EFRAG
European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 13 January 2016 to commentletters@efrag.org

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

[Date]

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 IASB'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.

If you would like to discuss our comments further, please do not hesitate to contact Patricia McBride, 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?

Notes to constituents

1 *It may be unclear how a specific requirement of the tax law applies to a particular transaction or circumstance. The acceptability of a particular tax treatment under the tax law might depend on the decisions taken by the relevant taxation authority or a court in future. Consequently, the outcome of examinations of a particular tax treatment by the relevant taxation authority or the outcome of a dispute may affect the entity's accounting for a current or deferred tax liability or asset. For example, the taxable profit (tax loss) for the particular period may be affected by the results of a tax examination or dispute, the results of which are uncertain at the end of the entity's reporting period.*

2 *When there is uncertainty over whether the taxation authority will accept a specific tax treatment under the tax law, that tax treatment is an uncertain tax treatment. An entity's decision not to submit any tax filing in one tax jurisdiction or not to include specific income in taxable profits would also be an uncertain tax treatment, if the acceptability is unclear under the tax law.*

3 *The Interpretations Committee received a request for clarification of the recognition of a current tax asset, in the situation in which tax laws require an entity to make an immediate payment when a tax examination results in an additional charge but an entity intends to appeal against the additional charge.*

4 *The Interpretations Committee decided that it should not limit the scope of the draft Interpretation to any specific situation, for example when an entity has unresolved disputes with a taxation authority. This is because attempting to limit the scope to specific situations would lead to an arbitrary rule.*

EFRAG's response

EFRAG agrees with the scope of the draft Interpretation focused on uncertainties over income taxes treatments. This is not explicitly addressed by IAS 12 and diversity in practice exists.

5 EFRAG observes that currently there is diversity in accounting for uncertain 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 tax assets and liabilities based on a 'probable' threshold.

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

Request for inputs from constituents

7 EFRAG observes that the proposed requirements may create an inconsistency between accounting for uncertainties in income tax treatments and accounting for uncertainties relating to other types of tax and similar positions.

8 EFRAG is seeking constituents' views on whether this potential inconsistency should be addressed through a separate Appendix to this draft comment letter. The outcome of this consultation will not be part of the final comment letter.

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?

Notes to constituents

9 *The issue is summarised in the first three paragraphs of the question above.*

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.

10 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. The method used should be the method that the entity concludes will provide the better prediction of the resolution of the uncertainty. Further, this approach is consistent with IFRS 15 *Revenue from Contracts with Customers* and its guidance on estimating variable consideration.

11 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 tax positions should be measured in accordance with management's best estimate.

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?

Notes to constituents

12 *The Interpretations Committee noted that the recognition and measurement of a current tax liability or asset could be affected by whether each uncertainty is considered individually or on a combined basis (i.e. whether the uncertainties form a single unit of account).*

13 *An entity would consider uncertain tax treatments together as a group (i.e. as a single unit of account) when doing so better reflects the manner in which the entity prepares and supports tax treatments or when collective assessment is consistent with the approach that the entity expects the taxation authority to take during an examination, or both.*

14 *An entity shall determine whether each uncertain tax treatment should be considered separately or in a group based on which approach provides a better prediction of the resolution of the uncertainty.*

15 *Illustrative example 2 of the draft Interpretation mentions a case of Entity B whose tax filings included a number of deductions related to transfer pricing. The taxation authority may challenge those tax treatments. This would mean that the taxation authority's treatment of one transfer pricing matter would affect, or be affected by, the other transfer pricing matters. As a result Entity B determines that the tax treatments should be considered collectively, because it concludes that this will provide the best prediction of the resolution of the uncertainty.*

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.

16 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 it tax treatments. Similarly, dissimilar uncertain tax treatments should be considered separately to faithfully reflect their dissimilar characteristics.

17 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?

Notes to constituents

18 *Appendix A deals with time limits on taxation authorities' rights for examinations. When these rights expire an entity shall reflect this change in circumstances. Appendix A includes additional guidance about the results of examination(s) by taxation authorities before their rights expire. The draft guidance suggests that:*

(a) *If the authorities continue to have the right to (re-)examine the amounts even after an examination(s) an entity shall continue to assume that the taxation authorities will (re-)examine any amounts and will have full knowledge of all relevant information;*

(b) *The results of examination(s) are new facts and circumstances which may affect an entity's conclusion. This would include information about the taxation authority has challenged a similar tax treatment;*

(c) *Explicit acceptance by a taxation authority of an entity's tax treatment during an examination for a specific period is a new fact that may affect similar tax treatments for other periods; and*

(d) *Implicit acceptance by a taxation authority (e.g. review of entity's tax filings) is a new fact for the tax treatments within the scope of the examination but not necessarily for tax treatments outside the scope.*

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.

19 EFRAG observes that IAS 12.46 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 principle.

20 EFRAG suggests that paragraph 13 of the draft Interpretation explicitly states that "IAS 12 is based on the principle 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 principle. As a result, whether the taxation authorities will or will not detect a misapplication of the law is not relevant to the preparation of the financial statements. EFRAG notes that the principle 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 principle.

21 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?

Notes to constituents

22 *The issue is summarised in the question above.*

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.

23 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.

24 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.

Appendix to the EFRAG's Draft Comment Letter – Request for Inputs from constituents on potential inconsistencies in the treatment of uncertainties related to taxes and similar transactions

Note to constituents

25 *This Appendix will not be part of the final comment letter. EFRAG will consider whether and how to address the issue after receiving the inputs from constituents.*

Background

26 Assuming the Interpretation is issued as drafted, uncertainties related to income taxes will be within its scope. Uncertainties related to other taxes (for example VAT) or similar uncertain positions (such as advance payments for penalties in antitrust litigation) will not be covered by the Interpretation.

27 EFRAG considers that different treatments may mainly arise in the area of uncertain *asset* positions.

(a) For uncertain **income tax** treatments the 'probable' recognition threshold as required by the Interpretation would apply.

(b) For uncertain positions **not related to income taxes** the treatment may not be clear. At least two views have been identified:

(i) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be applied to those provisions and contingencies which are not covered by another standard. Paragraph 33 of IAS 37 uses a 'virtually certain' threshold for recognition of contingent assets which is higher than the 'probable' recognition threshold in the Interpretation.

(ii) An uncertain position would not meet definition of a contingent asset in IAS 37. An uncertain position may be a net position of a payment and a potential obligation and the uncertainty relates only to the obligation. Such a treatment would be consistent with the requirements in the Interpretation.

28 The issue seems to be less of a concern in those cases where a *liability* is assessed for recognition. In these cases, entities would normally apply a 'probable' recognition threshold either by following IAS 37 or the Interpretation.

Request for inputs from constituents

29 EFRAG seeks inputs from constituents on whether they have concerns with the potential inconsistency in the recognition of uncertainties related to income taxes on the one hand and the uncertainties relating to other taxes and similar transactions on the other. Please explain how you account for these uncertainties at present, what IFRS you apply, and on this basis, your views on the outcome of the Interpretation.