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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Email: commentletters@iasb.org

9 November 2010

Dear Sir David,

Re: Exposure Draft ED/2010/11 *Deferred Tax: Recovery of Underlying Assets (Proposed amendments to IAS 12)*

Deloitte Touche Tohmatsu Limited is pleased to comment on the International Accounting Standards Board's (the Board's) Exposure Draft ED/2010/11 *Deferred Tax: Recovery of Underlying Assets* (Proposed amendments to IAS 12) (referred to in this letter as 'ED/2010/11' or the 'ED').

We appreciate the fact that the Board is trying to address the difficult practical issues that can arise when calculating and measuring deferred taxes associated with assets that are remeasured or revalued at fair value. Although we agree that additional guidance would be useful in this area, we do not support the introduction of an exception to the existing principles of IAS 12. Instead, we recommend the Board provides additional implementation guidance to illustrate how the existing principles within IAS 12 should be applied. In developing this implementation guidance, the Board should consider an approach based on an entity's underlying business model, an approach that we believe to be consistent with the current requirements in IAS 12.52.

Should the Board proceed with the amendments as proposed, we recommend the exception be limited to investment properties that are measured using the fair value model in IAS 40 *Investment Property*.

We do not believe assets accounted for using the revaluation model under IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets* should be included within the scope of the exception as proposed by the ED. Instead, we believe the Board should provide guidance on how the concepts of depreciation and amortisation in those standards should be reconciled with the requirement in IAS 12 to consider the expected manner of recovery of the carrying amount of the assets.

Additionally, we do not support the ED's proposal to withdraw SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*. In our view, the guidance in this Interpretation should be retained and expanded to deal with a wider group of assets and issues as indicated in our detailed responses in the Appendix to this letter. This would alleviate the current diversity in practice resulting from differing interpretations as to the applicability of SIC-21 by analogy.

Our detailed responses to the invitation to comment questions are included in Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884.

Sincerely,

Veronica Poole
Global Managing Director
IFRS Technical

Appendix – Detailed responses to the invitation to comment questions

Question 1 – Exception to the measurement principle

The Board proposes an exception to the principle in IAS 12 that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. The proposed exception would apply when specified underlying assets are remeasured or revalued at fair value.

Do you agree that this exception should apply when the specified underlying assets are remeasured or revalued at fair value?

Why or why not?

We do not support the proposed exception to the principles in IAS 12 for the following reasons:

- An exception is difficult to justify on conceptual grounds and it has the potential to undermine the objective of deferred tax accounting as expressed in IAS 12.
- The proposed rebuttable presumption may set a hurdle that is, or may be interpreted to be, difficult to overcome, potentially resulting in the recognition or non-recognition of deferred taxes from sale which may not reflect an entity's reasonable expectation of the future tax consequences due to a lack of 'clear evidence' that it will consume the asset's economic benefits throughout its economic life (which is inherently subjective).
- It is unclear why the measurement basis of an asset should determine whether the exception is available, particularly as the revaluation model is, in some cases, an accounting policy choice.
- The creation of an exception may have unintended consequences in the application or interpretation in other areas or result in different treatments for assets not directly impacted by the proposed amendments.

However, we recognise the current practical difficulties in applying IAS 12 in the circumstances described in the ED. Instead of introducing an exception, we recommend the Board provides additional implementation guidance within IAS 12 to illustrate how the existing principles within IAS 12 should be applied. In developing this implementation guidance, the Board should consider an approach based on an entity's underlying business model, an approach that we believe to be consistent with the current requirements in IAS 12.52

However, if the Board intends to proceed with the amendment as described and introduce an exception, we would strongly recommend that the exception is limited to investment property accounted for under the fair value model under IAS 40.

Investment properties

As stated above, we believe implementation guidance would be the best route for addressing the current practical difficulties of applying IAS 12 for investment property carried at fair value. Consistent with IAS 12.52, the implementation guidance could elaborate on how the business model considerations should affect the accounting for deferred tax.

It is inherent in the classification of an asset as investment property that it will not be consumed in the operations of the entity, i.e. it is an asset producing a direct return in its own right. From a commercial perspective, many entities owning investment property effectively intend to 'hold' the asset for a period of time before selling it. Entities may not have a current intention to sell the asset, but this may change as market conditions, funding requirements and other conditions dictate. Accordingly, management's expectation is that the investment properties are generally being 'held' for an indeterminate period of time.

Although investment properties often generate rental income during the 'holding' period, the generation of this income may not result in any 'use' of the asset in the normal sense of the term because the earning of rental income for a particular period will not necessarily change the value of the property, nor diminish its future earnings capacity.

Applying the business model considerations, where an entity believes that the entire carrying amount of the investment property will ultimately be recovered through 'sale' as the 'holding' period will not result in any 'use' of the asset, reflecting the tax consequences of sale of the investment property is appropriate, even though such sale may not be currently intended and may only occur at an indeterminate point in the future. In contrast, in situations where the investment property will clearly be 'used', different tax consequences would be reflected, consistent with management's expectations. In our experience, whilst many entities already apply this approach, practices differ and a clarification by means of implementation guidance would be useful.

In addition, there are further practical issues commonly encountered in the measurement of deferred taxes for investment properties for which we believe explicit guidance is needed:

- **Unit of account**. We are aware of diverse views as to the appropriate unit of account to be used when accounting for deferred taxes on investment properties. Some believe the entire investment property (land and any buildings and integral plant and equipment) should be a single unit of account when determining deferred taxes. However, for tax purposes, different tax rates may apply to the recovery of the different components of an investment property. It is unclear whether the unit of account should change for deferred tax accounting, and if and how these different tax consequences should be 'aggregated' in determining deferred taxes arising from the entire investment property.
- **Investment properties held in corporate structures**. In some jurisdictions, it is common for investment properties to be held in corporate structures (e.g., trusts and other 'single-purpose entities') with the effect of indefinitely deferring (or otherwise modifying) that tax consequences that would otherwise arise if the asset was held and disposed of directly by an entity. Because of the single nature purpose of these entities, future tax consequences arising from use and/or sale of the underlying assets may not be included in the valuation of such properties, as market participants may transact only at level of the corporate entity, i.e. investment properties in these jurisdictions are only sold within the structure itself, and not as underlying investment property assets individually or collectively. In such circumstances, applying the business model considerations, the only temporary difference for which deferred tax would be considered is at the entity level (i.e. the so-called "outside basis difference"), reflecting the tax consequences that would result from the sale of this entity. No deferred taxes would be recorded for temporary differences that would arise from the use or sale of the property itself (e.g., the so-called "inside basis differences"). The ED as proposed would result in a conclusion that is inconsistent with the entity's business model and the way market participants transact in these jurisdictions because the ED would require the calculation of deferred taxes resulting from sale at the individual asset level.

Property, plant and equipment

As discussed above, we believe implementation guidance would be the best route for addressing the current practical difficulties of applying IAS 12 for property, plant and equipment. The determination of useful life, depreciable amount, residual value and the expected manner of recovery for calculating deferred taxes are intrinsically linked and should be considered together. Therefore, we believe implementation guidance should focus on the relationship between the assumptions used to determine an entity's accounting policy for depreciating an item of property, plant and equipment and the assumptions used to calculate deferred taxes on that asset. We discuss the reasons for this below.

IAS 16 requires the depreciable amount of property, plant and equipment to be allocated on a systematic basis over its useful life. This requirement applies to all assets within the scope of IAS 16, regardless of whether such assets are measured on the cost or revaluation basis. The 'useful life' concept under IAS 16 is an entity-specific measure and reflects the time period (or units of use) of the asset. However, consistent with the discussion above regarding investment properties, an entity may intend to hold certain assets (most notably buildings), for an indefinite period of time. In such cases, many entities assume the residual value of such assets to be zero, applying the guidance in paragraph 53 of IAS 16. Thus, determining the associated deferred tax consequences of these assets leads to the conclusion that the carrying amount of the asset will generally be fully recovered through use, and the deferred taxes recognised would reflect the tax consequences expected from using (and subsequently scrapping, if relevant) the asset.

In contrast, other entities adopt an approach similar to that outlined above for investment properties to buildings under IAS 16, i.e. occupancy of a building accounted for under IAS 16 does not give rise to a material amount of 'use' of the building (following the guidance in paragraph 54 of IAS 16). Using this argument, the residual value of the building may be close to its carrying amount (allowing for reductions in value due to the possible condition of the building at the end of the useful life of the entity to the entity).

The Board argues in paragraph BC12 of the ED that the determination of the expected manner of recovery of assets measured using the cost method in IAS 40 is less difficult and less subjective than those measured using the fair value basis. The Board also notes in these cases there is a 'general presumption' that an asset's carrying amount is recovered through use to the extent of the depreciable amount and through sale to the extent of the residual value (as is stated in paragraph 6 of SIC-21).

As illustrated above, there remains a significant degree of subjectivity in the determination of the residual values for certain assets (particularly buildings) accounted for under IAS 16, and this in turn leads to subjectivity in the calculation of deferred tax balances. Therefore, in our view, the determination of useful life, depreciable amount and residual value, and the expected method of recovery for deferred tax purposes, are intrinsically linked and should be considered together.

Further, because these requirements and issues arise equally in the case of property, plant and equipment measured on the cost basis and the revaluation basis, it is unclear how the measurement basis is relevant in determining the possible application of any exception to the requirement of IAS 12 when measuring associated deferred taxes. Although assets accounted for using the revaluation basis are measured by reference to their fair value (an exit price notion), the utility embodied in the fair value of the asset may be expected to be fully consumed by the entity (i.e. 'used' rather than sold). Finally, the revaluation basis is an accounting policy choice under IAS 16. Therefore, the use of the measurement basis as the determinant of when the exception would apply is arbitrary.

Accordingly, in respect of assets accounted for under IAS 16, we recommend the Board clarifies, by way of implementation guidance, that deferred taxes should be calculated on a basis consistent with the assumptions made in depreciating the asset for the purposes of IAS 16, i.e. an asset's carrying amount is generally expected to be recovered through use to the extent of the depreciable amount and through sale to the extent of the residual value. This would mean that deferred taxes associated with land would be measured on the basis of sale in all but exceptional circumstances.

However, if the Board intends to proceed with the amendment as proposed, we strongly recommend that the exception is limited to investment property accounted for using the fair value model under IAS 40.

Intangible assets

As discussed above, we believe implementation guidance would be the best route for addressing the current practical difficulties of applying IAS 12 for intangible assets. The determination of whether an intangible asset will be recovered through 'use' or 'sale' will often depend on whether that asset is a finite lived or indefinite lived intangible asset and whether that asset is an integral part of an entity's business. Therefore, we believe the implementation guidance should consider an entity's business model in determining the expected manner of recovery of the carrying amount of such assets. We discuss the reasons for this below.

The treatment of intangible assets with limited useful lives is largely consistent with the treatment of property, plant and equipment discussed above and accordingly, the same issues arise. However, the presumption of a zero residual value in paragraph 100 of IAS 38 further complicates deferred tax accounting where an entity is expecting to sell the asset for a non-negligible amount before the end of its useful life.

In practice, many entities adopt an approach for limited life intangible assets that is similar to property, plant and equipment in that the full carrying amount of the asset is expected to be recovered through 'use' and deferred tax accounting reflects this expected consequence. Difficulties arise though where an asset may trigger a tax consequence at the end of its useful life. An example is an asset that is expected to be 'used' with no tax depreciation available for the asset, but a tax capital loss or other deduction will ultimately be available on disposal, with resulting tax losses often 'quarantined' for offset against particular types of taxable income, rather than being permitted to be offset against taxable income derived from many sources.

The situation with indefinite-life intangible assets (including goodwill) is more problematic. Because such assets are not depreciated, some entities argue the principles of SIC-21 should be applied by analogy, i.e. the tax consequences of sale should be reflected.

Others believe that although indefinite-life intangible assets are not depreciated, they may be *depreciable* in the normal sense of the term and that such assets may eventually be impaired when the future utility of the asset is less than its carrying amount with any recognised impairment loss reflective of the 'use' of the asset. Entities holding this view face the same problems in determining a 'residual value' for the asset as for buildings and investment properties discussed above. For indefinite life intangibles such as perpetual water licences and brand names the carrying amount might be expected to be fully recovered through sale as there is no foreseeable limit over which the asset will generate economic benefits, i.e. they cannot be 'used'.

Accordingly, we recommend the Board provides guidance on how to determine deferred taxes associated with intangible assets. We believe the business model should be considered in determining the expected manner of recovery of the carrying amount of such assets as follows:

- Intangible assets which are an integral part of the entity's operations might ordinarily be expected to be recovered through use – this is particularly true for intangible assets with a limited useful life which are being used in the generation of revenue on an ongoing basis in the entity's operations, (e.g., customer-related intangible assets, intellectual property).
- Intangible assets with indefinite useful lives might generally be expected to be recovered through sale (as the recovery of the asset through 'use' would imply it should be amortised).
- The Board should clarify that the recognition of an impairment loss does not have any direct impact on the manner in which the asset is recovered (i.e. it does not imply usage), and hence has no impact on the measurement of deferred taxes, other than the change in the temporary difference that may arise from the impairment.

However, if the Board intends to proceed with the amendment as described and introduce an exception, we would strongly recommend that the exception is limited to investment property accounted for under the fair value model under IAS 40.

Other assets

Whilst not contemplated in the current ED, we suggest the Board also considers providing implementation guidance on how deferred taxes associated with the following assets should be determined as part of its existing short-term project on income taxes:

- Assets held for sale – in general, assets classified as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* might be expected to be recovered through sale, unless the deferred tax consequences are effectively expected to be 'transferred' to the purchaser as part of a disposal group.
- Financial instruments – deferred taxes should generally be measured, to the extent relevant, on a basis consistent with how the asset is classified under either IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments,* as applicable (however, noting the different classification criteria under IFRS 9 which also considers contractual cash flows).
- Investments in subsidiaries, associates and joint ventures – guidance would be useful as these assets present difficulties because they are generally 'held' for an indeterminate period of time or may be recovered in many different ways with different tax consequences (e.g. distribution, sale, 'impairment', liquidation, in differing structures or involving tax consolidation). For recovery through distribution, the recent changes to IAS 27 *Consolidated and Separate Financial Statements* and IAS 18 *Revenue* to require all distributions to be recognised as income have somewhat clouded the concept of 'recovery of the carrying amount of the asset'. Implementation guidance should address both consolidated financial statements and separate financial statements of the investor.

- Agricultural assets – guidance needs to clarify that whilst these are measured under IAS 41 *Agriculture* at fair value, the expected method of recovery depends on the nature of the agricultural asset. For example, fruit trees are held for a period of time and produce income through agricultural produce harvested from them over a number of years, and harvesting of such produce for a particular period does not necessarily reduce the future productive capacity and value of the fruit trees themselves. In contrast, annual crops such as wheat and cotton are generally realised through sale after harvest and there is no 'underlying' asset producing more than one crop.
- Service concession arrangements and infrastructure assets – given their nature, these might generally be expected to be realised through use.

Question 2 – Scope of the exception

The Board identified that the expected manner of recovery of some underlying assets that are remeasured or revalued at fair value may be difficult and subjective to determine when deferred tax liabilities or deferred tax assets arise from:

(a) investment property that is measured using the fair value model in IAS 40;

(b) property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38;

(c) investment property, property, plant and equipment or intangible assets initially measured at fair value in a business combination if the entity uses the fair value or revaluation model when subsequently measuring the underlying asset; and

(d) other underlying assets or liabilities that are measured at fair value or on a revaluation basis.

The Board proposes that the scope of the exception should include the underlying assets described in (a), (b) and (c), but not those assets or liabilities described in (d).

Do you agree with the underlying assets included within the scope of the proposed exception?

Why or why not? If not, what changes to the scope do you propose and why?

We disagree. As noted in our response to Question 1, we do not support the introduction of an exception to IAS 12.

In the event the Board proceeds with the amendments, we strongly recommend:

- the exception be limited to investment properties measured at fair value under IAS 40. As stated above, we do not believe assets accounted for under IAS 16 or IAS 38 should be included within the scope exception as proposed by the ED. Instead, we believe the Board should provide implementation guidance on how the concepts of residual value, depreciation and amortisation in those standards should be interpreted when considering the expected manner of recovery of the carrying amount of the assets under IAS 12.
- the Board should address the treatment of a property that is classified differently in the consolidated and separate financial statements, e.g. where a property is leased by an entity to its parent or another subsidiary (as is contemplated by paragraph 15 of IAS 40). Because there are effectively differing characterisations of the property in the consolidated and separate financial statements, any assumption of recovery of the asset through sale in the separate financial statements of the subsidiary may not be appropriate in the consolidated financial statements.

Question 3 – Measurement basis used in the exception

The Board proposes that, when the exception applies, deferred tax liabilities and deferred tax assets should be measured by applying a rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely through sale. This presumption would be rebutted only when an entity has clear evidence that it will consume the asset's economic benefits throughout its economic life.

Do you agree with the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale when the exception applies?

Why or why not? If not, what measurement basis do you propose and why?

We disagree. Consistent with our responses to Questions 1 and 2 above, we do not support the introduction of the exception and the rebuttable presumption. Instead, we recommend the Board provides additional implementation guidance within IAS 12 to illustrate how the existing principles within IAS 12 should be applied. In developing this implementation guidance, the Board should consider an approach based on an entity's underlying business model, which we believe to be consistent with IAS 12.52.

In the event the Board proceeds with the proposals in the ED, we believe different assumptions should be considered for different classes of assets, consistent with an entity's business model (as discussed in our response to Question 1 above).

Question 4 – Transition

The Board proposes that the amendments should apply retrospectively. This requirement includes retrospective restatement of all deferred tax liabilities or deferred tax assets within the scope of the proposed amendments, including those that were initially recognised in a business combination.

Do you agree with the retrospective application of the proposed amendments to IAS 12 to all deferred tax liabilities or deferred tax assets, including those that were recognised in a business combination?

Why or why not? If not, what transition method do you propose and why?

Consistent with our responses to Questions 1 and 2 above, we do not support the proposed amendments, but instead recommend the Board develops additional implementation guidance on applying the existing principles of IAS 12.

However, in the event the Board decides to proceed with the amendments in the ED, we would support retrospective application of the proposed requirements on a modified basis. We believe the retrospective application should be limited to deferred taxes in existence at the beginning of the earliest reporting period presented in the financial statements.

The retrospective application of the proposed requirements may have an impact on deferred taxes recognised as part of a past business combination relating to assets that are subject to the new exception. It would be necessary for the Board to clarify whether adjustments to such deferred tax amounts should be recognised as part of goodwill or in profit or loss in the period (or retained earnings, as applicable)

We also note that the exception may result in a reduction of deferred tax liabilities and therefore may require a reassessment of the recoverability of deferred tax assets that were expected to reverse against these deferred tax liabilities. The information necessary to make this assessment may not be available and the application of judgement related the recoverability of assets in past periods may inherently be affected by hindsight. It would be useful for the Board to provide guidance with respect to such situations.

Question 5 – Other comments

Do you have any other comments on the proposals?

We include a number of additional comments below.

Proposed removal of SIC-21

The ED proposes to withdraw SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*. In our view, the guidance in this Interpretation should be retained and expanded to deal with a wider group of assets and issues as indicated in our detailed responses to the questions above.

In the event the Board decides to proceed with the proposals in the ED, we still recommend the requirements of SIC-21 be retained in some form either by retaining the Interpretation or incorporating the relevant guidance into the body of IAS 12. This is because the Interpretation provides useful guidance in respect of revalued land. We are also aware that the Interpretation is often applied by analogy to similar assets, including land measured on the cost basis and intangible assets with indefinite useful lives. Accordingly,

removing SIC-21 will leave little or no guidance in how deferred taxes should be determined in relation to these types of assets.

We recommend that, given the diversity in practice, the Board uses this opportunity to clarify to what extent the guidance in SIC-21 can be applied by analogy. Specifically, it would be useful to define the term "non-depreciable" to distinguish between assets not depreciated on the basis that they have been determined to have "an indefinite life" and those that do not depreciate due to their nature (e.g. land).

Disclosure requirements

We do not support the introduction of the disclosure requirement as represented by the proposed paragraph 81(l) of IAS 12. As an entity is required to reflect management expectations when calculating deferred taxes, an entity is required to make numerous judgements in applying IAS 12. Where such judgements are material, the existing requirements of IAS 1 would require disclosure. In light of these requirements, it is unclear why a particular judgement to override a rebuttable presumption would specifically require disclosure.

Therefore, we recommend the Board does not introduce this disclosure requirement in the event IAS 12 is amended as a result of the ED.

Recovery of deferred tax assets

The Basis of Conclusions on the ED provides additional discussion on how the proposed amendments might impact the assessment of the recoverability of an entity's deferred tax asset (paragraphs BC25-BC26). These requirements and the principles are not clearly articulated.

For instance, it is unclear whether the Board intends to allow for the tax consequences of a 'rebuttable' intention of sale to be taken into account in the measurement of deferred taxes arising from assets in the scope of the ED and another intention (usually 'use') to be taken into account in the forecast of future taxable profit to support the recognition of other deferred tax assets. It is unclear whether the reference to tax planning opportunities in paragraph BC26 would include the consideration of potential taxable income expected to arise from recovering the asset through use and thereby generating taxable profits which can then support the carrying amount of deferred tax assets. In our view, this may create an apparent overstatement of the net tax position in the statement of financial position.

For example, consider a revalued building that has no tax consequence on sale, but is expected to be held indefinitely. There are no tax deductions available from using the building, but the proceeds on sale are non-taxable (this is the situation in New Zealand). The carrying amount of the building is $100 and the tax rate is 30%. The entity also has tax losses of $80, the recovery of which is, for simplicity, dependent on the taxable profits to be generated from using the building.

- **Under the current IAS 12**. The entity would recognise a deferred tax liability of $30 ($100 x 30%) on the building (due to expectation of recovery through use), and also recognise a DTA of $24 ($80 x 30%) arising from the tax losses. The net deferred tax position is a deferred tax liability of $6 – this reflects the net tax outflow expected ($100 taxable profits from 'using the asset' less $80 tax losses = $20 taxable income x 30% = $6).

- **Under the proposals in the ED**. The entity would not recognise any deferred tax liability on the building (as recovery through sale yields no tax consequence and there is no 'clear evidence' the building will be recovered through use), but the taxable profits reasonably expected would support the recognition of the deferred tax asset. The net deferred tax position is a deferred tax asset of $24, which would not necessarily reflect any *possible* net tax outflow in the future (i.e. the deferred tax asset cannot be realised without having the taxable income from using the building).

If the Board decides to proceed with the proposals in the ED, we recommend the Board clearly clarifies its intention regarding this matter and also considers including any clarification in the body of the standard rather than in the Basis of Conclusions.