EFRAG

European Financial Reporting Advisory Group

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

12 February 2016

Dear Sir/Madam,

Re: Uncertainty over Income Tax Treatments

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Draft IFRIC Interpretation DI/2015/1 *Uncertainty over Income Tax Treatments,* issued by the IFRS Interpretations Committee (the 'draft Interpretation').

This letter is intended to contribute to the IFRS Interpretations Committee's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG agrees with the draft Interpretation as it will remove the existing inconsistencies in accounting for uncertain income tax treatments. Our detailed comments and responses to the questions in the draft Interpretation are set out in the Appendix.

EFRAG observes that the proposed requirements may, in certain circumstances, lead to accounting for similar uncertainties on different bases. Uncertainties arising in the area of *income* taxes would be in scope of the Interpretation. However, for other taxes or positions (e.g. value added taxes, antitrust litigations) which may be viewed as economically similar the treatment may not be clear and entities may apply different approaches. Based on EFRAG's observations, the potential for inconsistency is limited to asset positions resulting from payments made in respect of disputed amounts. EFRAG suggests that the IASB consider whether and how to address these differences for similar economic events. EFRAG understands that this issue is beyond the remit of the IFRS Interpretations Committee and therefore it should not influence its work on finalising the Interpretation.

If you would like to discuss our comments further, please do not hesitate to contact Martin Svitek or me.

Yours faithfully,

Roger Marshall
Acting President of the EFRAG Board

APPENDIX

Question 1 – Scope of the draft Interpretation

The draft Interpretation provides guidance on accounting for current and deferred tax liabilities and assets in circumstances in which there is uncertainty over income tax treatments. Such uncertain tax treatments may affect taxable profit (tax loss), tax bases, tax credits or tax rates that are used to recognise and measure current or deferred tax liabilities or assets in accordance with IAS 12 *Income Taxes*.

Do you agree with the proposed scope of the draft Interpretation? If not, why and what alternative do you propose?

EFRAG's response

EFRAG agrees with the scope of the draft Interpretation focused on uncertainties over income tax treatments. This is not explicitly addressed by IAS 12 and diversity in practice exists. EFRAG also notes that uncertain tax positions may arise in business combinations and suggests that the IASB, without affecting finalisation of the Interpretation, considers whether and what changes would be necessary in the relevant Standards.

1 EFRAG observes that currently there is diversity in accounting for uncertain income tax treatments. Some entities apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* where the recognition of assets is based on the 'virtually certain' criterion and liabilities are based on the 'probable' criterion. Other entities apply IAS 12 *Income Taxes* and recognise both uncertain income tax assets and liabilities based on a 'probable' threshold.

2 EFRAG agrees with the scope of the draft Interpretation because it would remove the existing diversity in practice.

3 EFRAG notes that uncertain tax positions may also arise in business combinations. Without affecting finalisation of the Interpretation, EFRAG would like to bring to the IASB's attention that changes may be necessary in the relevant Standards. EFRAG observes that paragraph BC295 of IFRS 3 *Business Combinations* explains that, when developing IFRS 3, IAS 12 was silent on income tax uncertainties and therefore the IASB did not address this issue. The issue of the Interpretation suggests that this might be reconsidered.

Question 2 – When and how the effect of uncertainty over income tax treatments should be included in determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates

The draft Interpretation requires an entity to consider whether it is probable that a taxation authority will accept an uncertain tax treatment, or group of uncertain tax treatments, that it used or plans to use in its income tax filings.

If the entity concludes that it is probable that the taxation authority will accept an uncertain tax treatment, the draft Interpretation requires the entity to determine taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment included in its income tax filings.

If the entity concludes that it is not probable that the taxation authority will accept an uncertain tax treatment, the draft Interpretation requires the entity to use the most likely amount or the expected value in determining taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates. The method used should be the method that the entity concludes will provide the better prediction of the resolution of uncertainty.

Do you agree with the proposal in the draft Interpretation on when and how the effect of uncertainty should be included in the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates? If not, why and what alternative do you propose?

EFRAG's response

EFRAG agrees with the proposal in the draft Interpretation on when and how the effect of uncertainty should be included in the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates. EFRAG considers that the Interpretation would benefit from defining the term 'probable'.

4 EFRAG agrees that the measurement of uncertainty over income tax treatments should reflect the entity's best estimate of the final outcome. That is, EFRAG agrees that:

(a) If the entity concludes that it is probable that the taxation authority will accept an uncertain tax treatment, the entity should determine its taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment included in its income tax filings. This is because the income tax filings provide the best estimate of the impact on tax-related cash flows.

(b) If the entity concludes that it is not probable that the taxation authority will accept an uncertain tax treatment, the entity should use the most likely amount or the expected value in determining taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates. EFRAG notes that this approach is consistent with IFRS 15 *Revenue from Contracts with Customers* and its guidance on estimating variable consideration.

5 In addition, this approach was supported by a majority of respondents to the EFRAG and UK FRC Discussion Paper *Improving the Financial Reporting of Income Tax* (the 'DP'). Among other things, the DP proposed to address recognition and measurement of uncertain tax positions, and asked whether measurement should be based on a 'most likely outcome' approach or a 'probability weighted method'. Respondents generally did not support the probability weighted average as a single measurement basis and argued that management should use its judgment and select the more appropriate measurement basis of tax positions having regard for facts and circumstances.

Question 3 – Whether uncertain tax treatments should be considered collectively

The draft Interpretation requires an entity to use judgement to determine whether each uncertain tax treatment should be considered independently, or whether some uncertain tax treatments should be considered together, in order to determine taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates.

Do you agree with the proposal in the draft Interpretation on the determination of whether uncertain tax treatments should be considered collectively?

If not, why and what alternative do you propose?

EFRAG's response

EFRAG agrees that entities should use judgement to determine whether each uncertain tax treatment should be considered independently, or whether some uncertain tax treatments should be considered on collective basis.

6 EFRAG believes that where disputes with the tax authority in one specific case relate to other uncertain tax positions, the group of uncertain tax treatments should be viewed as a single unit of account. Accounting for similar uncertain positions as separate units of account may not faithfully reflect the manner in which the entity prepares and supports its tax treatments. Similarly, dissimilar uncertain tax treatments should be considered separately to faithfully reflect their dissimilar characteristics.

7 EFRAG agrees that determination of whether each uncertain tax treatment should be considered independently or collectively should be based upon judgement. EFRAG considers that entities are in the best position to make the appropriate judgements based on the criterion that the chosen approach should provide the better prediction of the resolution of uncertainty. This is expected to result in relevant information for the users of financial statements.

Question 4 – Assumptions for taxation authorities' examinations and the effect of changes in facts and circumstances

The draft Interpretation requires an entity to assume that a taxation authority with the right to examine any amounts reported to it will examine those amounts and will have full knowledge of all relevant information when making those examinations.

The draft Interpretation also requires an entity to reassess its judgements and estimates if facts and circumstances change. For example, if an entity concludes that new information indicates that it is no longer probable that the taxation authority will accept an uncertain tax treatment, the entity should reflect this change in its accounting. The expiry of the period in which the taxation authority may examine the amounts reported to it would also be an example of a change in circumstances.

Do you agree with the proposal in the draft Interpretation on the assumptions for taxation authorities' examinations and on changes in facts and circumstances? If not, why and what alternative do you propose?

EFRAG's response

EFRAG observes that IFRS compliant financial reporting is expected to reflect the effects of tax laws and therefore agrees with the assumption that a taxation authority will examine any amounts reported to it and will have full knowledge of all relevant information when making those examinations as long as the rights to examine tax filings continue to exist. EFRAG also agrees with the requirement to consider changes in facts and circumstances and the related guidance.

8 EFRAG observes that IAS 12, paragraph 46 requires that income tax is measured in accordance with current tax laws. The assumption that a taxation authority will examine the uncertain tax treatments and have full knowledge of all relevant information when making those examinations is consistent with this requirement. As a result, the likelihood of whether the taxation authorities will detect a misapplication of the law is not relevant to the preparation of the financial statements.

9 EFRAG recommends that paragraph 13 of the draft Interpretation explicitly states that "IAS 12 requires that income tax is determined based on compliance with tax law". The assumption that a taxation authority will examine the uncertain tax treatments is a consequence of this requirement. EFRAG notes that this is captured indirectly in the second sentence of paragraph 3 of the draft Interpretation. However it could be made explicit in the paragraph dealing with the consequences of the requirement.

10 The requirement for reflecting a change in circumstances and the related guidance about the results of examinations provides a reasonable basis for keeping the judgements and estimates updated in order to reflect new information. This brings relevant information to the users of financial statements for assessment of uncertain tax positions.

Question 5 – Other proposals

Disclosure

The draft Interpretation does not introduce any new disclosure requirements, but highlights the relevance of the existing disclosure requirements in paragraphs 122 and 125–129 of IAS 1 *Presentation of Financial Statements*, paragraph 88 of IAS 12 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Transition

The draft Interpretation requires an entity to apply its requirements by recognising the cumulative effect of initially applying them in retained earnings, or in other appropriate components of equity, at the start of the reporting period in which an entity first applies them, without adjusting comparative information. Full retrospective application is permitted, if an entity can do that without using hindsight.

Do you agree with the proposals in the draft Interpretation on the disclosure and the transition requirements? If not, why and what alternative do you propose?

EFRAG's response

EFRAG agrees with the disclosure guidance which is based on references to the existing disclosure requirements in IAS 1, IAS 12 and IAS 37.

EFRAG also agrees with the limited retrospective application since the area of uncertain tax treatments is highly judgmental and a full retrospective application would carry significant risk of using hindsight.

11 EFRAG considers that the guidance referring to existing disclosure requirements in IAS 1 *Presentation of Financial Statements*, IAS 12 and IAS 37 provides an adequate and appropriate way to address disclosures related to uncertain tax positions.

12 EFRAG suggests that paragraph 10 of the draft Interpretation listing the issues should also refer to disclosure requirements since they are among those issues which are addressed in the draft Interpretation.

13 EFRAG considers that the area of uncertain tax treatments is highly judgmental and a full retrospective application would carry a significant risk of using hindsight. Therefore, EFRAG agrees with the proposal that the comparative period(s) does not have to be restated and the initial cumulative effect of applying the requirements should be recognised in retained earnings, or in other appropriate components of equity, at the start of the reporting period in which an entity first applies the Interpretation. EFRAG also agrees with the draft Interpretation permitting full retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* if this information is available without the use of hindsight.