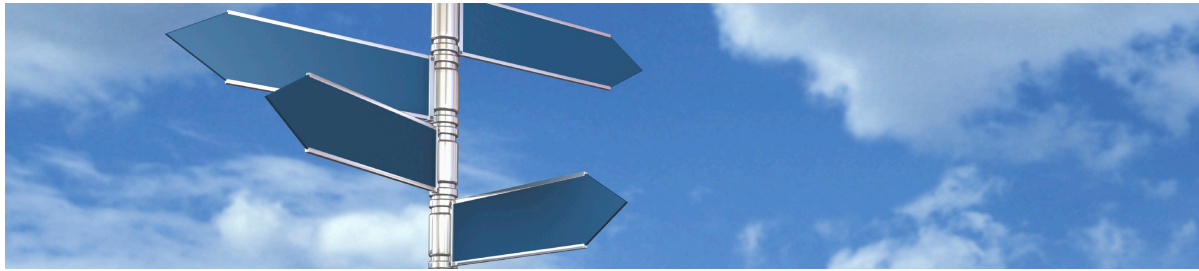


Accounting & Tax alert



Special edition

Taxing times ahead: IASB's income tax proposals

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- action points.

The International Accounting Standards Board (IASB) has released Exposure Draft ED/2009/2 *Income Tax*, which proposes a new IFRS to replace IAS 12 *Income Taxes*.

The most significant proposal of the exposure draft would require all uncertain tax positions to be measured on a weighted probability basis and disclosed – a significant change from current practice. This proposal is conceptually similar to the introduction of FIN 48 in the United States, which has had a significant impact on companies and the way they measure and disclose their tax positions.

A standard arising from the exposure draft is expected to be issued in the first half of calendar 2010 and is likely to apply to reporting periods commencing during 2011. All uncertain tax positions still subject to ATO review at implementation date would need to be documented, so early consideration of how your organisation will be affected is essential. The potentially onerous requirements will require significant planning and implementation of systems and ongoing compliance.

This joint Accounting & Tax alert gives a high-level overview of the exposure draft and focuses on some of the issues with it for Australian entities, covering:

- overview and background
- uncertain tax positions
- revised calculation methodology
- investment recognition exception
- transitional requirements
- action points.

Overview and background

Summary of the major proposals

The exposure draft includes proposed significant change from the current requirements of IAS 12, including:

- new recognition, measurement and disclosure requirements for 'uncertain tax positions'
- a new calculation methodology, introducing new steps in the deferred tax calculation, requiring a single deferred tax calculation for each asset and liability and a changed tax base concept, now called a 'tax basis' that is determined by reference to the sale or settlement of assets and liabilities at reporting date
- elimination of the 'investment recognition exception' for all but certain foreign subsidiaries, branches and joint ventures
- numerous other changes, both clarifying the existing requirements and introducing new requirements, which may have a big impact in some circumstances.

Overview of the exposure draft proposals

This table summarises the main proposals in the exposure draft.

Accounting for uncertain tax positions introduces a significant commercial risk

Area	Overview	Comments
Major proposals		
Uncertain tax positions <i>(new)</i>	<p>Uncertain tax positions must be measured using a probability weighted average of all possible outcomes.</p> <p>Interest and penalties must be accrued where relevant.</p>	<ul style="list-style-type: none"> • a high-risk area with commercial implications • potential significant transitional adjustments • ATO scrutiny can be expected.
Calculation methodology <i>(changed)</i>	<p>Deferred tax accounting is only performed where the entity expects an effect on taxable profit from recovering assets or settling liabilities.</p> <p>The tax basis of an asset/liability is determined by reference to the tax consequences that would arise if the asset were sold or the liability settled at balance date.</p> <p>The difference between the carrying amount and tax basis of an item gives rise to a temporary difference, but a deferred tax balance is only recognised to the extent that the temporary difference represents an expected effect on future taxable profits.</p> <p>One calculation is performed for each asset and liability, which may require a 'blended rate' calculation.</p>	<ul style="list-style-type: none"> • CGT cost bases will feature more prominently in the determination of the tax basis, meaning deferred taxes will be recognised less often for intangible and similar assets • systems are likely to require modification to conform with the new approach • training and other needs should be considered • blended tax rate calculations may be difficult in some cases, e.g. petroleum resource rent tax and normal income tax for certain oil and gas entities.
Investments <i>(changed)</i>	<p>Recognition exception for investments in subsidiaries, associates, branches, and joint ventures eliminated for all but temporary differences related to foreign subsidiaries and foreign joint ventures that are essentially permanent in duration.</p>	<ul style="list-style-type: none"> • more deferred tax will be recognised • complex calculations may be required • implementation in the context of tax-consolidated groups may be onerous.
Other proposals		
Tax allocation <i>(changed)</i>	<p>Elimination of 'backwards tracing' concept in favour of a more 'rules based' approach allowing pro-rata allocation in some cases.</p> <p>Deferred tax recognition in equity usually limited to initial equity event.</p> <p>(An alternate view based on the current 'backwards tracing' approach is presented in the ED but is not supported by the IASB.)</p>	<ul style="list-style-type: none"> • tax amounts will be recognised in profit or loss more often, impacting effective tax rates.
Tax consolidation <i>(clarification)</i>	<p>New allocation and disclosure requirements for the allocation of tax within tax-consolidated groups.</p>	<ul style="list-style-type: none"> • requirements are largely consistent with Interpretation 1052 <i>Tax Consolidation Accounting</i>.

The accounting methodology is onerous and requires substantial planning lead time

Area	Overview	Comments
Deferred tax assets <i>(changed)</i>	Deferred tax assets recognised on a 'gross' basis together with an associated valuation allowance so that the net carrying amount is recognised at the highest amount that is more likely than not that there will be sufficient profit to realise.	<ul style="list-style-type: none"> • may require more stringent analysis of DTAs, particularly in relation to unused tax losses whose availability under the tax law is uncertain • uncertain tax position accounting and disclosure requirements may often be triggered.
Initial recognition of assets and liabilities <i>(changed)</i>	Recognition exception eliminated in favour of a 'split accounting' approach, resulting in separate recognition of an asset and a tax advantage/disadvantage.	<ul style="list-style-type: none"> • the practical application of this change may produce outcomes largely consistent with the initial recognition exception in many cases.
Changes in tax status <i>(clarified)</i>	Changes in tax status can only be recognised on approval date or the filing date if approval is not required.	<ul style="list-style-type: none"> • the effects of changes in tax status may be recognised later • major impact may be on decisions to form a tax-consolidated group.
Classification <i>(changed)</i>	Some deferred tax balances will be classified as current assets or liabilities.	<ul style="list-style-type: none"> • treatment results in symmetry of treatment between the item giving rise to the deferred tax and the deferred tax balance itself.
Tax rates affected by distributions <i>(changed)</i>	Where the tax rate is affected by whether or not a distribution is paid, the entity must use the rate expected to apply.	<ul style="list-style-type: none"> • may have an impact on certain trusts and similar arrangements.
Substantive enactment <i>(clarified)</i>	The notion of 'substantive enactment' has been clarified to situations where future steps in the approval process historically have not affected the outcome and are unlikely to do so.	<ul style="list-style-type: none"> • this clarification is already widely applied in the Australian context under the existing standard.
New disclosures <i>(changed)</i>	<p>Description and possible financial effects of estimation of uncertainties and their timing (such as uncertain tax positions).</p> <p>Impacts of the effects of the possible outcomes of a review by the tax authorities on current and deferred taxes.</p> <p>Movement schedule for each type of temporary difference, unused tax loss and unused tax credit.</p> <p>Differences between tax bases and reported amounts of assets and liabilities for 'pass-through entities' (where income is taxed in the hands of owners).</p>	<ul style="list-style-type: none"> • some of the new disclosures are potentially onerous and/or commercially sensitive.

Area	Overview	Comments
	<p>Details of transactions between tax jurisdictions with different tax rates.</p> <p>Details of tax-consolidated groups including amounts of current/deferred expenses and payables/receivables from other entities in the group, and the basis of allocation (separate financial statements).</p> <p>Accounting policies for interest and penalties and exchange differences on foreign tax assets and liabilities.</p>	
Other		
Treatments carried over from IAS 12	<p>A number of requirements are effectively the same as IAS 12, including:</p> <ul style="list-style-type: none"> • the calculation of current tax • treatment of deferred taxes arising in relation to business combinations, share-based payments and foreign currency translation • the prohibition on the discounting of deferred taxes • set-off requirements • many disclosures. 	<ul style="list-style-type: none"> • whilst these requirements are largely consistent with the existing IAS 12, there are nuances in their application and there can be impacts from other changes, e.g. uncertain tax positions impacts the calculation of current tax even though the methodology is unchanged.
Consequential amendments to other standards	<p>IAS 32 will be amended to remove the reference to income tax consequences of equity transactions.</p> <p>IAS 34 would be amended to require valuation allowances to be determined in accordance with the new income tax standard, rather than being 'smoothed' in interim results.</p> <p>IFRS 1 will be amended to provide additional relief to first-time adopters.</p>	<ul style="list-style-type: none"> • the IAS 32 amendments would resolve a long-running issue about a potential conflict between the requirements of IAS 12 and IAS 32 • the impact of changes in the measurement of deferred tax assets will be fully recognised at interim reporting periods.
Transitional requirements	<p>The revised requirements are generally expected to be applied on a prospective basis from the beginning of the first annual reporting period to which the new IFRS is applied (expected to be some time in 2011).</p>	<ul style="list-style-type: none"> • comparative information will not be required to be restated • early adoption may be permitted • significant transitional adjustments are possible.

Project background

Accounting for income taxes under IAS 12 *Income Taxes* (and its Australian equivalent AASB 112 *Income Taxes*) is an area that has created numerous issues and uncertainties.

The IASB added income taxes to its active agenda in 2002 and a revised IAS 12 *Income Taxes* was originally planned to be implemented as part of the initial IFRS transition in 2005. However, the project has taken a long time to reach the exposure draft stage, as other projects have taken precedence.

Originally conceived as a joint IASB-FASB convergence project, the FASB decided in 2008 to suspend deliberations on the project indefinitely. This occurred as a result of the FASB deciding to review its strategy for the various short-term convergence projects with the IASB in light of the possibility that some or all US public companies might be permitted or required to adopt IFRSs at some future date.

As a result of its review, the FASB has no immediate plans to issue an exposure draft to propose an amendment to the equivalent United States' pronouncement, Statement 109 *Accounting for Income Taxes*, but will instead issue an Invitation to Comment containing the IASB's proposed replacement of IAS 12. After the FASB's review, it will decide whether to undertake projects that would eliminate those differences between IFRS and US-GAAP that are included in the short-term convergence project – accounting for income taxes, investment properties, and research and development – by adopting the relevant IFRSs.

In light of the delays, the question 'has the wait been worth it?' must be asked. Many reviewing the proposals in the exposure draft might answer 'no'. Because of the early emphasis on US-GAAP convergence, the proposals may seem to many to be a capitulation to US-GAAP approaches in various areas, sometimes arguably adopting a lower-quality solution. This convergence bias, combined with the board's decision not to undertake a fundamental rethink of key concepts and issues, has resulted in many changes but, with the exception of uncertain tax positions, little in the way of major new requirements and issue resolution – just a lot of 'tweaking' and the addition of new 'rules'.

Creating an accounting standard that caters for the vast diversity across income tax regimes around the world is not an easy task. But the IASB is unlikely to reconsider income taxes again in the foreseeable future. Does this exposure draft help Australian entities with their common tax accounting issues? Slightly. Should we have expected more? Maybe.

Uncertain tax positions

What is an 'uncertain tax position'?

It is common for uncertainties to arise with the tax treatment of items and whether the treatment adopted will ultimately be sustained on investigation by the relevant tax authority. These types of uncertainties are referred to as 'uncertain tax positions'.

In the Australian context, tax positions are often stated in terms of whether a tax position taken for a particular item 'will' or 'should' succeed, or whether the position is more likely than not; collectively taken as meaning a 50% or greater probability of succeeding.

The existing IAS 12/AASB 112 does not provide any explicit guidance on how to account for uncertain tax positions and divergence in treatment has developed in practice. In the Australian context, entities currently often adopt an 'all or nothing' approach, i.e. the benefit of a tax deduction is recognised in full in the financial statements if it is probable that it would be sustained.

Areas where uncertain tax positions might commonly arise in practice

Transfer pricing

Tax losses

Tax consolidation outcomes (ACA)

Depreciation

Research and development

What is the proposed accounting for uncertain tax positions?

It is proposed in the exposure draft that current and deferred tax assets and liabilities be measured using a probability-weighted average amount of all possible outcomes, assuming that the tax authorities will review the amounts submitted and have full knowledge of all relevant information.

This requires an entity to take these steps:

- determine what constitutes an 'uncertainty' and identify key positions taken during the statute of limitations under the relevant tax law
- determine the possible outcomes for each position and the probabilities of each occurring
- calculate the weighted-probability amount for the position

- compare the calculated amount to the amount submitted to the tax authority and recognise a liability for the difference
- recognise any interest and penalties in relation to the liability recognised, i.e. based on the tax law if the position is sustained at the probability-weighted average calculated amount, what interest and penalties would the entity be liable for at the reporting date?
- disclose the necessary information about 'estimation uncertainties' in the financial statements.

The measurement of uncertain tax positions is a mechanical but very subjective process. Although the ED indicates that the IASB does not intend entities to seek out additional information to determine their uncertain tax position assessments, in practical terms we expect many entities will be forced to do so, particularly where the impacts of the ED were not considered when the transaction or event occurred. This is because the statute of limitations on current transactions will not have passed when the ED is likely to be implemented as a Standard (2011). Determining the range of possible outcomes for each uncertain tax position and the probability of each of those outcomes occurring could prove to be a very difficult task which will require expert tax advice.

Example

An entity intends to claim a \$100,000 tax deduction in its 20X1 tax return. In consultation with its tax advisers, the entity develops the following possible outcomes and associated probabilities based on the assumptions that the tax position is the subject of an ATO review and that the entity ultimately negotiates a settlement with the ATO:

Possible estimated outcome	Individual probability	Weighted probability outcome
\$30,000	30%	\$9,000
\$25,000	25%	\$6,250
\$20,000	20%	\$4,000
\$15,000	15%	\$2,250
\$10,000	10%	\$1,000
		\$22,500

On the basis of the probability analysis above, the entity would conclude that the tax deduction represents an expected benefit of \$22,500 (tax effected). Because the entity has claimed \$30,000 (tax effected) in its tax return, a liability for the difference of \$7,500 is recognised.

The entity processes the following entry (may be recognised on a 'net' basis in some cases):

	DR	CR
Current tax liability (reduction in payable)	30,000	
Current tax liability (additional, might be non-current)		7,500
Current tax expense		22,500

The entity also needs to consider whether it is necessary to recognise interest and penalties on the \$7,500 liability. This will depend on when the tax law would impose such penalties, again assuming that the tax deduction is ultimately seen to have a benefit of \$22,500.

For the purposes of illustration, assume that tax penalties and interest would accrue from when the entity lodges its tax return during the subsequent accounting year. At the end of that year, \$500 of interest and penalties would be accrued. The entity processes the following entry:

	DR	CR
Tax interest and penalties expense	500	
Accrued penalties and interest		500

Entities must make an accounting policy choice about how to classify interest and penalties, (i.e. as part of income tax expense or together with other expenses) and must also disclose their accounting policy.

Penalties and interest will continue to be accrued until the uncertainty is resolved. It is proposed, however, that changes in the probability-weighted average amount can only be based on new information, not a new interpretation of previously available information.

Comparison with US-GAAP

The genesis of the uncertain tax position proposals can be found in United States FASB Interpretation No.48 *Accounting for Uncertainty in Income Taxes* (FIN 48). Our experience in the US with the implementation of FIN 48 reveals that this change is a significant challenge for major corporates to implement and can result in negative commercial outcomes and market perception.

In developing the exposure draft, the IASB did not agree with some of the approaches in FIN 48 and instead developed their own model by reference to their decisions in the non-financial liabilities (provisions) project.

A high-level overview of the differences between the exposure draft and FIN 48 is outlined in the table below:

In light of the vast array of differences between the IASB and FASB on this matter, the outcomes under the ED and FIN 48 can be significantly different. More uncertain tax positions would be required to be measured under the exposure draft than under FIN 48 (as the latter has a 'probable' threshold) and at different amounts (as the FIN 48 approach will result in the recognition of one of the possible outcomes).

The IASB is also relying on general disclosure principles for the disclosures about uncertain tax positions. While ostensibly the disclosures made under each regime should be equivalent in all material respects, accepted practice under the exposure draft requirements may be expected to develop over time.

Area	Exposure draft	FIN 48
Recognition	All uncertain tax positions must be accounted for following the proposed requirements	Acceptance of tax benefit by the tax authority must be probable before being recognised
Measurement	Weighted-probability average of all possible outcomes	Maximum amount that it is probable the tax authority will accept (cumulative probability approach)
Presentation	Not specified	FIN 48 liability
Disclosure	Principle-based requirement to disclose information about major sources of estimation uncertainties Impacts of the effects of the possible outcomes of a review by the tax authorities on current and deferred taxes Interest and penalties are not specifically required to be disclosed General requirements in IAS 1 would apply	Tabular reconciliation of unrecognised tax benefits Possible effect on effective tax rate Interest and penalties recognised Details of reasonably possible increases or decreases of unrecognised tax benefits Details of tax years that remain subject to examination

Despite the possibility of a more permissive approach to disclosure under the exposure draft proposals, entities would still be expected to make what could be quite revealing disclosures in their financial statements about their uncertain tax positions. This increased disclosure may provide guidance to the Australian Taxation Office (ATO) about what an entity considers to be its materially deficient tax positions.

It also raises the question of whether boards, when faced with the stringent reporting requirements under the exposure draft proposals, will take a far more conservative approach to tax risk management, through a reduced appetite for income tax planning.

Revised calculation methodology

How are deferred taxes calculated under the ED?

Calculation of deferred taxes under the ED requires the following steps:

1. Identify which assets and liabilities are expected to affect taxable profit if they were recovered or settled for their carrying amounts.
2. Determining the tax basis at the end of the reporting period of all those assets and liabilities, and of other items that have a tax basis.
3. Compute any temporary differences arising as the difference between the carrying amount and the tax basis.
4. Recognise deferred tax liabilities and deferred tax assets to the extent that the temporary differences are expected to increase or decrease taxable profit in the future.
5. Measure deferred tax liabilities and deferred tax assets based on the tax rates and tax laws that have been substantively enacted at the end of the reporting period and are expected to apply when the deferred tax liability is settled or deferred tax asset is realised.

Deferred tax assets arising from unused tax losses and unused tax credits are also recognised based on their gross amounts and the relevant tax rate.

Identifying assets and liabilities expected to affect taxable profit

The ED proposes that if there will be no effect on taxable profit when an entity recovers or settles the carrying amount of an asset or a liability, then no deferred tax will arise in respect of that asset or liability. The entity's expected method of recovery needs to be considered when making this assessment.

The ED states that this will happen in situations listed in the left-hand column in the table below. The right-hand column provides examples of situations where this might arise under Australian tax law:

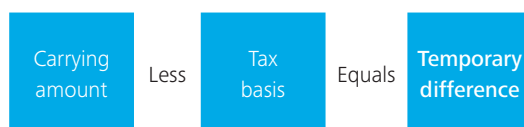


Situation noted in the ED	Australian examples
No taxable income or deductible amounts arise on recovery or settlement	Sale of a pre-CGT asset Accrual for a non-deductible fine Receivable for exempt income
Equal taxable income and deductible amounts arise (so there is a nil effect)	Sale of an asset where the carrying amount is the same as its CGT cost base Accrued fully franked dividend receivable
A nil tax rate applies to any taxable or deductible amounts	Exempt income Foreign dividends receivable (in some cases) Expected sale of certain investments in foreign entities

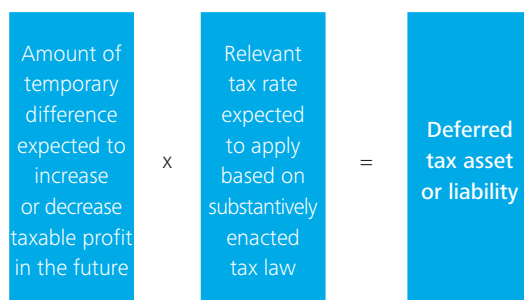
Where the expected method of recovery is not expected to give rise to a future tax consequence, no further deferred tax calculation is required for that item, i.e. no further steps in the calculation process are required.

Temporary differences and deferred taxes

Where a taxable consequence is expected from the recovery of an asset or settlement of a liability, the ED requires an entity to determine the temporary difference between the carrying amount and the 'tax basis':



The temporary difference that arises from this process (sometimes called a 'basis difference' or 'book to tax difference') is not automatically recognised as a deferred tax balance. Instead, measurement of the resultant deferred tax balance takes into account whether the temporary difference represents an expected future taxable amount or expected reduction in tax amounts:



The measurement of deferred taxes requires the determination of the portion (if any) of the temporary difference that is expected to increase or decrease taxable profits in the future. This step is required because of the assumption of sale or settlement at the balance date in determining the tax basis of the asset. In some cases, there may be limited or no tax deductions available on sale or settlement, but other taxable or deductible amounts (e.g. tax depreciation) may be expected to arise in the future. These other amounts will reduce the amount of the temporary difference recognised as a deferred tax balance.

The relevant tax rate is then applied to the component of the temporary difference to determine the deferred tax asset or liability. This rate may need to be a 'blended rate' where multiple tax consequences with different tax rates are expected or where more than one taxing regime is expected to apply, e.g. Petroleum Resource Rent Tax and corporate income tax, or foreign withholding and local Australian income taxes.

Determining the 'tax basis'

The 'tax basis' of an asset or liability is what the IASB likes to term 'a measurement attribute'. The exposure draft proposes that the tax basis is the measurement, under applicable existing tax law, of an asset, liability, or other item.

The tax basis must be determined by reference to the taxpayer's elections and status under the provisions of the tax law. For instance, if an entity is a member of a tax-consolidated group, the tax basis of the entity's assets and liabilities would be determined by reference to the consolidated tax return.

In an attempt to simplify the determination of the tax basis, the exposure draft contains proposals that the tax base of an asset/liability be determined by reference to the tax consequences that would arise if an asset were **sold** or a liability **settled** at the reporting date.

This approach is materially different to that currently required under IAS 12/AASB 112, which requires consideration of management's intentions for the relevant asset/liability at reporting date.

Ostensibly, this change was introduced to achieve US-GAAP convergence by eliminating the concept of 'management intention'. While the practice under the US tax regime may be to assume sale in the application of SFAS 109, it may however produce unusual outcomes in other jurisdictions, including Australia.

In particular, because of the comprehensive nature of Australia's capital gains tax regime, many assets and liabilities have CGT cost bases that are effectively deductible in the event of sale. The tax basis of the majority of assets may therefore be determined by reference to their CGT cost bases under the proposals in the exposure draft.

The requirement that the tax basis be determined by reference to the entity's current status and elections under the tax law also means that changes in tax values of assets can not be anticipated, no matter how likely. For example, it may not be possible to anticipate the voluntary formation of a new tax-consolidated group when accounting for deferred taxes arising in a business combination. In contrast, it is likely that any reset tax values arising where an entity joins an existing tax-consolidated group could be taken into account in measuring deferred taxes in a business combination, because it is mandatory that the entity join that group.

Examples applying the new calculation methodology

The examples below illustrate in very simple terms how the new calculation methodology works.

Dividend receivable

An entity recognises a fully franked dividend receivable of \$300 from an investee. Dividends are taxed by the tax authority on receipt, but because of the rebate for franked dividends, the dividend will effectively be untaxed in the hands of the recipient. Because there is no expectation of future tax payments or reductions in tax payments, no deferred tax is recognised and no further steps need to be performed.

Even if deferred tax accounting did not stop at the initial step, the same outcome would result. Because the tax authority only recognises the dividend on receipt, its tax basis would be nil. Due to the temporary difference arising (\$300) not being expected to result in a tax consequence, however, there is no amount of the temporary difference that needs to be recognised as a deferred tax amount.

	\$
Carrying amount	300
Tax basis	nil
Temporary difference	300
Amount of temporary difference expected to increase or decrease tax	nil
Deferred tax at 30%	nil

Brand name

An entity acquires a brand name as part of a business combination involving the acquisition of a company which becomes a wholly-owned subsidiary. The fair value of the brand name at the acquisition date is \$750. The acquired subsidiary joins the acquirer's existing tax-consolidated group and the brand name is ascribed a reset CGT cost base of \$750.

If the brand name was sold, the CGT cost base of \$750 would be available under one of the CGT events under the tax law. Accordingly, the tax basis of the asset is \$750. Because the tax basis and carrying amount are the same, there is no temporary difference and so no deferred tax to recognise.

	\$
Carrying amount	750
Tax basis	750
Temporary difference	nil
Amount of temporary difference expected to increase or decrease tax	nil
Deferred tax at 30%	nil

Comparing the ED approach with current practice

Although ostensibly similar to the approach under IAS 12/AASB 112, the focus of the new proposals is quite different and is designed to eliminate the use of management expectation or intention when determining deferred taxes. In reality, however, 'expectations' must still be applied in:

- determining whether there will be an effect on taxable profit when the entity recovers or settles the carrying amount of assets and liabilities
- assessing the amount of a temporary difference that is recognised as a deferred tax balance.

Under IAS 12/AASB 112, there are two main schools of thought about how multiple tax consequences are taken into account in the measurement of deferred taxes. One of these methods uses an 'aggregate' single tax base, whereas the other separately considers the use (revenue) and sale (capital) consequences of the recovery of the asset.

In some cases, the exposure draft proposals will produce the same outcome as applying the 'aggregate' single tax base approach under IAS 12/AASB 112. However, this will not always be the case as the exposure draft proposals' focus on sale at reporting date in determining the tax basis.

Example

An entity has a building with a carrying amount of \$150 and a residual value of \$80. There is an unclaimed building allowance of \$100 and the building has a CGT cost base of \$110.

The building is expected to be used for a period of time (during which \$20 of building allowances are expected to be claimed) before being sold. Any building allowances claimed reduce CGT cost base available on sale.

Item	Proposed approach (ED)	Single tax base approach	Separate tax consequences approach	
			Revenue	Capital
Carrying amount	150	150	70	80
Tax base components:				
– building allowance	-	20	20	-
– CGT cost base	110	90	-	90
Total tax basis/base	110	110	20	90
Temporary difference	40	40	50	(10)
Amount of temporary difference expected to increase or decrease tax	40	n/a	n/a	n/a
Deferred tax at 30%	12	12	15	(3)

Although the outcomes under the ED and the single tax base approach are the same, the calculation methodology is not the same and can produce different outcomes. For instance, in the event that the building was of a type where the building allowance did not reduce the CGT cost base of the building, the amount recognised under the exposure draft proposals would be different from the single tax base approach because only the tax consequences of selling the building could be taken into account in measuring the tax basis of the building under the ED.

The table above also illustrates that the outcome under the ED can be very different from the separate tax consequences approach commonly applied under IAS 12/AASB 112. The single deferred tax calculation for each asset based on an assumption of sale effectively means that expected tax consequences on revenue account can be 'shielded' by the CGT cost base available on sale.

The calculation methodology may not always produce a 'logical' outcome

As the above analysis and examples illustrate, the concept of 'intention' or 'expectations' is not being eliminated by the ED. This is because expectations must still be applied in considering whether there is an effect on taxable profit from recovery or settlement of each asset and liability, the amount of a temporary difference to recognise as deferred taxes and in calculating a 'blended rate' to determine the deferred tax balance arising from the temporary difference.

Because expectations are not taken into account in the assessment of the tax basis, deferred tax may sometimes *not* be recognised, even though it may be expected to arise. This is because the temporary difference is initially determined by reference to the tax basis arising on sale, but the deferred tax recognised is then assessed by reference to the expected use, sale or other method of recovery of the asset.

Example

An entity has an asset with a cost and carrying amount of \$1,000 that is expected to be used and which will give rise to tax consequences in the form of taxable profits. There is no tax depreciation or other deduction available from use of the asset, but in the event that it is sold, the entity can deduct the original cost from the proceeds of sale.

In applying the ED to the above fact pattern, there is no difference between the cost and tax basis, which are both \$1,000. There is therefore no need to recognise any deferred taxes.

	\$
Carrying amount	1,000
Tax basis	1,000
Temporary difference	nil
Amount of temporary difference expected to increase/decrease tax	nil
Deferred tax at 30%	nil

Accordingly, as the asset is used, current tax will arise on the profits earned from using the asset. Due to the operation of the ED proposals, no deferred tax liability is recognised in relation to the asset because no tax would arise on sale of the asset. The ED requires this approach even though there may be no intention to sell the asset and tax may arise from using the asset.

In contrast, if no deduction is available on sale, but the cost of the asset is permitted as tax depreciation over time, the tax basis of the asset applying the ED would be nil (due to no deduction being available on sale).

In this case, a temporary difference of \$1,000 arises. However, this temporary difference will not be expected to give rise to a future tax consequence if the asset is expected to be used (as tax depreciation will be available to offset the profits earned from using the asset) and so no deferred tax will arise.

	\$
Carrying amount	1,000
Tax basis	nil
Temporary difference	1,000
Amount of temporary difference expected to increase/decrease tax	nil
Deferred tax at 30%	nil

Note that in this case, expectations can effectively be taken into account in measuring the deferred taxes arising from the asset. This is because the assumption of sale produces a temporary difference, but that temporary difference is not expected to give rise to a future tax consequence because the asset is going to be used, thus permitting the tax depreciation to be claimed.

In other words, the ED permits the consideration of expectations/intention where the 'assumed sale' of an asset would create a temporary difference that is not expected to give rise to tax, but does not permit the use of judgement to 'create' a temporary difference arising from use where there is no temporary difference arising from the assumption of sale.

Investment recognition exceptions

The exposure draft proposes the partial elimination of the 'investment recognition exceptions' available under IAS 12/AASB 112, which permit an entity to avoid the recognition of deferred taxes, most commonly in relation to subsidiaries. It is proposed, however, that an exception be retained for foreign investments in subsidiaries and joint ventures where the difference between the carrying amount of the investment and its tax basis is essentially permanent.

The exemption from the recognition of deferred taxes for foreign investments is predicated on an argument that the calculation of an amount of deferred taxes for permanently reinvested unremitted earnings of foreign subsidiaries is so complex that the costs of doing so outweigh the benefits. It is understood that this has largely been driven by the complex foreign tax regime in the US.

The same cost versus benefits argument could, however, be used to justify the non-recognition of deferred taxes associated with domestic investments in other jurisdictions.

In the Australian context, this change is likely to have a significant impact within tax-consolidated groups.

The tax treatment of entities that leave a tax-consolidated group is complex, requiring detailed calculations that depend on numerous factors (tax values, carrying amounts and other items) at the time when the entity leaves the tax-consolidated group in the so-called 'exit ACA' calculation.

Because the tax basis of an asset requires the assumption of sale at reporting date, the calculation of the deferred tax consequences of an investment in a subsidiary within a tax-consolidated group would require the performance of a notional 'exit ACA' calculation at *each* reporting date to determine the amount of deferred tax to recognise for each period in applying the revised calculation methodology.

Although IAS 12/AASB 112 currently requires the disclosure of temporary differences associated with investments in subsidiaries, branches, associates and joint ventures, in practice this disclosure is not always made, or the amounts disclosed are perhaps prepared with a lower level of precision than recognised income tax amounts.

The effort and cost required to calculate the CGT cost bases of investments, particularly for subsidiaries within tax-consolidated groups, may be significant. We expect that this requirement, if implemented, could require systems modification.

The exact application of these requirements in the context of tax-consolidated groups raises a number of technical interpretational issues that may affect implementation, e.g., whether the first step in the calculation process can be used to avoid the recognition of deferred taxes in such circumstances or whether leaving a tax-consolidated group is considered a change in tax status. We expect that this may result in some diversity in practice, which may need AASB or IFRIC involvement to resolve.

Entities that are expected to be adversely affected by the proposals should consider making a submission to the IASB and AASB. Comments close on the IASB exposure draft on 31 July 2009. The AASB is expected to issue an equivalent exposure draft in due course, but in accordance with the AASB's usual practice, is likely to have an earlier closure date for comment so that the AASB can formulate its own response to the IASB.

Transitional requirements

The IASB's work plan indicates that it expects to make an IFRS based on the exposure draft in the first half of calendar 2010, which means that the likely application date will be some time during 2011.

The exposure draft indicates that the proposals would be applied prospectively from the beginning of the annual reporting period in which it is first applied. This means that comparative information will not be required to be restated in the year of adoption. Consequential amendments would also be made to IFRS 1 for first-time IFRS adopters.

Action points

You should consider taking action and starting to plan for the possible implementation of the exposure draft's proposals.

Understanding the proposals

- what are the major effects expected in our organisation?
- at a macro level, what is the possible impact of the proposals on our financial statements?
- should we consider submitting a comment letter to the IASB and AASB on the proposals highlighting the effects that are unfavourable, potentially onerous or which produce unreasonable outcomes?
- how will we monitor the outcomes of the exposure draft?

Uncertain tax positions

- what areas of our tax affairs may give rise to potentially significant uncertain tax positions? How are these currently identified and managed?
- what action is planned or required to mitigate the risk of a substantial transitional adjustment?
- what awareness training do we need within the organisation to ensure that the relevant people know about the impact of the proposals and can work on pre-readiness activities?
- should a contingency plan be put in place so we're ready to address our major uncertain tax positions?
- do existing disclosures about and treatments of uncertain tax positions need to be considered?

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