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STAFF PAPER

March 2014

IFRS Interpretations Committee Meeting

Sep and Nov 2011, May 2012

Project	**IFRS Interpretations Committee work in progress**		
Paper topic	IAS 12 *Income Taxes*—Recognition of deferred tax for a single asset in a corporate wrapper—Cover note: background information, project status and analysis of concerns raised		

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26. Sitzung IFRS-FA am 29.04.14
26_10b_IFRS-FA_Interpret_IAS12

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify the accounting for deferred tax in the consolidated financial statements of the parent, when the subsidiary has only one single asset within it (the asset inside) and the parent expects to recover the carrying amount of the asset inside by selling the shares in the subsidiary (the shares).

2. The Interpretations Committee noted significant diversity in practice in accounting for deferred tax when tax law attributes separate tax bases to the asset inside, and the parent's investment in the shares and each tax base is separately deductible for tax purposes (ie tax law considers the asset inside and the parent's investment in the shares to be two separate assets):

   (a) some follow the tax perspective and recognise deferred tax related to both the asset inside and the shares; while

   (b) others recognise only the deferred tax related to the shares.

   (c) A third group of preparers determines deferred tax by comparing the carrying amount (in the consolidated financial statements) of the asset inside with the tax base of the shares, and using the tax rate that applies if the parent recovers the carrying amount of the shares.

3. The Interpretations Committee discussed the issues at three meetings and noted that the current IAS 12 requires the parent to recognise both the deferred tax related to the asset inside and the deferred tax related to the shares, if tax law considers the asset inside, and the shares, to be two separate assets (see paragraph 2(a) of this Staff Paper).

4. Considering however the concerns raised by commentators during the project and in particular on the tentative agenda decision published in the IFRIC Update[1] on this issue, the Interpretations Committee decided at the last of these three meetings[2] to explore options to address this issue that would result in a different accounting for this specific type of transaction.

5. The Interpretations Committee noted that such amendments would be more than simply clarifying or correcting in nature and would therefore be beyond the scope of the Annual Improvements project. However, targeted narrow-scope amendments to IAS 12 could be developed by the Interpretations Committee in consultation with the IASB as separate amendments to IAS 12 (limited scope project to amend IAS 12).

6. Consequently, the staff analysed whether the requirements of IAS 12 should be amended in a limited scope project to amend IAS 12 in response to the concerns raised by commentators and consulted IASB members at various meetings in December 2013 to obtain their individual views on possible amendments to the principles in IAS 12.

Objective of Staff Papers

7. The objective of Staff Papers 3 and 3A is to analyse whether IAS 12 should be amended in a limited scope project that the Interpretations Committee does on behalf of the IASB in order to address concerns raised by commentators.

8. In this context, we have drawn on feedback from IASB members when developing our proposals.

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[1] http://www.ifrs.org/Updates/IFRIC-Updates/2011/Documents/IFRICUpdateSept11.pdf

[2] http://www.ifrs.org/Updates/IFRIC-Updates/Documents/IFRICUpdateMay12.pdf

Structure of Staff Papers 3 and 3A

9. Staff Paper 3 therefore:

   (a) gives background information on the issue;

   (b) summarises the IAS 12 analysis of the Interpretations Committee;

   (c) summarises the status of the project;

   (d) analyses the concerns raised by commentators in the course of the project; and

   (e) asks a question to the Interpretations Committee.

10. In addition, Staff Paper 3A:

    (a) reproduces the alternative proposals that we developed and discussed as part of the consultation with the IASB members;

    (b) summarises the feedback from consultations with IASB members in December 2013;

    (c) makes a staff recommendation; and

    (d) asks questions to the Interpretations Committee.

Background information

11. We understand that the issue raised in the submission does not arise only in the investment property sector. However, the issue is prevalent in the investment property sector and by far most of the cases are observed in this sector.

12. Most of these cases share the following characteristics:

    (a) The investment properties held by the subsidiaries are usually measured at fair value in the consolidated financial statements of the parent.

    (b) The parent and the subsidiary are two separate tax entities and file separate tax returns.

    (c) Tax law allocates separate tax bases to the investment property held by the subsidiary and to the shares held by the parent.

(d) The subsidiary's tax base of the investment property is depreciated cost.

(e) The parent holds the investment properties in subsidiaries in order to limit its liability or because it is tax-beneficial. For example, the tax arising on the sale of the shares is lower than the tax arising on the sale of the investment property itself.

(f) The parent focuses on operating and developing investment properties, eg by renting and marketing them. Investment properties are sold but only in the case of a favourable opportunity. Consequently, acquisitions and resales of investment properties in the short term by this type of parent do occur, but they are not usual.

Analysis of the Interpretations Committee

13. At its meetings in September[3] and November 2011[4] and in May 2012,[5] the Interpretations Committee noted that the parent must recognise in the consolidated financial statements the deferred tax related to the asset inside its shares in the subsidiary, if no specific exception applies.

14. This analysis is based on the following requirements in IAS 12:

(a) If no specific exception applies, deferred tax liabilities are recognised for all taxable temporary differences (see paragraph 15 of IAS 12).

(b) If no specific exception applies, deferred tax assets are recognised for all deductible temporary differences for which it is probable that they can be utilised (see paragraph 24 of IAS 12).

(c) Because the parent and the subsidiary file separate tax returns and tax law allocates separate tax bases to the asset inside and to the shares in the subsidiary:

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[3] http://www.ifrs.org/Updates/IFRIC-Updates/2011/Documents/IFRICUpdateSept11.pdf

[4] http://www.ifrs.org/Updates/IFRIC-Updates/2011/Documents/IFRICUpdateNov11.pdf

[5] http://www.ifrs.org/Updates/IFRIC-Updates/Documents/IFRICUpdateMay12.pdf

(i) The temporary difference related to the investment property held by the subsidiary is determined by comparing the carrying amount of the investment property in the consolidated financial statements of the parent with the tax base that is deductible for the investment property in the subsidiary's tax return (see paragraph 11 of IAS 12).

(ii) The temporary difference related to the shares in the subsidiary is determined by comparing the parent's share of the net assets of the subsidiary in the consolidated financial statements with the tax base that is deductible for the shares in the parent's tax return (see paragraph 38 of IAS 12).

(d) Accounting for deferred taxes distinguishes between recognition and measurement of deferred taxes:

(i) The recognition of deferred taxes in based on the assumption that the entity recovers the carrying amount of an asset (see *Objective* of IAS 12 and paragraphs 15, 16 and 24 of IAS 12).

(ii) The measurement of deferred taxes takes into consideration the expected manner of recovery, if tax law makes reference to the manner of recovery (see paragraphs 51 and 51A of IAS 12).

In other words, an entity recognises deferred taxes based on the assumption that it recovers the carrying amount of both the asset inside and the shares. If, in this situation, tax law leads to different results depending on the manner of recovery, the entity measures deferred tax using the tax rate and the tax base that result from the entity's expectation of the manner of recovery.

15. The accounting required by IAS 12, as identified by the Interpretations Committee, is illustrated in Appendix A to Staff Paper 3A.

Project status

September 2011

16. The Interpretations Committee discussed this issue for the first time at its meeting in September 2011 (see Staff Paper 13 presented at the September 2011 Interpretations Committee meeting[6]) and noted that IAS 12 requires the parent to recognise both the deferred tax related to the asset inside and the deferred tax related to the shares in the subsidiary, if tax law considers the asset inside and the shares to be two separate assets and if no specific exceptions in IAS 12 apply.

17. Furthermore, the Interpretations Committee thought that the requirements in IAS 12 in respect of this issue are clear. Accordingly, it decided not to add the issue to its agenda and published a tentative agenda decision.

November 2011

18. At its meeting in November 2011, the Interpretations Committee analysed the comments that it had received on the tentative agenda decision (see Staff Paper 4B presented at the November 2011 Interpretations Committee meeting[7]).

19. It confirmed its conclusion that IAS 12 requires the parent to recognise both the deferred tax related to the asset inside and the deferred tax related to the shares in the subsidiary, if tax law considers the asset inside and the shares to be two separate assets and if no specific exceptions in IAS 12 apply.

20. Furthermore, the Interpretations Committee observed that there is diversity in practice with respect to the recognition of the deferred tax relating to the asset inside.

21. It withdrew the tentative agenda decision that it had reached in the September 2011 meeting and asked the staff to do further analysis on the issue, with the aim of assessing whether the issue could be clarified through an annual improvement.

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[6] http://www.ifrs.org/Meetings/Documents/IFRICSep11/131109AP13IAS12corporatewrapper.pdf

[7] http://www.ifrs.org/Meetings/Documents/041111AP4B_IAS12.pdf

May 2012

22. The staff presented further analysis and a draft annual improvement at the Interpretations Committee meeting in May 2012 (see Staff Paper 8 presented at the May 2012 Interpretations Committee meeting[8]).

23. At this meeting, the Interpretations Committee confirmed its conclusion that IAS 12 requires the parent to recognise both the deferred tax related to the asset inside and the deferred tax related to the shares in the subsidiary, if tax law considers the asset inside and the shares to be two separate assets and if no specific exceptions in IAS 12 apply.

24. Considering however the concerns raised by commentators in respect of these requirements in IAS 12, the Interpretations Committee decided not to recommend an Annual Improvement to the IASB in this meeting but to explore further options to address this issue that would result in a different accounting for this specific type of transaction.

25. Consequently, the Interpretations Committee asked the staff to analyse whether the requirements of IAS 12 should be amended in response to the concerns raised by commentators. The Interpretations Committee noted that such amendments would be more than simply clarifying or correcting in nature and would therefore be beyond the scope of the Annual Improvements project.

26. However, targeted narrow-scope amendments to IAS 12 could be developed by the Interpretations Committee in consultation with the IASB as separate amendments to IAS 12.

27. The Interpretations Committee asked the staff to present such an analysis, including a recommendation, in a future meeting of the Interpretations Committee.

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8 http://www.ifrs.org/Meetings/Documents/081205AP08IAS12Recognitionofdeferredtaxforasingleassetinacorporateentity.pdf

Staff analysis of concerns raised

Concerns raised

28. The Interpretations Committee asked us to analyse whether the principles in IAS 12 should be amended to address the concerns raised by commentators during the project and in particular on the tentative agenda decision published in the September 2011 IFRIC Update on this issue.

29. We noted that commentators raised the following concerns on the requirements in IAS 12 in the course of the project:

    (a) **Concern 1 (liability will never result in tax payments):** recognising deferred tax liabilities related to the asset inside will result in the recognition of liabilities that will never result in tax payments (by the parent's group). This is because the investment in the asset inside will not be recovered through the sale of the asset inside by the subsidiary. Instead, it will be recovered through the sale of the shares in the subsidiary by the parent.

    (b) **Concern 2 (reflect management intention):** The determination of the tax base (ie the tax base of the asset inside or the shares) should reflect management intent because management will act in the most economically advantageous way under normal circumstances.

    (c) **Concern 3 (in substance the same):** distinguishing between the asset inside and the shares in the entity does not reflect the commercial substance of the investment. The asset inside and the 'corporate wrapper' are, in substance, the same. The single asset entity only exists for tax reasons or to limit the liability of the parent.

30. We analysed these concerns and came to the following conclusions.

Concern 1 (liability will never result in tax payments)

31. Several commentators were concerned that recognising deferred tax liabilities related to the asset inside will result in the recognition of liabilities that will never

result in tax payments (by the parent's group). This is because the investment in the asset inside will not be recovered through the sale of the asset inside by the subsidiary. Instead, it will be recovered through the sale of the shares in the subsidiary by the parent.

Conflict with guidance in IFRSs

32. We think that an accounting that responds to this concern would conflict with the consolidation requirements in paragraph B86 of IFRS 10 *Consolidated Financial Statements.*

33. This is because paragraph B86(a) of IFRS 10 requires the combination of like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.

34. In the fact pattern that is addressed in this Staff Paper, the deferred tax liability related to the asset inside is one of the liabilities of the subsidiary and is therefore combined with like liabilities of the parent and the other subsidiaries of the group.

35. Furthermore, the single asset entity (ie the subsidiary) expects that a deferred tax liability related to the asset inside will result in tax payments, because it is usually established to host the asset inside for its economic life.

36. Only from its parent's perspective might (parts of) the deferred tax liability never result in tax payments because the subsidiary leaves the group before (parts of) the tax become due.

37. Consequently, the commentators' argument reflects the view that only liabilities that will result in payments while the subsidiary is part of the group are liabilities in the consolidated financial statements. We refer to this approach as the 'parent concept'.

38. However, the parent concept is not the concept that underlies IFRS 10. This is because paragraphs B86 and following of IFRS 10 do not include an elimination requirement for liabilities that will result in payments after the subsidiary has left the group. The concept underlying IFRS 10 is very often referred to as the 'entity concept'.

Should the principle be amended?

39. We think that the principles in paragraphs B86 and following of IFRS 10 should not be amended to respond to the concern raised.

40. Liabilities of the subsidiary that will be paid or settled by the subsidiary after it has left the group should be included in the consolidated financial statements of the parent.

41. Otherwise, we think that the consolidated financial statements would not reflect the financial position of the group correctly.

42. This may be illustrated by a subsidiary that must repay bank borrowing in ten years' time. If is probable that the parent will sell all of the shares in the subsidiary within the next five years, we think that the parent should continue to recognise the liability of the subsidiary to the bank in its financial statements. Even if the liability will not result in a cash outflow from the group, the liability will affect the consideration that the parent will receive for the shares in the subsidiary.

43. We think this is the same in the case of the deferred tax liability related to the asset inside. The deferred tax liability related to the asset inside represents future tax payments that result from achieving taxable inflows of economic benefits by using the asset inside. These tax payments affect the value of the shares in the subsidiary.

Consistent assumptions

44. Finally, the assumption that the deferred tax liability related to the asset inside will never result in tax payments is only correct if the parent immediately resells the shares in the subsidiary.

45. We understand however that trading the investments in the asset inside through the shares is not the business of the parents in the fact pattern that we are addressing. Typically, they hold and operate the investment in the asset inside through the shares. Only if there is a good opportunity they might sell the shares in one of the subsidiaries and buy a new one with the asset inside. In other words,

the parent holds the shares in the single asset entity for a while before selling them.

46. During this period, the subsidiary, and with it the group for the consolidated financial statements, realises the income that triggers some of the tax payments represented by the deferred tax liability.

Concern 2 (reflect management intention)

47. Several commentators think that the determination of the tax base (ie the tax base of the asset inside or the shares) should reflect management intention, because management will act in the most economically advantageous way under normal circumstances.

Conflict with guidance in IFRSs

48. We think that an accounting that responds to this concern would conflict with the requirement to recognise (with exceptions that are not relevant in this context) deferred tax liabilities for all taxable temporary differences (see paragraphs 15 and 16 of IAS 12).

49. Consequently, we think that management's intention is not relevant in assessing the **recognition** of deferred tax liabilities. It is, instead, relevant for the **measurement** of the deferred tax liability (see paragraphs 51 and following of IAS 12).

Should the principle be amended?

50. We agree that accounting should generally reflect management's intention when management intention is relevant for future transactions.

51. However, reflecting management's intention is no justification for giving incomplete information. Not accounting for the tax effect related to the asset inside results in incomplete information if tax law attributes separate tax bases to the shares in the subsidiary and to the asset held by the subsidiary. Separate tax effects arise on both levels.

52. In particular, the deferred tax liability related to the asset inside represents future tax payments that result from achieving taxable inflows of economic benefits by

using the asset inside. These tax payments affect the value of the shares in the subsidiary (see paragraphs 41-43 of this Staff Paper).

Concern 3 (in substance the same)

53. Several commentators think that distinguishing between the asset inside and the shares in the entity does not reflect the commercial substance of the investment. The asset inside and the "corporate wrapper" are, in substance, the same. The single asset entity only exists for tax reasons or to limit the liability of the parent.

Conflict with guidance in IFRSs

54. We think that an accounting that responds to this concern would conflict with the guidance in paragraphs 11 and 38 of IAS 12. These paragraphs require distinguishing between the asset inside and the shares in the subsidiary in accounting for deferred taxes in the consolidated financial statements, if tax law distinguishes both assets.

Should the principle be amended?

55. We agree that the asset inside and the entity housing it should be assessed in combination if a single asset entity is established to house the asset inside for its economic life.

56. However, assessing the asset inside and the entity housing it in combination is no justification for ignoring or overriding economically relevant circumstances if this results in incomplete information. We think such incomplete information results from omitting the tax effect related to the asset inside (see paragraphs 39-43 of this Staff Paper).

Overall

57. We think the concerns presented in the previous paragraphs show that several constituents think that the application of IAS 12 results in significant overstatement of deferred tax liabilities and therefore in an incorrect presentation of the statement of financial position (especially for the investment property sector).

58. As explained in paragraph 43, we disagree with this concern in principle, because we think that the deferred tax liability related to the asset inside affects the value of the subsidiary holding it and therefore affects the value of the group.

59. However, we acknowledge that the presentation of the financial position of the group might be impaired, because deferred taxes are not measured at fair value or on a discounted basis (see paragraph 53 of IAS 12). This is in particular relevant for the investment property sector. Deferred tax liabilities related to investment property measured at fair value are significant in many cases. The effect of the time value of money related to deferred tax would be material because of the long periods over which the temporary differences usually reverse by use of the investment property.

Question for the Interpretations Committee

Question for the Interpretations Committee
1. Do the Interpretations Committee members have any questions or comments on the background information, status of the project or the analysis of the concerns raised?