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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Berlin, 29. July 2009

United Kingdom

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 ED.

The GASB welcomes the completion of the ED as part of the due process of the short-term convergence project on 'income taxes' where the IASB and the FASB intended to create a principle-based standard for income taxes. However, as the FASB decided to review its strategy for short-term convergence projects in the light of the possibility that some or all US public companies might be permitted or required to adopt IFRSs at some future date, convergence between IFRS and US GAAP in that area seems to be no longer a primary objective when establishing new requirements for the accounting and reporting for income taxes. In contrast, the primary objective of setting high quality principle-based standards should be accomplished including a reduction of existing complexity whenever possible.

Under the above objective, we do not support the ED as a basis for a new IFRS on income taxes. In our view, important proposals contained in the ED do not represent an improvement in financial reporting because they either lack a clear underlying accounting principle, are rule-based, increase complexity or do not meet a cost-benefit analysis. We also believe that overall the ED does not represent an improvement to the existing IAS 12.

We have noted that substantive parts of this ED, e.g. the requirements on tax basis, outside basis differences and expected value computation for uncertain tax positions,



have already been implemented in the IFRS for SMEs; we do not see this as a compelling argument for implementing the same requirements into full IFRS. The SME-Standard and full IFRS differ significantly and in many respects for valid reasons. Therefore, an alignment in the accounting for taxes does not seem to be necessary. Furthermore, we would like to point out that the treatment of income tax as implemented in the IFRS for SMEs has never been exposed for public comment.

Our detailed comments are set out in appendix 1 to this letter, but our main concerns, supporting our above conclusions, can be summarised as follows:

- We disagree with the proposal to define the tax basis of an asset or liability to be determined on the simplistic basis of a sale or settlement at the reporting date. In contrast, we propose to retain management intent in the determination of the tax basis, which is consistent with other IFRSs as well as other provisions within the ED.
- We do not support the ED's proposal regarding the allocation of tax to components of comprehensive income and equity. The SFAS 109 approach can produce misleading results as evidenced in the recent past. In our view the current IAS 12 approach avoids such misstatements, is conceptually superior to the SFAS 109 approach and also, all aspects considered, easier to apply. Accordingly, we strongly request the IASB to retain the IAS 12 accounting for the allocation of tax to components of comprehensive income and equity.
- We believe that the amendment in the ED eliminating the initial recognition exception does not result in an improved accounting treatment of initial recognition differences; accordingly, we suggest to look for another superior accounting treatment for initial recognition differences or to keep the exemption of IAS 12.
- We agree that often it is not possible to measure reliably the deferred tax asset or liability arising from outside basis differences. Nevertheless, we do not support the ED's approach applying a differing accounting treatment for domestic and foreign entities as the difficulties and complexities depend in particular on the tax law of each country. Therefore we disagree with the ED's proposal and suggest retaining the existing exceptions for temporary differences that arise on foreign as well as domestic subsidiaries, associated companies and joint ventures.
- For uncertain tax positions, we disagree with the ED's proposal that current and deferred tax assets and liabilities should be measured at the probability-weighted average of all possible outcomes as this could result in unrealistic and therefore misleading amounts. In contrast, we prefer to adopt an approach based on the most likely outcome using management's best estimate of the expenditure required to settle the present obligation.
- We do not support the new requirement on the classification of cost of implementing a tax strategy to realise a deferred tax asset. These are costs from the ongoing operating business and do not fulfil the definition of income



taxes. Accordingly, they should not be presented in the line 'income taxes' of the Income Statement as intended by the ED's proposal..

Please find our detailed comments on the questions raised in the ED in the appendix 1 to this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President



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 to change the definition of tax basis thus removing management's intention relating to the recovery or settlement of an asset or liability. The simplistic "sale" approach inappropriately ignores the economic reality that many if not most assets and liabilities are recovered by use or settled by performance respectively. Accordingly, actual tax cash flows will be different from the deferred tax effects reflected in the financial statements. In addition, the proposed requirement is neither consistent with other IFRSs nor other provisions of within the ED where management's intent is considered.

Accordingly, we propose to retain management intent in the determination of the tax basis based on a 'more likely than not' notion.

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 definitions of tax credit and investment tax credit, as both were not in the scope of any standard before. However, we do not understand why the ED gives no guidance on the accounting for these two issues. We recommend that a new or revised standard should incorporate additional guidance to clarify the accounting.

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 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?

In general we support the Board's attempts to eliminate exceptions from IFRS. Nevertheless, we believe that any new requirement should be practicable and an improvement when compared to the previous requirement.

We considered the discussion during the convergence project to adopt the requirements 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 were considered to be very rare - because the deferred credit does not fulfil the criteria for a liability under the IFRS framework.

We also analysed the new proposition in the ED which represents in our view a more difficult and complex requirement than EITF 98-11. The main reason is that the ED requires determining the asset or liability excluding any entity-specific tax effects, i.e. in fact a fair value with a tax basis available to market participants. We expect that this will lead to major difficulties in practical application and to different interpretations by preparers as well as users.

As obviously neither the proposed new requirement nor EITF 98-11 lead to an improved accounting treatment of initial recognition differences, we suggest to look for other superior accounting treatment for initial recognition differences or to keep the exemption of IAS 12.

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

**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. Our main reasoning is that an exception limited to outside basis differences relating to foreign subsidiaries and joint ventures lacks an underlying conceptual basis. The ED's proposal obviously responds to the complexity of a reliable computation of tax effects in certain countries. However, the complexity of computation in certain countries should alone not suffice as a reason for an exemption.

Although we agree that often it is not possible to measure reliably the deferred tax asset or liability arising from outside basis differences, we do not support the ED's approach applying a different accounting treatment for domestic and foreign entities. The difficulties and complexities result from the tax laws of certain countries and apply regardless of the location of the parent.

Irrespective of the question whether the computation of outside basis differences on foreign entities is more complex than on domestic entities, we think that the ED's objective of clarifying and improving IAS 12 is not met. 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, however, 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. On the other hand it remains questionable whether all consolidation activities have to be considered in order to determine the carrying value. This particularly relates to the elimination of



intercompany accounts and profits that change the carrying value of a subsidiary but (except in the case of consolidated tax returns) do not affect the tax basis. Thus, they are not recognised within group financial statement but have a tax basis and therefore give rise to deferred taxes in accordance with section 16. However, if the subsidiary were to be disposed of, these items would not be eliminated by a third party and thus would have an impact on the selling price. Both examples show that, in any event, the calculation of deferred taxes for outside basis differences is still complex and not clarified by the proposal. For this reason, the proposal does not improve IAS 12; on the contrary, mandatory application for domestic entities will increase the complexity and the need for clarification.

As a result, we disagree with the ED's proposal and favour retaining the existing exceptions for temporary differences that arise on foreign as well as domestic subsidiaries, associated companies 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 the 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 are not expected to 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.

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 the



current IAS 12 and therefore reduces existing judgment and improves the comparability of IFRS financial statements.

BC 54 mentions that in some jurisdictions that apply IFRSs, the term 'probable' is understood to denote a different likelihood than the term 'more likely than not'. We believe that without specific guidance a reporting entity that will be required to change to the ED's likelihood requirement 'more likely than not' would have to treat this as a change in accounting principle. In accordance with IAS 8 the change would thus have to be retroactively applied. However, it is apparent that besides practicability problems hindsight effects will impact such retroactive application. Therefore we believe that a prospective application is more appropriate and ask the Board to clarify this issue as outlined above as well as to provide for a prospective application in the new standard's transition requirements.

Regarding a current/non-current classification of valuation allowances, please 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 the ED 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 with the new requirement on the cost of implementing a tax strategy to realise a deferred tax asset. These costs are partly costs from the ongoing operating business and do not fulfil the definition of income taxes. Accordingly, they should not be presented in the line 'income taxes' of the Profit and Loss Statement as proposed by the ED. To illustrate our concerns we read the ED to propose that internal staff costs or consultancy fees will be recognised in the income tax line if they have been incurred to implement a tax strategy.

Beyond that the Board should clarify which costs are included in the definition (internal and/or external cost) if the ED's proposal will be retained in the final standard.



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 appreciate that the Board emphasizes the issue of tax uncertainties. However, we disagree with the ED's respective proposals as explained below.

In terms of the measurement of current and deferred taxes, the ED requires that all possible outcomes of a tax audit should be taken into account and the measurement should be based on a probability-weighted average approach. In theory, such a measurement method is more appropriate if it is based on a sufficiently large population of outcomes, which inherently assumes that the normal (Gaussian) distribution applies. However, without a population of appropriate size, which hardly exists for uncertain tax positions, the probability-weighted average approach is likely to result in unrealistic and therefore misleading amounts provided for.

Consistent with our responses to question 1, 5 and 9 we prefer adopting an approach based on the 'most likely' outcome according to management's expectations. Accordingly, liabilities concerning uncertainties for pending tax audits should be measured using the best estimate of the most likely outcome. We are convinced that this measurement, which is also reflected in the tax returns, filed or intended to be filed, 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.

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 would like to emphasise that we do not support individual guidance for specified jurisdictions as provided in B26 or BC66 of the ED. We believe that the general principle (last sentence in BC65) of the ED also covers the U.S. procedure adequately.

In addition, we would prefer the underlying general principle to be placed in the body of the standard rather than in the Basis of Conclusion as currently proposed.



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 disagree with the proposal in the ED because it represents a commingling of prescriptive rule for deductions available only on sale of the asset and consideration of management intent where deductions are not restricted.

We continue to support the full retention of management intent as it best reflects expected economic reality, i.e. we prefer the use of a tax rate that depends on the expected manner of recovery for all instances.

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. The basic principle should be that the income tax effects of distributions should not be recognised before the distribution is recognised as a liability in the financial statements.

In addition, especially in cases where distributions to shareholders varied in the past and where long-term deferred assets and liabilities exist, the required estimations of future dividend distributions, which generally are not under the control of management, become very difficult. In case of differing shareholders' resolutions income tax expense becomes very volatile. Besides the outlined estimation issues computation problems are foreseeable depending on the underlying tax rules. Taking into account these issues, we do not believe that the ED's requirements will result in a consistent and comparable application.

The situation might be different for certain entities like real estate investment trusts (flow-through entities) which pursue a policy of distributing permanently all or almost all of their distributable earnings. However, these entities do not represent the majority of preparers. Therefore, it is not appropriate to derive a general requirement



from what is appropriate for a minority thus requiring difficult estimations and calculations from the majority of entities.

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 separate requirement 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 and would like to reconfirm our serious concerns in respect of the IASB's decision to adopt the SFAS 109 requirements for purposes of accounting for the allocation of tax to components of comprehensive income and equity, as already articulated in our previous correspondence to the Chairman of the IASB dated October 20, 2005 (Appendix 2).

In our view, the proposed SFAS 109 approach often produces misleading results as proven in the recent past, in particular with regard to financial assets available for sale. We still consider the current IAS 12 requirement of recognising the effects of tax changes in the income statement except to the extent that they relate to items previously recognised in equity to be both conceptually superior to the FAS 109 approach and, all aspects considered, easier to apply.

As discussed further in question 13C below, we also do not support the alternative approach outlined in the ED due to the additional rule-based requirements which in our view result in a more complex allocation method. In other words, we support retaining the more principle-based approach of IAS 12.

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 would provide more useful information when compared to the proposed SFAS 109 approach. It complies with the temporary approach not only at initial recognition but also in subsequent periods. The alternative approach, similar to the proposed approach, does not completely eliminate arbitrary results. Nevertheless, we consider applying a pro rata or some other appropriate method in cases where ‘backwards tracing’ is not practicable to be a reasonable approach which makes it possible to allocate tax expense in a way consistent with the applicable tax jurisdiction. For further details see the examples given in appendix 3¹.

Finally, however, GASB’s general policy is to support principle-based standards. Accordingly, we disagree with the additional rules-based guidance in the ED to cover the so-called ‘gaps’ in IAS 12. In our view, the requirements in the ED will also result in an allocation method that is more difficult than we believe necessary. As a result, we favour retaining IAS 12’s more principle-based approach as implemented in the new IFRS for SMEs.

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?

See our response to Question 13C. The current IAS 12 acknowledges that in exceptional circumstances it may be difficult to allocate current and deferred taxes among the categories, but allows for a pro rata or another method that achieves a more appropriate allocation in these circumstances. This requirement allows one to make an appropriate allocation when faced with that problem. In addition the potential IAS 12 allocation issue was found not to be a significant area of concern.

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

¹ We are aware of the proposed accounting for financial instruments classified as available for sale under ED/2009/x: However, we do not think that the new proposal for financial instruments solves the problems.



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?

In principle, we agree with both the accounting method and disclosures as proposed in the exposure draft. From our perspective, financial statements would become more comparable than under the existing IAS 12.

Nevertheless, we would like to point out that push down accounting is not a common accounting principle within IFRS and we have doubts whether IFRS should implement such an accounting requirement.

In addition, we believe that the term "consolidated tax return" needs to be defined because B7 and B100, and the terms used therein, are not sufficiently clear. Taking into account the definitions contained in IAS 27 when interpreting the terms "consolidated" and "Group" used in the ED, someone would understand a "consolidated tax return" as a tax return for a parent and all its subsidiaries. Other people considering (the - in our view - unclear) paragraphs B7 and B100 of the ED only might understand the term in a more general manner, i.e. any group of two or more entities according to any tax law and not necessarily all of the group's subsidiaries. For example, in Germany there are no consolidated tax returns in the former sense. However, there is an established practice of tax pooling agreements between two group companies where only one company, generally the group's parent, is liable to the tax authorities, i.e. all tax consequences are borne by this company. Accordingly, in practice that company which, in our view, represents an appropriate accounting treatment accounts for pooled current as well as deferred taxes.

The example highlights that the Board needs to clarify the issue and to properly define the term "consolidated tax return" in order to avoid an inconsistent accounting. With regard to tax pooling agreements or comparable tax structures as outlined above the IASB should consider to retain the above described appropriate accounting treatment as it also avoids the proposed allocation of income taxes to entities covered by the tax pooling agreement.

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 agree with the proposed current / non-current classification of deferred taxes as it is consistent with other standards. Although we are aware that the simplification requirement is only an approximation of the real situation (except for carry forwards of unused tax losses which must be analysed regarding their scheduling) we believe that the new requirement is acceptable for practicability reasons (avoiding detailed scheduling for each asset and liability).



Assuming that the Board approves the proposed classification requirement, we agree allocating the valuation allowance for deferred tax assets to the current and the non-current portion of these deferred tax assets as well. For practical reasons, this allocation should generally be performed on a pro rata basis in accordance with the guidance included in the current FAS 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 required by 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 by entities which do present their balance sheet in accordance with IAS 1.63 and, therefore, do not classify deferred tax assets and liabilities either. Our understanding is that in such cases all deferred tax assets and liabilities which meet the requirements of paragraphs 37(c) and (d) shall be offset (i.e., paragraphs 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?

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 if 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.

We disagree with the following disclosure requirements:

Tax uncertainties (paragraphs 41(b); 41(e); 49)

We apprehend that the proposed additional tax uncertainty related disclosure might have negative impacts for the entity, e.g. where unresolved disputes with the tax



authorities exist. That could turn a provision for uncertainties into a liability as 'self-fulfilling prophecy'.

In some cases, disclosure of some or all of the information required by paragraphs 41(b), 41(e) and 49 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, we prefer, in consistency with IAS 37.92, that an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

'Roll forward' of deferred tax assets and deferred tax liabilities (paragraph 46(b))

We disagree with the disclosure requirement in 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 loss and tax credit.

Basically, main components of this information are already included in other disclosure requirements, although on a higher level of aggregation. Paragraph 41 requires the 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 loss and tax credit must be disclosed. Finally, paragraph 45 requires the disclosure of taxes recognised in other comprehensive income and equity.

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

Hence, in our view, the 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 the potential information overload, even decrease the benefits for users. Moreover, this requirement would increase the administrative cost of preparers.

Therefore, we believe that the resulting benefit for users of financial statements, if any, would not justify the cost of generating this information.

Intercompany Sales (Paragraph 48(d))

We agree that tax consequences of intergroup transfers should be recognised (BC45 onwards). However, we do not agree with 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 believe that the broad language and reasoning used represent a sufficient explanation for requiring such an excessive disclosure requirement. No evidence is given and according to the wording of BC108 these perceptions might exist. According to the nature of the disclosure, the possible perceptions relate obviously to the use of different tax systems, i.e. tax rates, existing worldwide. However, in internationally operating groups intergroup transfers represent a common process to benefit from different economic situations in various countries including different legal and tax systems. This cannot be equated to earnings management.

According to paragraph 48(d) (ii) and (iii) the possible perceptions seem to relate to tax effects on "non-customary" transfers and "subsequent modifications including



unwinding (reversals)". If, albeit the possible – unjustified - perceptions, the Board wants to capture these, an appropriate definition of "non-customary" and "subsequent modifications" is required in order to avoid inconsistent application. Using the alternative of disclosing the net tax effect for all transfers is in our view completely meaningless and does not meet the Board's objective, i.e. to give an indication whether earnings were managed or not.

Irrespective of our concerns whether such perceptions are justified, we believe that such a matter should be dealt with under IAS 24 "Related Party Disclosures" but not in the ED and final standard on income tax respectively

Comparing the extensive investigations and complicated calculations within a consolidated group required to provide the proposed disclosure with the unjustified benefits - whereby such disclosures could also result in a potential information overload for the users -, we disagree with the proposed disclosures. If the Board decides to retain the proposed requirement, we request that the Board should carry out an appropriate cost/benefit analysis before such a decision becomes final.

Aggregate amount of temporary differences with respect to outside basis differences (paragraph 48(c))

We propose changing the disclosures for outside basis differences to the SFAS 109 disclosures. We agree that there are certain situations in which temporary differences cannot be calculated and such situations are acknowledged by SFAS 109 as outlined in the following.

SFAS 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 or a statement that determination is not practicable*' should be disclosed. We think that this disclosure is also useful under the existing IAS 12 and the entity should disclose the fact if 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.

Although we support retrospective application in principle, with regard to the amendments proposed in the ED, we nevertheless prefer a prospective application. This is mainly due to cost benefit considerations, e.g. efforts needed to recalculate the new tax bases, as well as hindsight effects, in particular regarding the determination of valuation allowances and uncertain tax positions. If a retrospective application were required by the IASB, we would request an allocation of catch-up effects within retained earnings.



Appendix 2

Letter to IASB:

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



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Sir David Tweedie
Chairman
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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-Schiplinger*, 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.



Appendix 3

GASB examples in regard to question 13C

Changes in tax rates

IAS 12 requires the allocation of the effects of a rate change outside continuing operations where relating 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 are easy to keep track of.

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 for as such. Recognition through continuing operations in the current year, as currently proposed, requires an entity to track the amount for the recognition of the reversal in a subsequent year.

Example 1 - Changes in tax rates

An entity recognises a fair value loss of CU100 relating to a financial asset classified as available for sale² in other comprehensive income (OCI). The financial asset is considered not 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 future taxable profits. At the end of the second year, a statutory rate change to 20 per 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 fair value losses of CU100 had been recognised in OCI. 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 the deferred tax expense arising at the time of disposal from the same component of OCI is recognised in accordance with ED.29A. The realised loss is deductible in determining taxable profit. The entity recognises deferred taxes arising from losses carried forward in continuing operations.

² Cf. foot note 1.



	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: losses carried forward	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%



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 the 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 financial asset classified as available for sale in OCI. The financial asset 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 that year the entity recognises no further profits or losses in continuing operations or OCI. The entity therefore derecognises a tax benefit of CU30 previously recognised in OCI.

In the third year, the entity sells the asset, for which fair value losses of CU100 had been recognised in OCI. 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: losses carried forward	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%



Changes in assessments of recovery of deferred tax assets

A valuation allowance can 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 in which the pre-tax item is recognised. As mentioned above, IAS 1 already requires the disclosure of items recognised outside continuing operations together with their tax consequences and the 'backwards 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 the categories within comprehensive income and equity.

Although the Board is of the opinion that there is no non-arbitrary way of allocating the benefit or disadvantage arising from a change in the valuation allowance, the numerical example provided in appendix 3 example 3 illustrates an acceptable method which produces results that achieve 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 of CU210 on the disposal of an asset it had previously classified as available for sale of and a loss of CU150 in OCI which relates to another financial asset classified as available for sale. 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 entire 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 financial asset on stock was generated after the loss on disposal. Consequently, the change in the valuation allowance is allocated to OCI first.

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 financial asset on stock was generated after the loss generated on disposal and the increase is first 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 first against continuing operations and second against OCI until the balance on the valuation allowance account is zero.



In the fourth year the entity recognises a profit of CU310 from continuing operations and sells the asset for which fair value losses of CU90 had been recognised in OCI. 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 financial asset 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 losses carried forward 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: losses carried forward	(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%

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

Similarly to the accounting for changes in tax rates, the effect of the change in an uncertainty regarding an amount previously recognised outside continuing operations is also recognised in the component of comprehensive income or equity, in which the pre-tax item is recognised.

Tax uncertainties are regularly under separate review by entities. Therefore, ‘backwards 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 in OCI relating to a financial asset classified as available for sale. The financial asset is considered not 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 considering 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 determines that the gain is not taxable. The entity therefore derecognises the tax accrual of CU3 previously recognised in OCI. The gain is recognised in profit or loss upon disposal 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: losses carried forward	0	0	0
Balance sheet			
Current tax liability	3	0	0
Effective tax rate for continuing operations	0%	0%	0%