

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income, within continuing operations (ie without allocating these effects to the other components of income) to avoid the need for backward tracing.

3) The allocation of tax changes to income and equity as provided by IAS 12 does not impose additional record keeping requirements; this allocation merely requires an entity to collect and keep track of information that it is already required to disclose under FAS 130.25; allocation should therefore not pose any practical problems.

4) Unlike IAS 12, FAS 109 requires considerable tracking of tax positions in equity in periods subsequent to a tax change (because they have not been adjusted for the effects of the change).

5) The fact that tax changes represent current changes in assets and liabilities is not a valid argument for recognising it in income, if – as is required under both US-GAAP and IFRS – fair value adjustments of available for sale securities or hedging instruments in a cash flow hedge, which also represent current changes in assets and liabilities, are recorded directly in equity.

Ad 1) Distortion of net income and OCI

The FAS 109 approach requiring all effects of tax changes to be included in income from continuing operations will distort both net income and equity in the period of a tax change, whenever deferred taxes have been recognised in equity prior to the change. This is because instead of adjusting the deferred taxes reported in equity that are actually affected by the change, the total impact of the change is recorded in income. Additionally, reported net income will be misrepresented for a second time when the gains or losses directly recognised in equity will be reclassified into profit and loss. Since the related deferred taxes that will also have to be removed from equity and recognised in profit and loss, reflect previous tax rates or laws, they will cause taxes reported in the income statement to be misstated. Reported net income in both periods will therefore not capture the economic substance of the transaction requiring reclassification of the equity items.

Under the FAS 109 approach, deferred taxes reported in equity following a tax change will – from the period of the change to the final disposal of the underlying asset or liability (which may not occur until several years later) – no longer reflect the actual tax consequences of the related equity items.

Net income and equity will be significantly misrepresented as a result of a tax change if large amounts of deferred taxes are recognised in equity or a major tax change occurs, or both. Consequently, we are particularly concerned that many European companies faced with substantial tax reforms in their countries of origin may be adversely affected by the FAS 109 requirements in the near future.

In contrast, under IAS 12 the deferred taxes on gains or losses recognised directly in equity always reflect applicable tax rates because any tax changes would require the deferred taxes reported in equity to be directly adjusted for the effects of those changes. So neither the tax changes themselves nor the reclassification of equity items and their related deferred taxes into profit and loss will create any distortion of reported net income or equity. We therefore consider IAS 12 to be conceptually superior to FAS 109 in this respect. We have attached an example to this letter which illustrates the effects described so far.

Ad 2) Allocation of tax effects to different components of income not at issue

It is solely for practical reasons, it seems, that the FAS 109 guidance has been preferred to IAS 12. It is argued that IAS 12 would require complex backward tracing which in many cases would be impracticable. This is true to the extent that the effects of tax changes would have to be allocated to different components of income. In this case, proper allocation would indeed require keeping track of those portions of existing temporary differences which previously have affected components of income other than income from continuing operations. We agree that such tracking would be extremely complex and involve costs that would exceed the likely benefits to users. Therefore, as far as allocation of the effects of tax changes to different components of income is concerned, we agree with the FAS 109 requirement to include these effects in income from continuing operations. However, allocating tax effects to different components of income is not our issue.

Ad 3) Allocation of tax effects to income and equity *is* practicable

Our issue is that the effects of tax changes should be allocated to net income or equity depending on whether the deferred taxes affected by the changes have been reported in net income or equity. We definitely consider such an allocation to be practicable, since it will require no more than to keep track of the deferred taxes which have been recognised directly in equity. In this respect FAS 130.25 already requires an entity to separately disclose the amount of income tax expense or benefit allocated to each component of other comprehensive income. So the allocation of the effects of tax changes to equity and net income to be made under IAS 12 would basically require an entity to collect and keep track of information it is already required to disclose under FAS 130.25. We therefore do not think the argument that allocation should not be required for reasons of practicability to have much merit.

Ad 4) Tracking of tax positions in subsequent periods required under US-GAAP

We would further like to underscore that as far as allocating the effects of tax change to either equity or net income is concerned, the FAS 109 guidance will require considerable tracking effort in periods subsequent to the tax change where IAS 12 requires none. This is because under IAS 12 the deferred taxes reported in equity will always reflect current tax rates (as a result of the allocation requirement). In contrast, under FAS 109 deferred taxes related to items directly recognized in equity will reflect the tax rates that were applicable in the period the equity items were initially recognised. As a result, each tax change will produce another layer of deferred taxes recognised in equity which will have to be tracked over subsequent periods in order to be able to identify the particular layer to be eliminated from equity on reclassifying the related gains or losses into earnings. We are concerned that requiring FAS 109 to be applied for purposes of accounting for tax changes under IAS 12 will produce just the result the IASB intended to avoid when taking the decision to converge with FAS 109.

Ad 5) Accounting for tax effects and related gains or losses should be consistent

Finally, in favour of the FAS 109 it is argued that the effects of changes in tax laws and rates rightly belong in income from continuing operations because the remeasurement of deferred taxes represents changes in assets and liabilities that occur in

the current period. We do not consider this a valid argument because we think the same reasoning would apply to the gains and losses reported directly in equity to which these deferred taxes relate. Surely, items such as fair value adjustments of available for sale securities or of derivatives designated as the hedging instrument in a cash flow hedge represent changes in assets or liabilities that occur in the current period; but still, these items are not reported in income. It is inconsistent to allow these items to be recognised directly in equity, and at the same time require the deferred tax effects related to these items to be reported in income on the ground that the tax effect represents current changes in assets and liabilities. It is also inconsistent to allow deferred taxes to be recognised in equity on initial recognition of the related gains or losses, but prohibit an equity adjustment of these deferred taxes in the event of a change in tax rates or laws.

It is a stated objective of the short term convergence projects to achieve “a high quality solution by selecting between existing US-GAAP and IFRS”. With respect to accounting for tax changes, the IAS 12 approach appropriately reflects the economic substance of the tax changes, and we therefore consider it to be conceptually superior to FAS 109 in this respect. Since there does not seem to be any basis for rejecting the IAS 12 approach for reasons of practicability, and since it clearly requires less tracking effort in periods subsequent to tax changes than the FAS 109 approach, we once again urge the IASB to retain current IAS 12 guidance and possibly help convince the FASB of its merits.

Yours sincerely,

Signed:

Klaus Pohle, German Accounting Standards Board

Allianz AG*: Eva Meyer-Schipflinger,* Head of Tax Planning & Tax Accounting
Bayerische Hypo- und Vereinsbank AG: *Lothar Härteis*, Head of Group Tax
Commerzbank AG: *Martina Bass,* Head of Tax Accounting & Reporting
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Deutsche Bank AG*: Martin Edelmann,* Head of Group Accounting
Münchener Rückversicherungsgesellschaft AG: *Liselotte Hepperger,* Head of Central Division Taxes
Siemens AG: *Dr. Thomas Schaenzle,* Vice President Tax & Accounting EU Affairs

APPENDIX A: Illustrative Example

Entity A buys 100 shares at €100,000 in 2000, and classifies them as available for sale. At the balance sheet dates of 2000 and 2001 the fair values of the shares amount to €150,000 and € 170,000 respectively. In 2002, Entity A sells 50% of the shares acquired in 2000 at € 85,000, (the fair values not having changed since the end of 2001). The applicable tax rates are 40% in 2000, and 25% in 2001 and 2002 as a result of a change in tax laws that occurred in 2001.

The accounting under both US-GAAP and IFRS for the periods from 2000 to 2002 would be as follows:

31 Dec 2000	US-GAAP		IFRS	
To record the purchase of 100 shares:				
	DR	**CR**	**DR**	**CR**
Shares AfS (100)	**100,000**		**100,000**	
Cash		**(100,000)**		**(100,000)**
To record the shares at fair value (tax rate @ 40%):				
Shares AfS	**50,000**		**50,000**	
OCI		**(50,000)**		**(50,000)**
Deferred tax (OCI)	**20,000**		**20,000**	
Deferred tax liability		**(20,000)**		**(20,000)**
Selected balance sheet items 2000				
	US-GAAP		**IFRS**	
Shares AfS (100)	**150,000**		**150,000**	
Unrealised fair value gains in OCI	**50,000**		**50,000**	
Deferred taxes in OCI	**(20,000)**		**(20,000)**	
Effective tax rate OCI	***40.0%***		***40.0%***	
Deferred tax liability	**20,000**		**20,000**	

31 Dec 2001	US-GAAP		IFRS	
To record the change in tax rates from 40% to 25%:				
	DR	**CR**	**DR**	**CR**
Deferred tax liability	**7,500**		**7,500**	
Deferred tax (OCI)		**0**		**(7,500)**
Income tax benefit		**(7,500)**		**0**
To record the shares at their fair value of 170,000 (tax rate @ 25%):				
Shares AfS	**20,000**		**20,000**	
OCI		**(20,000)**		**(20,000)**
Deferred tax (OCI)	**5,000**		**5,000**	
Deferred tax liability		**(5,000)**		**(5,000)**
Selected balance Sheet Items 2001				
	US-GAAP		**IFRS**	
Shares AfS (100)	**170,000**		**170,000**	
Unrealised fair value gains in OCI	**70,000**		**70,000**	
Deferred taxes in OCI[1)]	**(25,000)**		**(17,500)**	
Effective tax rate OCI	***35.7%***		***25.0%***	
Deferred tax liability	**17,500**		**17,500**	
Income tax benefit in p&l	**7,500**		**0**	
Effective tax rate p&l[2)]	***not defined***		***not applicable***	

Note 1): Under IAS the effects of the tax change would be recognised directly in equity. Under US-GAAP, the tax benefit is recognised in the income statement. As a result, deferred taxes in OCI reflect a blended rate made up of 50,000 gain @ 40% and 20,000 gain @ 25%.

Note 2): Under IAS there is neither pre-tax income nor any tax expense or benefit. Under US-GAAP the tax benefit of 7,500 does not correspond to reported pre-tax income of zero.

31 Dec 2002	**US-GAAP**		**IFRS**	
To record the sale of 50% of the shares:				
	DR	**CR**	**DR**	**CR**
Cash	**85,000**		**85,000**	
Shares AfS		**(85,000)**		**(85,000)**
OCI (reclassified)	**35,000**		**35,000**	
Gain on sale of shares		**(35,000)**		**(35,000)**
Current tax expense	**8,750**		**8,750**	
Current tax liability		**(8,750)**		**(8,750)**
Deferred tax expense	**3,750**		**8,750**	
Deferred tax liability	**8,750**			
Deferred taxes in OCI reclassified[3)]		**(12,500)**		**(8,750)**
Selected balance Sheet Items 2002				
	US-GAAP		**IFRS**	
Shares AfS (50)	**85,000**		**85,000**	
Unrealised fair value gains in OCI	**35,000**		**35,000**	
Deferred taxes in OCI[4)]	**(12,500)**		**(8,750)**	
Effective tax rate OCI	***35.7%***		***25.0%***	
Deferred tax liability	**8,750**		**8,750**	
Current tax liability	**8,750**		**8,750**	
Pre-tax income	**35,000**		**35,000**	
Def & current tax expense in p&l	**-12,500**		**-8,750**	
Effective tax rate p&l	***35.7%***		***25.0%***	

Notes 3)&4): On reclassifying the fair value gain from OCI into profit and loss, the related deferred taxes are also removed from OCI. Under IAS 12, determining the deferred taxes to be removed is unproblematic since they invariably reflect current tax rates. Under US-GAAP, taxes to be reclassified from OCI are made up of a current tax @ 25% on the gain reclassified from OCI of €35,000 (ie €8,750) plus 50% of the deferred tax adjustment recognised in 2001 in profit and loss instead of in OCI (ie €3,750).

The comparison shows that recognizing the adjustment of deferred taxes reported in OCI in the profit and loss leads to distortions of net income, and deferred taxes reported in OCI under the FAS 109 approach in the period of a tax change as well as in subsequent periods. As apparent from the example above, the consequences of this adjustment through net income will have an impact on:

- **OCI in equity**: In 2001 and 2002, deferred taxes reported in OCI under US GAAP include a portion which reflects a tax rate of prior periods. It misstates OCI by €7,500 in 2001 and €3,750 in 2002 in that the deferred tax excess it represents does not correspond to any future tax payments or receipts.
- the **income statement**: Under the FAS 109 approach, profit and loss will be impacted by the tax change both in the period in which the change occurs and on the sale of the shares. In both periods taxes reported in profit and loss are misstated, as the tax effects reported in profit and loss do not correspond to any current, past or future tax payments or receipts, and are not caused by realised pre-tax profit and loss. Under IAS 12, the tax effects reported in profit and loss do reflect actual tax payments or receipts made or to be made, and relate to pre-tax profit and loss items.
- the **effective tax rate**: Recognizing the adjustment in the income statement will lead to distortions on the effective tax rate both in the period the change occurs in and on the subsequent sale. In contrast, the effective tax rate under IFRS will always match the applicable legal tax rate.