CFOFORUM

The European Insurance CFO Forum
C/O Dieter Wemmer
Zurich Financial Services Ltd
Mythenquai 2
CH-8002 Zurich
Switzerland

Mr Robert Garnett
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

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Dear Mr Garnett,

IAS 12 Income Taxes – Recognising DTA's for unrealised losses on AFS debt securities

Thank you for providing us the opportunity to meet with IFRIC and IASB Staff ("the Staff") on 18 August 2010 to further explain the comments in our letters of 11 June and 2 August 2010 on the above subject. In that meeting, representatives of our Forum explained some practical examples showing how unrealised gains and losses on AFS debt securities arise and reverse and explained the circumstances under which we believe it is appropriate to record a deferred tax asset (DTA) for such unrealised losses. We also appreciated being able to discuss with the Staff the specific fact pattern which was presented to IFRIC, how certain aspects of it differ from the facts faced by other companies, the distinctions between capital gains and ordinary income in the US, how these issues are interpreted and treated under US GAAP (by both the FASB and the SEC) and why we believe that the recommended agenda rejection wording creates unforeseen interpretative issues. Finally, we were able to illustrate that the alternative view, which was tentatively rejected by IFRIC, is widespread in practice, and accepted by auditors, and that, therefore, the recommended agenda rejection may have significant unforeseen impact on published financial statements. In our discussions with the Staff, we agreed on submitting this letter, with the objective to summarise the key points that we have discussed with the Staff, so that these may be shared with IFRIC Board members in order to enable them to consider an appropriate course of action to address the issue raised.

Temporary differences on AFS debt securities

Debt securities classified as Available for Sale (AFS) under IAS 39 generate during their holding period unrealised gains and/or losses due to market movements, which are accounted for in the revaluation reserve in equity. As long as the investment is not impaired (i.e. the investor expects to recover all contractual cash flows when due), these unrealised gains and losses reverse due to the passage of time and at the maturity date the fair value of the investment will equal its amortised cost value. Unrealised gains and losses arising during the holding period are not recognised in the P&L. In accordance with IAS 12, the unrealised gains and losses must be regarded as taxable temporary differences (TTD) and deductible temporary differences (DTD), respectively, on which a deferred tax liability (DTL) or DTA exists.

It is noteworthy that if a debt security, with an unrealised loss due to a decline in market price as a result of interest rate changes was classified as Held to Maturity ("HtM") under IAS 39, the asset would be measured at amortised cost and there would be no recognition of the unrealised loss and no corresponding DTA. Insurance companies often hold debt securities to maturity (or earlier recovery); however they do not make the formal election to treat these assets as HtM in order to avoid the harsh tainting rules under IAS 39. Therefore, although these assets are generally held to maturity or recovery, resulting in no realised losses incurred, the accounting requirements within IFRS lead to a DTD (and a potentially recognisable DTA).

US tax rules - capital versus ordinary income and loss

In the above analysis, as long as the company holds a debt security which is not impaired, it generates income (and cash flows) which is subject to income tax. The investment, just like any other asset, generates taxable income. However, in certain jurisdictions like the US, this stream of "ordinary" income cannot be offset by losses on investment assets which are "capital" in nature. As a result, unlike the specific fact pattern of the requestor as included in the Agenda Papers, many companies are currently generating taxable income and paying tax even though they hold AFS securities in an unrealised loss position.

Under the US tax rules, unrealised capital gains/losses are not taxable, and, therefore, not recognised for tax return purposes. A sale transaction converts an unrealised capital gain/loss into a realised capital gain/loss which is reported in the P&L and on the US tax return. It is only at this point in time that realised capital losses face conditions on their realisability – for example, capability of being offset against realised capital gains or face expiry due to limitations on carrybacks or carryforwards. A realised capital loss in the US may only be offset against realised capital gains, and cannot be offset against ordinary income. A net realised capital loss (that is, net of capital gains realised in the same year) can be carried back 3 years to offset prior realised capital gains or carried forward for 5 years to offset future realised capital gains, after which the loss expires if unutilised. If a net realised capital loss is carried forward, it results in the potential recognition of a DTA for IFRS reporting purposes and a company thus needs unrealised capital gains, a tax planning opportunity or future realised capital gains in order to satisfy the probability criterion for the recognition of a DTA for a net realised capital loss carryforward.

Guidance available within IAS 12

IAS 12 requires a company to satisfy the probability criterion when assessing whether a DTA should be recorded or not. Under this criterion, a company can record a DTA for a DTD only to the extent it can show that it is probable (more likely than not) that taxable profit will be available against which the DTD can be utilised.

IAS 12 goes on to explain that "probable that taxable profits will be available" can happen pursuant to the following three principles:

- when there are sufficient TTD's relating to the same taxation authority and the same taxable entity which are expected to reverse in the same period as the expected reversal of the DTD or in periods into which a tax loss arising from the DTA can be carried back or carried forward;
- when there is sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the DTD (or in periods into which a tax loss arising from the DTA can be carried back or carried forward);
- when tax planning opportunities are available that will create taxable profit in appropriate periods.

A loss making entity must further demonstrate by convincing evidence that it can generate income in future periods which would utilise the DTA.

IAS 12 addresses the accounting of deferred taxes for revalued assets like property, plant and equipment; however, there is no negative revaluation reserve (and thus no DTD) involved for such assets. This could be because at the time IAS 12 was written, IAS 39 and the concept of negative revaluation reserves (with a corresponding DTD) did not yet exist. When IAS 39 was issued, IAS 12 was amended to reflect that movements in the revaluation reserve give rise to TTD's and DTD's. However, before the financial crisis that started in 2008, few companies envisaged a situation where they would have a net negative revaluation reserve with a corresponding net DTD in relation to items of a capital nature which had to be assessed for recoverability.

This seems to be the reason why all the above principles in IAS 12 assume that only income subject to tax would utilise a DTA (be it either ordinary or capital in nature) and if an entity has a net DTA and inadequate taxable income to utilise the DTA, only the existence of viable tax planning opportunities will enable the utilisation of the net DTA's. In none of the above principles was a solution considered should the generation of taxable income not be a precluding condition to the utilisation (reversal) of the DTA. In the case of AFS investments where a DTA is recorded for unrealised losses, the generation of taxable revenue income will not enable the company to utilise (or reverse) the unrealised losses. Only the passage of time and market movements in the fair value enable the utilisation (reversal) of the DTA's.

Similarly, IAS 12 appears to have been written with DTA's established through the P&L in mind and not with respect to unrealised losses which have neither gone through P&L nor been realised for tax purposes. DTA's typically relate to tax deductible amounts that will be realised for tax purposes in years subsequent to the years in which they are reported for IFRS accounting purposes. However, this typical situation does not exist with respect to DTA's related to unrealised losses where a decrease in value of an AFS financial instrument continues to be recorded as an unrealised loss in the revaluation reserve and there is no impact to the IFRS P&L unless objective evidence exists that the asset is impaired.

This difference causes the literal interpretation of IAS 12 to defy logic. That is, following the literal interpretation of IAS 12 would require the reporting entity to show that it is probable that it will earn taxable profit against which DTD's related to unrealised losses in equity can be offset (which again is logical if the reversal of those DTD's were to generate deductions in determining taxable profits in future periods). However, if the reporting entity simply held the securities to maturity (or recovery prior to maturity), the DTD's will never impact IFRS or taxable profits in future time periods. Only if there is objective evidence of impairment will the loss impact the IFRS P&L, and in the case of an AFS debt security in an unrealised loss that objective evidence simply does not exist. As a result, it is not logical to require the reporting entity to show probable evidence of future taxable profits to recognise the DTA's related to unrealised losses reported in equity.

Assessment of temporary differences – discrete versus combined

IAS 12 requires taxes in the same entity and for the same tax jurisdiction to be presented net. Consistent with this line of reasoning, when assessing whether a potential net DTA meets the probability criterion for recognition, all temporary differences are combined as part of the assessment. There is no explicit requirement within IAS 12 to separate capital and ordinary items, despite the fact that there are tax laws in some jurisdictions which limit the ability of a company to offset capital losses against ordinary income. This may be a reason why different companies have interpreted the requirements of IAS 12 (and similar requirements in US GAAP) differently. That is, some companies evaluate temporary differences for capital items separate from ordinary items. Other companies combine the capital and ordinary items when assessing whether or not to recognise a DTA.

Depending on which approach is adopted impacts the net DTA and consequently the recognition criteria of whether a DTA can be recognised or not.

Tax planning techniques

Many companies in the financial industry, especially insurers, carry a portfolio of debt securities that is classified as AFS. Not all investments are held to maturity, since companies may choose to sell investments occasionally to rebalance their portfolios, for ALM purposes or to manage other risks (for example, counterparty, industry/sector, and market risks like currency and interest rates). Companies may also sell investments to manage their tax positions.

An example: a company holding a large portfolio of AFS debt securities may be in either a net unrealised gain or a net unrealised loss position; however, each individual security has an unrealised gain or loss. If a security with an unrealised gain is sold, the company may also choose to sell other securities with unrealised losses so as to neutralise the net realised capital gain and thus manage the company's liability for taxes on capital gains. Or, a company may have a balance of realised capital losses (which have a carryforward life of 5 years in the US, after considering the possibility to carry back those losses for 3 years to offset previously taxed realised gains). If these realised losses are approaching the end of their carryforward life, the company could sell debt securities with an unrealised gain so as to generate realised gains to offset the losses before they expire. Alternatively, a company may have debt securities with unrealised capital losses that it decides to sell to realise losses to carry back to recover capital gains taxes paid in the prior three years. Tax planning strategies to recognise DTA's are thus not just hypothetical in nature for accounting purposes, but may in fact be executed upon for companies to manage their tax positions.

Many companies view their ability to control the timing of when they hold and sell investments as a tax planning strategy. To the extent that the sale of a security with an unrealised gain generates a taxable capital gain, the company's technique meets the strict literal definition of a tax planning opportunity in IAS 12. However, there are other techniques available to the company which do not create or increase taxable income but rather avoid taxes that would otherwise be payable. We believe that these equally represent an effective tax planning strategies and, therefore, equally meet the principle of IAS 12 even though they do not meet the definition of a "tax planning strategy" under a strict literal reading of the standard.

Providing users with relevant information on expected cash flows

We understand from our discussions that the Committee's tentative agenda decision follows the principle that DTA's and DTL's should be assessed based on the assumption that the entity could expect to recover or settle the carrying amount of the asset or liability at the balance sheet date. In such reasoning one could argue that a DTA related to unrealised losses on AFS securities usually never results in the receipt of cash and, therefore, should not be recorded. In this respect, we discussed the following example in our August meeting:

A company owns a portfolio of AFS debt securities with a cost basis (ignoring premiums, discounts and fees) of 1000. Current fair value is 900, resulting in an unrealised loss of 100. If the applicable tax rate is 30%, the company should evaluate whether it can recognise a DTA of 30. Although the company is profitable and in a tax paying position, tax laws do not allow offsetting operating profits with capital losses. The company also does not have any prior realised capital gains in the carryback period or unrealised gains.

We understand that the Committee's tentative agenda decision reflected a view that a DTA should not be recognised in this situation because, based on the assumption that the entity could expect to recover or settle the carrying amount of the AFS asset at the balance sheet date, it would record an asset that will never actually be received and, thus, would not result in relevant information for users that are interested in information on future cash flows. We discussed that we respectfully disagree with this view. In most cases, an entity would never sell the securities if it were not able to realise the tax benefit. Therefore, the company may either sell the assets if it is confident that it can realise the tax benefit (i.e. the company is confident that it will realise 930 of cash flows) or the company may hold the securities until recovery/maturity (i.e. the company is confident that it will realise 1000 of cash flows). The Committee's tentative agenda decision would result in recognising assets for an amount of 900, which does not represent the expected cash flows in either case.

Furthermore, we discussed that a consistent approach in following the Committee's tentative agenda decision would result in not recognising similar DTL's on unrealised gains because an entity may never actually expect to pay cash to settle such DTL's. Similarly, we wonder if settlement at the balance sheet date should be the overriding criterion for recognising a DTA since most tax planning opportunities would also not result in the receipt of cash on the balance sheet date.

Convergence between IFRS and US GAAP

As noted in the Staff's Agenda Paper, there was a belief that the requirements in US GAAP should be considered as similar issues have been discussed in that context and one of the objectives of the IASB in accounting for income taxes is convergence with US GAAP. In the Agenda Paper, it was noted that the proposed recommendation ("View 2") is consistent with recent decisions taken by the FASB and, consequently, that maintaining the current guidance in IAS 12 based on View 2 will avoid divergence with US GAAP on this issue. We respectfully disagree that the view expressed is entirely consistent with recent decisions by the FASB.

The similar FASB discussion was based on "View B" (as described in a letter from 2009 by one of its constituents), which included the following two items:

- A component of the DTA related to the tax effect of unrealised losses on AFS debt securities should not be discretely considered; and
- The ability and intent to hold the securities to maturity rather than selling them at a loss implies a source of future taxable income, but it cannot be considered in isolation. Rather, taxable income must be considered in the context of all sources of taxable income and would need to prove an incremental source of income for the realisation of a DTA. For example, if the effect of holding the security would be to simply reduce future operating losses, it would not result in the realisation of the DTA and therefore would not provide sufficient evidence that a valuation allowance is not necessary.

This View B was accepted by the SEC staff. We believe that the view expressed in the Agenda Papers is consistent with the first item above, but *not* with respect to the second item.

The Staff's July's Agenda Paper states that divergence with US GAAP would be temporary because the proposed guidance under US GAAP is consistent with the approach in the Committee's tentative agenda decision in May 2010. We again respectfully disagree as the inconsistency with respect to the second item did not change with the FASB's tentative decision in March 2010 when it decided that the DTA on AFS debt instruments should be evaluated in combination with other DTA's of an entity. The minutes of that meeting and the board meeting handout focused exclusively on the question whether the assessment should be done discretely from other DTA's or in combination with other DTA's of an entity. FASB's conclusion that DTA's must be considered in combination with other DTA's of the reporting entity is not fully consistent with the broader conclusion that was reached.

We believe that in reaching its tentative agenda decision, the focus was almost exclusively on IAS 12.30, which, when read literally, requires a tax planning opportunity to create or increase taxable income. It should be noted, however, that IAS 12.29(a) provides that a DTA is also recognised to the extent that it is probable that the entity will have sufficient taxable profit. This criterion in IAS 12.29(a) is consistent with ASC 740-10-30-18 which provides that future taxable income is another source of taxable income exclusive of tax-planning strategies. In accepting View B, the SEC staff has accepted that the ability and intent to hold the securities to maturity implies a source of future taxable income. If this ability and intent is an incremental source of taxable income in the context of all sources of taxable income then the DTA can be realised. We believe that that this is also the case under IAS 12.29(a) and should be made clear.

Timing / relevance of this issue

We have explained in our meeting that "View 1" as expressed in the Agenda Papers (which is proposed to be rejected by IFRIC) is widespread in practice, applied by many companies both in Europe (under IFRS) and in the US (under US GAAP). Companies have applied this view because they believe there are strong arguments to support the technical merit of View 1. Given that IAS 12 is unclear in addressing this issue, several audit firms have accepted this accounting interpretation.

Interestingly, most companies' net unrealised losses on AFS debt securities arose in 2008 as a direct result of the financial crisis and the accompanying significant movement in market interest rates (due to increasing liquidity spreads). As interest rates have decreased again during 2009 and 2010, most of these net unrealised loss positions have significantly decreased or reversed and in some cases have even been replaced by net unrealised gains. The proposed IFRIC agenda decision will require companies to change their accounting policies and restate only the comparative financial information (equity and DTA balances, without any P&L impact) despite the fact that the impact on the current 2010 balance sheet is negligible. This, in our view, only confuses users of financial statements.

Conclusion

In our meeting, we informed the Staff that the issue is more complex than the original fact pattern and the Agenda Papers originally assumed. Furthermore, we noted that there is clear divergence in practice and that the proposed agenda decision would have a significant impact on several companies and their audited financial statements. Although we understand how the proposed agenda decision was arrived at through a literal interpretation of IAS 12, we also believed that, from a conceptual point of view, the alternative interpretation applied by several companies does properly reflect economic substance. Finally, we informed the Staff that the issue of convergence with US GAAP is more complex and dependent on the final direction of the FASB, and is not achieved solely by the proposed agenda decision.

As a result, we suggested that it may be beneficial to explore alternative processes, other than finalising the agenda decision as proposed. Alternatives that were discussed include:

- deferring the agenda decision until all aspects of the issue have been fully explored
- clarifying or amending IAS 12 as part of the annual improvements project
- adding the issue to the IFRIC agenda in order to arrive at a formal IFRIC interpretation

Each of these would allow, under appropriate due process, resolution of the current divergence in practice and allow adding explanatory language that, whilst the mere holding of investments to maturity is not a tax planning opportunity under IAS 12, the intent and ability to control the timing of realisation of DTD's and TTD's could satisfy the probability criteria under IAS 12 to recognise a DTA.

Finally, we would like to thank you again for the constructive dialogue and, as we explained in our meeting, we are fully committed to work together with the Staff to resolve this important issue and are available for further questions and discussions.

Yours sincerely

Dieter Wemmer
Chairman – CFO Forum

cc. Sir David Tweedie (IASB)