IFRS

STAFF PAPER

September 2016

IFRS® Interpretations Committee Meeting

Project	**New items for initial consideration**
Paper topic	IAS 12 *Income Taxes*— Recognition of deferred taxes when acquiring a single-asset entity

CONTACT(S) Craig Smith csmith@ifrs.org +44 (0)20 7246 6462

54. Sitzung IFRS-FA am 03.11.2016
54_02a_IFRS-FA_Interpret_AP

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify how an entity applies paragraph 15(b) of IAS 12 *Income Taxes*—the exception from recognising deferred taxes on the initial recognition of an asset (the initial recognition exception). Specifically, the question relates to the acquisition of all of the shares of an entity that is not a business (applying IFRS 3 *Business Combinations*) and that has an investment property as its only asset.

2. The objective of this paper is to:
   (a) provide the Interpretations Committee with a summary of the issue and the staff's research and analysis; and
   (b) ask the Interpretations Committee if it agrees with the staff recommendation not to add this issue to its agenda.

Structure of the paper

3. This paper includes:
   (a) background information;
   (b) summary of outreach conducted;

(c) staff analysis;

(d) assessment against the Interpretations Committee's agenda criteria;

(e) staff recommendation; and

(f) questions for the Interpretations Committee.

4. Appendix A to the paper outlines the proposed wording of the tentative agenda decision. The submission is included in Appendix B to the Paper. In addition, Appendix C contains relevant extracts from Agenda Paper 19A, which was presented to the Board in May 2016.

Background information

5. In the transaction described by the submitter:

(a) an entity (Entity A) acquires all of the shares of another entity (Entity B). Entity B's only asset is an investment property that Entity B measures at fair value applying IAS 40 *Investment Property*. Entity B also recognises a deferred tax liability for the taxable temporary difference that arises from carrying the investment property at fair value.

(b) the purchase price is equal to the equity held by Entity B (ie the fair value of the investment property minus the carrying amount of the deferred tax liability). Accordingly, the purchase price is lower than the fair value of the investment property. For example, at the date of acquisition, Entity B's statement of financial position comprises an investment property with a fair value of CU100 (applying IAS 40) and a corresponding deferred tax liability of CU10. Entity A purchases the shares for CU90.

(c) the transaction does not meet the definition of a business combination applying IFRS 3. Applying the initial recognition exception in IAS 12, Entity A does not recognise a deferred tax liability on initial recognition of the investment property. Accordingly, Entity A allocates the entire purchase price (ie CU90) to the investment property in its consolidated financial statements.

(d) Entity A chooses to apply the fair value model in IAS 40 to measure the investment property after initial recognition. This results in Entity A recognising a gain (ie CU10) immediately after the initial recognition of the investment property (a day two gain). This is because the amount at which the investment property was recognised on initial recognition (ie CU90) was lower than its fair value (ie CU100). Applying IAS 12, Entity A would also recognise any resulting deferred tax liability.

6. We understand that these transactions are common in jurisdictions in which there may be greater tax advantages associated with the sale of shares compared with the sale of an individual investment property—for example, the sale of shares might be tax-exempt or be taxed at a rate that is substantively lower than the rate applied to the sale of an investment property.

7. The submitter questioned whether applying the requirements of IAS 12 would result in Entity A accounting for the transaction as described in paragraph 5 of this paper, or if Entity A should instead recognise the investment property at fair value (ie CU100) and a deferred tax liability (ie CU10) at the time it acquires Entity B.

8. The submitter said that recognising a day two gain (as described in paragraph 5(d) of this paper) would not reflect the underlying economics and would be inconsistent with the underlying rationale in IAS 12. If applying the requirements in IAS 12 resulted in an entity accounting for the transaction as described in paragraph 5 of this paper, the submitter suggested that the Interpretations Committee either:

(a) clarify that the requirements of paragraph 15(b)(ii) of IAS 12 are not for transactions that result in an entity recognising a day two gain (ie the initial recognition exception does not apply to such transactions); or

(b) amend paragraph 15(b) of IAS 12 to prohibit an entity from recognising a day two gain.

Summary of outreach conducted

9. To gather information about the issue described in the submission, we sent requests to securities regulators, members of the International Forum of Accounting Standard-

Setters (IFASS) and the global IFRS technical teams of the international networks of the large accounting firms.

10. We included the example described in paragraph 5 of this paper in our outreach request. In our outreach request, we asked:

> *Q1. How common is the issue in the stakeholder's jurisdiction?*
>
> *Q2. If the issue is common, is the predominant accounting treatment in the stakeholder's jurisdiction consistent with paragraph 5 of this paper?*
>
> *Q3. If the predominant accounting treatment in the stakeholder's jurisdiction is not consistent with the treatment in paragraphs 5 of this paper, what is the predominant accounting treatment, referring to specific requirements in IFRS Standards?*

Responses received

11. We received ten responses, from four national standard-setters; two organisations representing groups of regulators; and the global IFRS technical teams of four of the large accounting firms.

12. The views received represent informal opinions and do not reflect the formal views of those respondents.

13. Many respondents said that the transaction described in the submission is common in a number of jurisdictions, including several European countries, Israel, Brazil, Australia and India. In contrast, the transaction was not identified as being common in Canada, the United States of America and Japan.

14. A large number of respondents supported the accounting treatment outlined by the staff in the outreach request (ie the treatment described in paragraph 5 of this paper). They said this was the predominant treatment applied in their respective jurisdictions.

15. However, some respondents said they have observed some situations in which Entity A recognises both the investment property and the deferred tax liability in its consolidated financial statements on initial recognition (ie at the date Entity A

purchases Entity B). Some respondents who observed this accounting treatment said that the initial recognition exception in IAS 12 does not apply to this transaction. This is because Entity B recognises both the investment property and the deferred tax liability in its financial statements, and Entity A consolidates Entity B after the purchase (applying IFRS 10 *Consolidated Financial Statements*).

Staff Analysis

The requirements in IFRS Standards

16. IFRS 3 does not apply to the acquisition of an asset or a group of assets that is not a business. When an entity acquires an asset or a group of assets that is not a business, IFRS 3 requires a purchaser to allocate the purchase cost to the individual identifiable assets acquired and liabilities assumed on the basis of their relative fair values. Paragraph 2 of IFRS 3 states (emphasis added):

> This IFRS applies to a transaction or other event that meets the definition of a business combination. This IFRS does not apply to:
>
> …
>
> (b) the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38 Intangible Assets) and liabilities assumed. *The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.* Such a transaction or event does not give rise to goodwill.
>
> …

17. Paragraph 15 of IAS 12 requires an entity to recognise a deferred tax liability for all taxable temporary differences except in specified situations and states (emphasis added):

> A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
>
> …
>
> (b) the initial recognition of an asset or liability in a transaction which:
>
> *(i) is not a business combination; and*
>
> *(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).*
>
> ….

18. Paragraph 20 of IAS 40 requires an entity to measure an investment property initially at its cost. IAS 40 also requires an entity to choose either the fair value model or the cost model to measure its investment properties after initial recognition.

Application of the requirements in IFRS Standards

19. In the scenario described by the submitter, the purchase does not result in a business combination applying IFRS 3. Accordingly, applying paragraph 2(b) of IFRS 3, Entity A allocates the purchase price to the individual identifiable assets acquired and liabilities assumed when it acquires Entity B.

20. Paragraph 15(b) of IAS 12 specifies that when Entity A acquires Entity B, Entity A does not recognise any deferred tax liability for the taxable temporary difference previously recognised by Entity B. This is because any deferred tax liability would arise from the initial recognition of an asset (ie the investment property) by Entity A in a transaction that is not a business combination and which, at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

21. We think that the initial recognition exception in IAS 12 applies to this transaction, despite the fact that Entity B recognises a deferred tax liability in its financial

statements. This is because the requirements in IAS 12—including the initial recognition exception—are applied from the perspective of the reporting entity, Entity A. This entity has not previously recognised the investment property in its consolidated financial statements.

22. Accordingly, Entity A does not recognise the deferred tax liability in its financial statements and allocates the entire purchase price to the investment property. This is also consistent with the requirements of paragraph 20 of IAS 40, which requires an entity to measure its investment property at cost on initial recognition. The cost of the investment property is the purchase price of Entity B in this scenario.

23. Subsequent to initial recognition, applying the fair value model in IAS 40, Entity A measures the property at its fair value. In this scenario, the value of the investment property applying IAS 40 is higher than the purchase price of the shares of Entity B. Therefore, Entity A recognises a gain on remeasuring the investment property at fair value subsequent to initial recognition. Applying IAS 12, Entity A also recognises any resulting deferred tax liability (asset).

24. For the reasons outlined in paragraph 21 of this paper, we suggest that it is inappropriate for an entity to apply the accounting treatment described by some respondents in paragraph 15 of this paper—to recognise both the investment property and the deferred tax liability in Entity A's consolidated financial statements on initial recognition—when the transaction is not a business combination.

25. We think the requirements in IFRS Standards are clear with respect to this transaction, and result in an entity accounting for the transaction as described in paragraphs 19-23 of this paper. Responses to our outreach request indicate that the predominant accounting treatment is to apply the requirements in IFRS Standards as outlined in paragraphs 19-23 of this paper. Nonetheless, we next analyse whether the requirements in IFRS Standards should be amended to address the concern raised by the submitter.

Should the requirements in IFRS Standards be amended?

26. As outlined in paragraph 8 of this paper, the submitter suggests either:

   (a) clarifying that the requirements in paragraph 15(b)(ii) of IAS 12 are not met for transactions that result in an entity recognising a day two gain (ie the initial recognition exception does not apply to such transactions); or

   (b) amending paragraph 15(b) of IAS 12 to prohibit an entity from recognising a day two gain.

27. This issue arises because the asset bought and sold (ie the shares) is not the asset that the purchaser recognises in its consolidated financial statements (ie the investment property). In the scenario described by the submitter, it appears that the purchaser has effectively purchased the investment property together with the related deferred tax liability. However, paragraph 15(b) of IAS 12 prevents the purchaser from recognising the deferred tax liability resulting from the taxable temporary difference.

28. We understand that many of the requirements in IAS 12 were developed at a time when little fair value accounting took place. For example, the initial recognition exception in paragraph 15(b) of IAS 12 was introduced by the International Accounting Standard Committee (IASC), the Board's predecessor, in October 1996.

29. According to an IASC background document published with Exposure Draft E49 Income Taxes in 1995, the IASC created the initial recognition exception because it thought that consideration paid for a long-term asset implicitly takes into account the non-deductibility of the asset for tax purposes. In the scenario described in the submission, the purchase price for the shares of Entity B takes into account the difference between the tax base and the carrying amount/fair value of the investment property. In these circumstances, the IASC considered it inappropriate for an entity to recognise a deferred tax liability for which the related deferred tax expense would have to be either recognised as an expense immediately, added to the cost of the asset, or recognised as a separate asset. Therefore, the IASC decided not to permit the recognition of a deferred tax liability in respect of the origination of such temporary differences. However, the IASC did not create a similar exception which would apply

when an asset is subsequently measured at fair value, and that subsequent remeasurement results in a taxable temporary difference.

30. Some respondents to our outreach request said they have seen similar transactions with slight variations. For example, some respondents noted transactions in which the purchase price that an entity pays to acquire an entity with a single asset is greater than the fair value of the asset. This can occur if there are positive tax attributes associated with the entity being purchased—for example higher stamp duties on the purchase of properties than on shares. Applying the requirements of IFRS Standards to these transactions can result in the purchaser recognising a loss on subsequent measurement of the asset at fair value.

31. The Interpretations Committee has considered another issue relating to the recognition of deferred tax for a single asset in a single-asset entity. The agenda decision published in the IFRIC Update in July 2014 states:

> The Interpretations Committee noted that several concerns were raised with respect to the current requirements in IAS 12. However, analysing and assessing these concerns would require a broader project than the Interpretations Committee could perform on behalf of the IASB.
>
> Consequently, the Interpretations Committee decided not to take the issue onto its agenda but instead to recommend to the IASB that it should analyse and assess these concerns in its research project on Income Taxes.

32. We think that any project to amend IAS 12 to address the issue raised by the submitter would have to take into account different variations of the transaction (such as that described in paragraph 30 of this paper), and would have to consider other issues that arise when a single-asset entity is purchased. We think that these issues would be better considered by the Board as part of a more comprehensive review of IAS 12, or a review of particular aspects of IAS 12.

33. The Board considered feedback received on its research project on IAS 12 as part of its recent Agenda Consultation. Agenda Paper 19A for the Board meeting in May 2016 identifies and discusses a number of application issues identified regarding IAS

12. Paragraphs 43-45 of that paper specifically discuss application issues relating to the interaction of fair value measurement and the requirements in IAS 12 (including those that arise in the context of single asset entities, ie 'corporate wrappers'). Paragraphs 67-70 of that paper suggest various narrow scope amendments the Board could undertake to address these application issues, including those relating to fair value measurement and corporate wrappers. On the basis of the feedback on the Agenda Consultation, the Board concluded that a review of IAS 12 was not a higher priority than other projects, and decided not to add a project on IAS 12 to its work plan.

34. For ease of reference, Appendix C to this paper reproduces paragraphs 43-45 and 67-70 of Agenda Paper 19A for the Board meeting in May 2016.

35. Having considered the factors noted above, we recommend that the Interpretations Committee does not add a project to its agenda that would propose that the Board amend the requirements in IAS 12 to address the issue raised by the submitter.

Assessment against the Interpretations Committee's agenda criteria

36. Our assessment of the Interpretations Committee's agenda criteria is as follows:[1]

Paragraph 5.16 of the Due Process Handbook states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Met.** The outreach performed shows that these types of transactions are common in a number of jurisdictions. These transactions could have a material effect on those affected.

[1] These criteria can be found in the *IFRS Foundation Due Process Handbook* .

Paragraph 5.16 of the Due Process Handbook states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Not met.** The outreach indicates that the predominant accounting treatment is to apply the requirements in IFRS Standards as outlined in paragraphs 19-23 of this paper.
that can be resolved efficiently within the confines of existing IFRS Standards and the *Conceptual Framework for Financial Reporting*.	**Not met.** We think that the existing requirements in IFRS Standards are sufficient with respect to this issue. We also think that a project to amend the existing requirements in IAS 12 is too broad for the Interpretations Committee to address.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable
The solution developed should be effective for a reasonable time period (paragraph 5.21).	Not applicable

Staff recommendation

37. On the basis of our analysis, we think that the requirements in existing IFRS Standards enable an entity to account for the transaction described in the submission. On the basis of our assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee does not add this issue to its agenda.

38. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff recommendation not to add this issue to its agenda?
2. Does the Interpretations Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A
Proposed wording of the tentative agenda decision

IAS 12 *Income Taxes*—Recognition of deferred taxes when acquiring a single-asset entity

The Interpretations Committee received a request to clarify how an entity accounts for a transaction in which it acquires all of the shares of another entity that has an investment property as its only asset. In its statement of financial position, the acquired entity had recognised a deferred tax liability arising from measuring the investment property at fair value. In the fact pattern submitted, the amount paid for the shares is less than the fair value of the investment property and reflects the carrying amount of the deferred tax liability in the acquired entity's statement of financial position. The transaction described in the submission does not meet the definition of a business combination in IFRS 3 *Business Combinations*.

The Interpretations Committee noted that paragraph 15(b) of IAS 12 *Income Taxes* states that an entity does not recognise a deferred tax liability for taxable temporary differences that arise from the initial recognition of an asset or a liability in a transaction that is not a business combination and that, at the time of the transaction, affects neither accounting profit or loss nor taxable profit (tax loss). Accordingly, on acquisition, the entity recognises only the investment property and does not recognise a deferred tax liability. The entity allocates the purchase price of the shares to the investment property applying paragraph 2(b) of IFRS 3.

The Interpretations Committee concluded that the requirements in IFRS Standards provide an adequate basis to enable an entity to account for deferred taxes on the acquisition of the shares of another entity that has an investment property as its only asset.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee [determined] that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B
Submission

A1. The submission has been reproduced below. We have deleted details that would identify the submitter of this request.

…

We are enclosing our submission to the IFRS Interpretations Committee regarding the implementation of IAS 12 *Income Taxes* in cases of acquiring a company that does not constitute a business according to IFRS 3 *Business Combinations*.

Background:
Company A, a listed company, acquired 100% of Company B. Prior to the acquisition Company B's financial statements included a building that was classified as investment property measured at fair value and deferred tax liability. The deferred tax liability was recognized due to the revaluations of the investment property over the years. Company B does not constitute a business according to IFRS 3 *Business Combinations*. The consideration paid was an amount equal to the equity of company B, according to its financial statements (i.e. an amount that is less than the fair value of the investment property in a sum equals to the deferred tax liability).
Following the acquisition, company A implemented the following accounting treatment, According to IFRS 3, IAS 40 and IAS 12:
1. Since the transaction was treated as acquisition of an asset, and in light of IAS 12.15 according to which a deferred tax liability is not recognized in the acquisition of assets that is not a business combination, the entire consideration was allocated to the investment property.

2. As the amount in which the investment property was initially recognized was less than its fair value, it was revalued immediately after the initial recognition, and a revaluation gain was recognized, in an amount equals to the deferred tax liability that was not recognized.

The issue:
Can Company A recognize a gain in an amount equals to the deferred tax liability that was recognized in B's financial statements or should it recognize a differed tax liability (or other liability) and recognize the property in its fair value initially?

Current Practice
IFRS 3 does not apply to the acquisition of an asset or a group of assets that does not constitute a business.
According to IFRS 3.2(b): *"In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38 Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill."*
According to IAS 12.15 "*A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:*
…
(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss). However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39."

The reason for our submission
We have encountered the issue described above several times so we believe it is widespread. The gain recognized in this situation might have material effect on the financial statements.
To our understanding, the rational for paragraph IAS 12.15 is to avoid the recognition of "day one profits". This rational is not essentially met under the above described circumstances.
We believe that a clarification is required in order to avoid the recognition of "day one profits" when there is no economic substance that supports it.

Therefore, we suggest the following clarification:
1. A clarification by the IFRIC according to which - When "day one profit" is recognized just because a deferred tax liability is not recognizes when an asset is initially recognized, the exemption in IAS 12.15(b)(ii) is not met;

or
2. Amending the wording of 12.15(b), so that such a gain cannot be recognized.

We believe that the above described transaction does, ultimately, affect the accounting profit. The "day one profit" is a direct result of the transaction, as it arises from not recognizing the differed tax liability. Therefore, the exemption in IAS 12.15(b)(ii) is not met, and hence a deferred tax liability should be recognized.
…

Appendix C
Extracts from Agenda Paper 19A for the May 2016 Board meeting

A1. The following are extracts from Agenda paper 19A for the Board meeting held in May 2016:

…

Type Two—issues that arise because some believe IAS 12 may not fit well with recent standards or recent tax laws

Issues relating to fair value measurement (including corporate wrapper)

43. In some situations, a temporary difference arises when an entity initially acquires an asset. This is the case, for example, when:

(c) an entity acquires a building but the tax law does not allow any tax deduction for depreciation of the building (see Example 4); or

(d) an entity acquired a company (corporate wrapper) whose only asset is a building, which has already been depreciated within the corporate wrapper for tax purposes, earlier than for accounting purposes (see Example 5).

44. In some jurisdictions, the amount of tax payable on recovering the carrying amount of an asset depends on the manner of recovery. For example, in some jurisdictions capital gains are exempt from tax or subject to a lower tax rate. Applying paragraph 51 of IAS 12, deferred tax reflects the expected manner of recovery. In December 2010, the Board issued *Deferred Tax: Recovery of Underlying Assets* (Amendment to IAS 12). The amendment addressed the expected manner of recovering the carrying amount of investment property. However, it did not address the recovery of other assets, such as property, plant and equipment (paragraph 43(a)) or assets held by a corporate wrapper (paragraph 43(b)). The former issue exists only in a limited number of jurisdictions. However, the latter issue was raised by international accounting firms and is more widespread. In response to a submission in 2011, the Interpretations Committee staff conducted outreach and commented that the corporate

wrapper issue was pervasive in Europe and emerging in China.[2] Those issues are generally raised in the context of the expected manner of recovery in paragraph 51 of IAS 12. However, the staff think that those issues also contain more difficult issues such as fair value and tax effect, which are reflected in the following examples.

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

Example 4—Depreciation is non-deductible for tax purpose

Assume a building is located in Country A where depreciation is not deductible for tax purposes. The tax rate in Company A's jurisdiction is 28%. The fair value of the building is computed as follows in 20X5 (Year 1):

	Year 1	Year 2	Year 3	…	Year 49	Year 50
	CU	CU	CU		CU	CU
Rental income	5,000	5,000	5,050	…	6,000	6,000
Admin expense	(400)	(400)	(404)	…	(500)	(500)
Depreciation –tax deduction	0	0	0	…	0	0
Income taxes (28%)[3]	(1,288)	(1,288)	(1,301)	…	(1,540)	(1,540)
Net cash inflow	3,312	3,312	3,345	…	3,960	3,960
NPV@5%	**66,000**			…		

Case 1) Initial acquisition

Assume Company A purchases this building for its own use in 20X5 for its fair value of CU66,000. The entity recognised the building at CU66,000 and does not recognise any deferred tax liability (paragraph 15 of IAS 12).[4]

Case 2) Subsequent Revaluation

Assume Company B purchased the building in 20X4 for CU50,000 (ie fair value at the time of the purchase in 20X4) and chose to use the revaluation method in paragraph 31 of IAS16 *Property, Plant and Equipment*. It revalues the building to CU66,000 in 20X5. A deferred tax liability is not recognised for the initial temporary difference of CU50,000 but is recognised for a subsequent remeasurement gain of CU16,000 (66,000-50,000=16,000. 16,000*28%=CU4,480**)** (paragraph 20(a) of IAS12).

Case 3) Business Combination

Assume Company C purchases the same building in 20X5 in a business combination. The building is recognised at CU66,000 (paragraph 18 of IFRS 3) and a deferred tax liability is recognised for the entire temporary difference of CU66,000 (paragraph 24 of IFRS 3, paragraph 66 of IAS12). This also increases the carrying amount of goodwill by the same amount (66,000*28%=CU18,480).

[3] According to the result of our outreach to a valuation specialist, generally a value of a business asset is computed taking into consideration its tax effect.

[4] If US GAAP were applied, Topic 740-10-25-51 requires that the simultaneous equation method is used and the carrying amount of an asset is grossed up to 91,667 with a deferred tax liability of 25,667 for the initial temporary difference of 66,000 (91,667-25,667=66,000)

The balance sheets at the end of 20X5 are as follows:

	Case 1	**Case 2**	**Case 3**
	CU	**CU**	**CU**
Cash	10,000	10,000	10,000
Building	66,000	66,000	66,000
Goodwill	-	-	18,480
	76,000	**76,000**	**94,480**
Liability	10,000	10,000	10,000
Deferred tax liability	-	4,480	18,480
Equity	66,000	61,520	66,000
	76,000	**76,000**	**94,480**

In the above example, several questions arose, such as:

(a) Is the economic substance of the building held by Company A different from that of Company B or Company C?

(b) Companies A, B and C own the same building, which has the same amount of temporary difference. However, only Company B and Company C recognise deferred tax liabilities and the amounts recognised by Company B and Company C are different. Why?

(c) Some people say that the tax effect of disallowing the building's depreciation has already been reflected in the fair value of the building; therefore, recognising a separate deferred tax liability would double-count the same tax effect. Is this right?

(d) Is the goodwill arising from the business combination in Case 3 overstated?

Example 5—Corporate Wrapper

In the jurisdiction where Building X is located, annual depreciation deductible for tax purposes is equal to 10% of cost and taxable profit is subject to income taxes at 28%. However, any gain from selling shares in a company is taxed at 0%.

Properties are usually traded through selling and buying shares in a company whose only asset is the property (corporate wrapper). Estimates of fair value typically assume that any disposal will be of the corporate wrapper by the owner, and will not involve a disposal of the building by the corporate wrapper itself. Thus, the only tax payable within the corporate wrapper will arise on the rental income less depreciation.

Company A purchases, for CU74,475, Company B, which owns a single asset, Building X, at the beginning of Year 1. The tax base of Building X at that date was CU67,779, which was the original cost (CU75,310) less accumulated depreciation to date (CU7,531).

	Year 1	**Year 2**	**Year 3**	**…**	**Year 49**	**Year 50**
	CU	**CU**	**CU**		**CU**	**CU**
Income	5,000	5,000	5,050	…	6,000	6,000
Expense	(400)	(400)	(404)	…	(500)	(500)
Depreciation - tax deduction	(7,531)	(7,531)	(7,531)	…	0	0
Income taxes (28%)	0	0	0	…	(1,540)	(1,540)
Net cash inflow	4,600	4,600	4,646	…	3,960	3,960
NPV@5%	**74,475**					

At the end of Year 2, due to increased expected cash inflow, Company Y revalued Building X to 79,222.

	Year 3	**Year 4**	**…**	**Year 49**	**Year 50**
	CU	**CU**	**CU**	**CU**	**CU**
Income	5,800	5,800	…	6000	6,000
Expense	(440)	(440)	…	(500)	(500)
Depreciation tax deduction	(7,531)	(7,531)	…	0	0
Income taxes (28%)	0	0	…	(1,540)	(1,540)
Net cash inflow	5,360	5,360	…	3,960	3,960
NPV@5%	**79,222**				

Case 1—Subsequent fair value remeasurement

At the end of Year 2, Company A has the following temporary difference and recognises the following deferred tax liability:

	Inside Basis (a difference between the tax base of Building X—in Company B's jurisdiction—and its carrying amount)	Outside Basis (a difference between the tax base of shares in Company B —in Company A's jurisdiction—and their carrying amount)
Temporary difference	(79,222 – 52,717) =CU26,505	(83,110 –74,475) = CU8,635
Initial difference	CU7,531	-
Deferred tax liability recognised	(26,505-7,531)*28% = CU5,312	8,635*0% = CU0

Tax base of the building: 67,779-(7,531*2)=CU52,717

Carrying amount of the building (at fair value) = CU79,222

Tax base of the shares in Company B: CU74,475

Carrying amount of the shares in Company B (assume no dividends were paid out by the company): the carrying amount of the building + cash received after initial acquisition – deferred tax liability provided after initial acquisition = 79,222+4,600+4,600-5,312 = CU83,110

Case 2—Initial recognition

Assume Company C initially purchases Company B at the end of Year 2 and the purchase is considered not to be a business combination. No deferred tax will be recognised for the initial temporary difference: (paragraph 15 of IAS 12)

	Inside Basis	Outside Basis
Temporary difference	26,505	-(*)
Initial difference	26,505	-
Deferred tax liability	-	-

* The carrying amount of the shares in Company B = its tax base = CU79,222

Case 3—Business Combination

If the purchase in Case 2 is considered a business combination, the following deferred tax liability is to be recognised with an opposite entry to goodwill:

	Inside Basis	Outside Basis
Temporary difference	26,505	-
Initial difference	-	-
Deferred tax liability and goodwill	26,505*28% = 7,421	-

In the above example, several questions arose, such as:

a) Is the economic substance of Building X held by Company B different at the end of Year 2, depending on whether:

(i) it is initially acquired in an asset acquisition (Case 2);

(ii) it is subsequently re-measured to fair value (Case 1); or

(iii) it is initially acquired in a business combination (Case 3)?

b) Deferred tax liability is only recognised in Cases 1 and 3 and the amounts recognised are different. Why?

c) Some people say that the non-deductibility of the difference between the carrying amount and the tax base of Building X has already been taken into consideration in the fair value assessment process and the separate recognition of a deferred tax liability has double counted the tax effect. Is this right?

d) Is the goodwill arising from the business combination in Case 3 overstated?

45. According to a background document published by the IASC with Exposure Draft E49 in 1995, the IASC created the initial recognition exception in paragraph 15 of IAS12 because it thought that consideration paid for a long-term asset implicitly took account of the non-deductibility of the asset for tax purposes. If this is correct, a similar situation also arises in the subsequent remeasurement of a long-term asset at fair value. However, the IASC did not create another exception for the case of subsequent fair value measurement. The staff think that this may be because

subsequent fair value measurement was not so common in 1996. For example, IAS 40 *Investment Property*, which permits an entity to choose the fair value measurement of investment property, was issued only in April 2000.

…

Option 2: Narrow scope amendments to address some practice issues

67. The Board could undertake a series of narrow scope amendments to address some practice issues (mainly Type Two issues), for example:

    (a) to create an exception similar to the exception in paragraphs 15 and 24 of IAS 12 (initial recognition exception) but applying to some cases of subsequent fair value measurement, if the tax effect is already included in the fair value; and

    (b) to introduce the entity's expectation of future dividend payments in deciding the applicable tax rate, rather than simply to use the tax rate that applies to undistributed profits.

68. The Board could also choose this option to address some Type One issues. For example, it could consider using OCI to bridge between the result of the balance sheet liability approach and the result of another approach if the Board concludes that the former approach would produce less relevant information, in profit or loss, than the latter. This would not be completely consistent with the Exposure Draft *Conceptual Framework for Financial Reporting*, published in May 2015, because paragraph 7.24(a) of that Exposure Draft would not permit the use of OCI for assets that are not measured at current value. Arguably, this has some similarities to some of the Type One issues that arise when the tax base, as opposed to the carrying amount, of an asset is measured at current value.

69. The Board could undertake those narrow scope amendments on a selective basis, according to their priorities. The Board could also investigate the possibility of undertaking some narrow scope amendments after the post-implementation review of other IFRS Standards, such as IFRS 13 *Fair Value Measurement*.

70. According to the 2013 EFRAG Feedback Statement, many respondents supported an approach similar to Option 2. However, there were concerns that the more exceptions the Board creates in IAS 12, the more sceptical people would be about the usefulness of the main principles and that it would not be clear what the amendments would achieve if there is no overall vision of what the accounting model has to show. If the Board thinks that it would end up creating many exceptions by a series of narrow scope amendments, it should consider a fundamental change in the main principle, even though this has some disadvantages highlighted previously.

…