CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

31 July 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft on *Income Tax*

The Hong Kong Institute of Certified Public Accountants ("the Institute") is pleased to provide our comments on the above Exposure Draft ("the proposals"). Our responses to the questions in the Invitation to Comment are included in the attached appendix. In this letter we would like to bring to your attention some general observations and also comment on a particular aspect of accounting for income taxes in Hong Kong that we consider urgently needs to be addressed by a change to IAS 12 - that relating to deferred tax arising from investment property valuation gains.

Overall position

Whilst we welcome the IASB taking the opportunity to revisit IAS 12, as further elaborated in the appendix, we have significant concerns about the approach that the proposals are taking in a number of areas. The accounting for income taxes, in particular for deferred taxes, is recognised by many preparers and users as one of the more difficult areas of IFRS. However, certain of the proposals, for example the replacement for the initial recognition exception and the practical application of the change in the tax basis, are likely to be more complex and difficult to follow than the current requirements under IAS 12. Indeed, certain observers already take the view that the accounting for deferred tax has become so complex that it is no longer relevant to understanding an entity's financial position and that the entire approach needs to be revisited, including whether it is consistent with the current framework. Overall we consider it unlikely that the proposals will allay such views and will instead greatly increase the confusion over how to identify and measure deferred tax, with very little benefit in terms of improved information for users of financial statements.

We therefore do not support replacing the current IAS 12 with this proposed standard. Instead, we would suggest that the Board undertakes a more fundamental review of accounting for income taxes with the objective of issuing a new standard in the longer term. In the meantime, as a short term solution to address the more significant issues arising in IAS 12, limited amendments should be made to the current standard and additional guidance provided where needed.

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

Deferred tax arising from investment property valuation gains

As stated above, one issue in particular that we would urgently seek to be addressed relates to deferred tax arising from investment property valuation gains.

Financial reporting standards in Hong Kong (HKFRS) fully converged with IFRS from January 2005. We previously communicated to the IASB in our letter of 7 April 2006, certain application issues when applying IAS 12, in particular the requirement to recognise deferred tax liabilities on valuation gains arising in respect of investment properties that in practice will never be settled. This situation arises due to the particular features of property/land ownership in Hong Kong, further details of which are included in the above letter, combined with the fact that Hong Kong capital gains are not subject to tax and are not likely to be. We understand that other jurisdictions such as New Zealand also have a similar situation to that of Hong Kong.

The holding of investment properties is a common feature of many companies in Hong Kong, not just for those primarily involved in real estate. Under IAS 12, over time, they have often built up large deferred tax liabilities where such properties are stated under the valuation model, even though there are no future tax consequences from the valuation gain. This situation has given rise to much adverse comment from the local business community and market analysts. IAS 12 is frequently cited by our members as being in urgent need of revision.

We have been in regular communication with the IASB on this matter and had understood that the issue would be addressed in the revised IAS 12. We are particularly concerned, therefore, that the proposals do not appear to resolve the matter.

Although the fundamental approach under the proposals, whereby the tax basis focuses on the deductions available on sale and for the tax rate also to be that applicable on sale, might prima facie appear to address the issue and not require a deferred tax liability to be recognised; because of the particular requirements of the tax regulations (including that on disposal any previously granted tax allowances would be recouped - thereby giving rise to taxable income), a temporary difference arises to which the profits tax rate would need to be applied. Furthermore, under the proposals, deferred tax would need to be provided on the whole of the temporary difference, even though on disposal only a relatively small amount might fall due relating to the recouped allowances.

Whilst we agree that it would be appropriate for the deferred tax to be recognised in respect of the tax allowances that would be recouped, we consider that it should be limited only to that amount, rather than being based on the full amount of the temporary difference (being temporary difference as defined in the Standard).

Furthermore there would also seem to be inconsistencies in the proposals. For example, paragraph B30 would appear to require a tax rate based on recovery through use to be applied in Hong Kong, because, as land in Hong Kong is leasehold land, the investment property would be depreciated should IAS 16 apply and B30 would therefore require the entity to determine whether recovery of the property would be through use or sale and in practice the former would normally apply. Also, Example 14 is not clear in what circumstances recovery through use would have to be applied.

To address this issue we consider that that the proposals should establish clear principles on which the deferred tax should be based and that inconsistencies in the proposals with that principle be addressed.

Whilst we accept that it may be difficult to arrive at a solution that meets all circumstances, one approach that we believe would be appropriate and workable for assets stated at fair value would be a fundamental principle that deferred tax be recognised reflecting the tax that would be payable on disposal of the asset for the carrying amount. This approach, in addition to being a straightforward concept to apply, is also conceptually consistent with the basis on which fair value is normally determined- that being an amount determined assuming an exchange transaction.

Whilst we appreciate that the current standard has a number of issues that need to be considered, we cannot stress too strongly how important it is for the Institute and our members that a revised standard addresses the above issue relating to investment properties. Should the IASB decide to delay the issue of a new standard, we would urge the IASB to make the necessary changes to the current IAS 12 as an interim measure, as a matter of priority.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong

Steve Ong, FCA, FCPA
Director, Standard Setting Department

SO/WC/ac

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft on *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 of the Basis for Conclusions.)

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

In general, we consider that the proposals as currently worded are unclear and as a result would often be difficult to apply in practice. For example, in the case of a fixed asset which is being depreciated for accounting purposes but without a tax deduction and no tax is payable on disposal, it is not clear when determining deferred tax whether an entity would apply paragraph 10 (i.e., not affecting taxable profit), paragraph 15 or the initial recognition requirements.

Also, the guidance is not consistent. In principle the tax basis is based on the deductions available on sale and the tax rate to be applied would follow the rate applicable upon sale. However the ED diverges from this principle in a number of areas, with the result that it is often unclear when and why management intent relating to the tax basis and tax rate is required. For example, where the same deductions are available on use of the asset and on sale, the tax rate is based on management's expectations of recovery of the asset. However there would seem to be no conceptual basis why management intent would be applied, simply because the tax basis is the same.

As indicated in our covering letter, we consider that these proposals are more complex and difficult to follow than the existing IAS 12 and will greatly add to the confusion over deferred tax. We therefore do not support the changes made in this respect and consider that the majority of the existing standard should be retained until a more fundamental review of accounting for income taxes has been completed.

However, if the Board continues with this revision, we consider that the fundamental principles should be more clearly set out and consistently applied. We would suggest that this is made more clear in the Core Principle, so that it is more explicit that deferred tax is tax payable or recoverable *upon disposal or settlement of an asset or liability* as this will help to apply the proposals in those situations for which the amount of deferred tax to be booked may not be readily evident.

If under the final proposals management intent will not be eliminated entirely and the above principle in the preceding paragraph not be applied to all assets and liabilities, we consider that at least it should be adopted for those assets and liabilities that are stated at fair value, as the approach is conceptually consistent with the basis on which fair value is normally based - i.e., an amount determined assuming an exchange transaction. As stated in our covering letter, this amendment is particularly relevant to investment property in Hong Kong which is generally carried at fair value, where the gains are not subject to any tax on disposal.

We agree with the principle that temporary differences should exclude differences that are not expected to affect taxable profit, however we would suggest that if IAS 12 is re-written as proposed, there should be additional guidance as to what is meant by *affecting* (i.e., increasing or decreasing) taxable profit. For example, does the affect to taxable profit occur for an asset from the revenue that the asset produces, or does the affect arise from the amortisation or derecognition of the asset? Without clear guidance, this could easily be misunderstood. For example, when there are no tax deductions given for an asset which is being depreciated for accounting purposes, a tax professional and many others would consider that taxable profit is not "affected" by such permanently disallowable items, since no tax deduction is given. If a different meaning of "affected" is intended in the standard then this should be made plain.

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 of the Basis for Conclusions.)

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

We agree with the proposal to include definitions for the above. However, we would suggest that the definition for investment tax credit should be widened to include other capital assets and not only those that are relating to depreciable assets.

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 of the Basis for Conclusions.)

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

We do not agree with the proposals.

Although the removal of the initial recognition exception seeks to bring the treatment to be more principle based, we fail to see the benefit of introducing a complicated process that will have the same impact to the net assets of the entity to that under the current approach, when the transaction is initially recognised. Also, entities may in practice find it difficult to identify entity specific tax effects, particularly for assets acquired in overseas jurisdictions.

We would therefore recommend that the existing requirements under IAS relating to the initial recognition exception be retained, together with new additional guidance for those areas for which practical issues arise in application, to help ensure consistency when applying the requirements. However, should the proposals be adopted, additional guidance should be provided as to the accounting after initial recognition for a transaction where there are entity specific tax effects.

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 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?

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

We do not agree with the proposals.

The distinction in the proposals between domestic and foreign subsidiaries is unclear and appears to be addressing particular US tax requirements rather than having a conceptual basis. We consider that domestic and foreign subsidiaries should be treated in the same way.

We would prefer that the current requirements in IAS 12 covering subsidiaries, joint ventures and associates be retained. However, should the proposals be adopted, further guidance should be included for the situation of a parent operating in a country with different regions or territories and each having their own tax rules. Would a subsidiary in a region or territory different to that of the parent be deemed to be a domestic or foreign subsidiary?

<u>Question 5 – Valuation allowances</u>

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.)

<u>Question 5A</u>

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

We agree with the proposals.

<u>Question 5B</u>

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 with the proposals.

<u>Question 6 – Assessing the need for a valuation allowance</u>

<u>Question 6A</u>

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 broadly support the proposals. However we note that the guidance could result in more deferred tax assets being recognised than under the current IAS 12 in those jurisdictions that currently take a more conservative approach to their recognition.

<u>Question 6B</u>

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 agree with the proposals.

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 of the Basis for Conclusions.)

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

We are broadly in agreement with the proposal to include guidance relating to the measurement of uncertain tax positions as this will help to reduce different practices being applied. Although we question the practicalities of applying the probability-weighted average approach, we agree that the standard should be consistent with the approach to be adopted under the revised IAS 37. Please refer to our comment letter dated 3 November 2005 for our response to the proposals for IAS 37.
(The letter can be viewed at
http://www.hkicpa.org.hk/professionaltechnical/accounting/exposuredraft/IASB_ED_amendment.pdf)

We do however have concerns that the proposals would permit changes to amounts previously recognised only where there is new information, and not when there may be a new interpretation of previously available information. The distinction between what is new information and a new interpretation may not be clear in practice. Also, it will often be the case that the acceptability of certain tax treatments evolves over time, particularly where the tax rules are silent or unclear and it would seem inappropriate for this not to be taken into account should the entity consider it appropriate to revise its estimate of the previously recorded tax position.

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 of the Basis for Conclusions.)

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

We agree with the proposals.

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, ie 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 of the Basis for Conclusions.)

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

Please refer to our response to Question 1.

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 entity's past practices and expectations of future distributions. (See paragraphs BC74–BC81 of the Basis for Conclusions.)

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

We do not agree with the proposals.

Whilst the proposal would provide relief for certain entities such as real estate investment funds that under current IAS 12 are required to measure deferred tax at undistributed rates until there is a commitment to distribute a dividend, we believe it is important that the proposals should follow the principle adopted by other standards such as IAS 10 relating to the timing of the recognition of the dividend liability. Accordingly, in our view, the tax consequences of a dividend distribution should not be taken into account if the dividend distribution itself is not recorded at the end of the reporting period.

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 recognized 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 would suggest for the proposals to give an explanation as to how special deductions fall to be treated within the fundamental principles of accounting for deferred tax and the rationale for them being excluded. In the absence of this information we are unable to comment as to whether it is appropriate for the proposals to be silent in this area.

We would also suggest that further guidance be included on what distinguishes special deductions from other deductions as this will be particularly important for those jurisdictions outside of the US that are not familiar with the concept of special 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 with the proposals.

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 of the Basis for Conclusions.)

Question 13A

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

We do not agree with the proposals.

The current approach under IAS 12, (often referred to as backwards tracing) is conceptually more supportable and avoids distortions to the tax expense in the income statement for adjustments to tax which relate to items reflected in other comprehensive income or equity.

Question 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 of the Basis for Conclusions.)

As we do not adopt US GAAP in Hong Kong we have not commented on this question.

Question 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?

Please refer to our response to Question 13A.

Question 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?

Please refer to our response to Question 13A. In addition, we are not aware that the current approach gives rise to particular difficulties in practice.

Question 14 – Allocation of current and deferred taxes within a group that files a consolidated tax return

IAS 12 is silent on the allocation of income tax to entities within a group that files a consolidated tax return. The exposure draft proposes that a systematic and rational methodology should be used to allocate the portion of the current and deferred income tax expense for the consolidated entity to the separate or individual financial statements of the group members. (See paragraph BC100 of the Basis for Conclusions.)

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

We agree with the proposals.

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

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

We do not support the proposals. Rather we would support the classification as current when the underlying temporary difference is expected to reverse and the related tax asset/liability is expected to be realised/settled within 12 months after the balance sheet date.

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 with the proposals.

<u>Question 17 – Disclosures</u>

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?

We agree with the proposals.

However we note that the Board is proposing to eliminate the approach under the existing IAS 12.85 whereby, the explanation of the relationship between tax and accounting profit can currently also be presented by aggregating separate reconciliations using the domestic tax in each jurisdiction. Under the proposals the reconciliation would use the domestic rate of the parent company jurisdiction only. For an investment holding company preparing consolidated financial statements that include subsidiaries operating in different jurisdictions, a reconciliation based on the tax rate of the parent may not be particularly informative and so we would suggest to retain the current approach permitted under IAS 12.85.

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 have no further suggestions.

<u>Question 18 – Effective date and transition</u>

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 agree with the approach, however, for existing preparers it would be helpful to provide an example to illustrate how the transitional provisions are to be applied, in particular to illustrate our understanding that comparative information is not restated, as this is not so clear in the proposals.