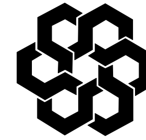

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **24 January 2007, London**

Project: **Short-term convergence income taxes**

Subject: **Investment allowances (Agenda paper 6)**

Introduction

1. This paper discusses a tax issue that has arisen relating to investment allowances. The background to the issue and the reasons for bringing it to the Board are set out in section 1. Section 2 analyses the issue in the context of existing IAS 12. Section 3 analyses the issue in the context of the proposed amendments to IAS 12.

2. The staff recommends that:

   a. no action be taken on this issue other than as part of the forthcoming amendments to IAS 12

   b. that a broad overview of the treatment of tax deductions and tax credits be developed in the short-term convergence project to ensure a coherent and converged approach is developed.

Background

3. A standard setter and a regulator have approached the IFRIC staff and two Board members for guidance on how to apply IAS 12 to a tax allowance in their jurisdiction. The allowance is given as an incentive to entities to encourage expenditure on qualifying projects/activities.

4. The allowance is given to entities after they have incurred qualifying expenditure on a qualifying project or activity. The rate of the allowance is 60% of the qualifying expenditure. So, if an entity incurred 10m on a qualifying fixed asset, it would be able to claim a total of 16m in tax deductions, 10m of 'normal' capital allowances and 6m of investment allowance.

5. The allowance is deducted from taxable income, after any other available capital allowances have been used. The amount of the allowance used in each tax assessment year is restricted to 70% of taxable income. Any unused amount of the allowance can be carried forward to future years to be used when there is sufficient taxable income.

6. If the asset is disposed of within two years of its date of acquisition, there is a 'claw-back' of the allowance.

7. The accounting standard on income taxes in the jurisdiction is based on IAS 12. The standard setter added a paragraph to its standard that required the allowance to be regarded as part of the tax base of the related asset. So, in the example above, on initial recognition the tax base of the 10m asset would be 16m. Because of the initial recognition exception in IAS 12, no deferred tax asset is recognised for the allowance. Instead, the benefit is recognised in the period(s) in which the allowance is used, resulting in a lower current tax expense.

8. This treatment has created extensive debate in the jurisdiction in question. The standard setter and the regulator asked the IASB to give its view on how the allowance should be treated under IAS 12.

Staff analysis under existing IAS 12

9. The staff has identified four possible ways of regarding the allowance under existing IAS 12, which give potentially very different answers:

    a. as an investment tax credit

    b. as part of the tax base of the qualifying asset

    c. as a tax credit

    d. as a special deduction.

10. Investment tax credits are scoped out of IAS 12 (IAS 12.4), although temporary differences that may arise from investment tax credits are covered. IAS 12 does not define or discuss investment tax credits beyond scoping them out. So whether the allowance is an investment tax credit is open to question. However, the scope exception in IAS 12 derives from a similar exception in US GAAP. [Rest of paragraph omitted from observer notes.]

11. Investment tax credits are also scoped out of IAS 20. The staff has not analysed how investment tax credits might be treated under the IFRS hierarchy given these scope exceptions.

12. Alternatively, the allowance could be regarded as part of the tax base of the qualifying asset. The tax base of an asset is defined as the amount attributed to that asset for tax purposes. IAS 12.7 explains that the tax base of an asset is the amount that will be deductible for tax purposes against any taxable consequences that will flow to the entity when it recovers the carrying amount of the asset. It could be argued that the amount attributable to the asset for tax purposes includes the allowances. This is the approach taken by the standard setter. Because the total tax deductions available relating to the asset are greater than the cost of the asset, there is a temporary difference on initial recognition of the asset. Under existing IAS 12, no deferred tax is recognised in respect of such temporary differences.

13. Next, the allowance could be regarded as a tax credit, which, like an investment tax credit, is not defined in IAS 12. Although the amount of the

allowance is determined by expenditure on qualifying assets, thereafter the allowance is not related to the asset. This is particularly true after two years when the allowance cannot be reclaimed on sale of the asset. The allowance is no different in substance to an unused tax credit. There is no exception in IAS 12 for the recognition of deferred tax assets relating to unused tax credits, assuming that it is probable that there will be future taxable profit against which it can be used. So, a deferred tax asset could be recognized under this approach.

14. Finally, the allowance could be regarded as what is known under US GAAP as a special deduction. IAS 12 does not discuss special deductions. Any potential deduction against taxable income that does not form part of the tax base of an asset or liability is covered by default by the requirement to measure tax assets and liabilities at the rate expected to apply[1]. A future deduction arising from the use of an existing unused allowance effectively reduces the tax rate that will apply in that future period. Because IAS 12 is silent on the matter of special deductions, it might be possible to argue that the effect of that reduction should be recognised upfront, ie that a deferred tax asset should be recognised for the allowance.

15. [Paragraph omitted from observer notes.]

16. The Statement of Best Practice: Working Relationships between the IASB and other Accounting Standard-Setters agreed earlier this year gives guidance on standard-setters issuing their own interpretations. The Statement says:

    IFRSs are intended to apply worldwide regardless of local legislative and regulatory environments. However, some issues may affect only one or two jurisdictions and may relate to particular legislative or other local requirements – for example, a tax law that is unique to a jurisdiction. In these cases, which are likely to be rare, other accounting standard-setters may decide to issue their own interpretations. Care needs to be exercised, however, to ensure that the issues are not more widely relevant. In considering their own issues, other accounting standard-setters should liaise with the IFRIC, and if they believe it

[1] Based on rates substantively enacted at the balance sheet date.

is necessary to issue an interpretation, they should avoid incompatibility with IFRSs.

17. The above statement had not been developed when the standard setter issued its standard. [Part of paragraph omitted from observer notes.] The staff therefore suggests that we consider the issue as part of the short-term convergence project. The standard setter and others can then put in their views as part of the comment process on the ED.

Staff analysis under the proposed amendments to IAS 12

18. The proposed amendments to IAS 12 include expanded definitions of and guidance on tax bases and on special deductions. An analysis of the allowance under those definitions/guidance is given below. The proposed amendments do not, as yet, include any definitions of an investment tax credit or a tax credit. The question of whether the allowance might be regarded as being as either is discussed in paragraphs 29-31 below.

19. The staff has also discussed the issue with the FASB staff. Their reaction is given in paragraph 34 below.

Tax base

20. The tax base of an asset is defined as:

> *Tax base* is the measurement, under applicable existing tax law, of an asset, liability, or equity instrument. That asset, liability, or equity instrument may be recognised for both tax and financial reporting purposes, for tax purposes but not for financial reporting, or for financial reporting purposes but not for tax.

21. The staff has also developed the following guidance to determine whether deductions should be anticipated in the tax base of an asset.[2]

> The tax base of an asset or liability is the amount that would be recognised in a balance sheet created using tax law as the basis for accounting. The tax law that shall be used is that applicable to the taxpayer given its elections, status, etc. under the provisions of the law.
>
> The tax base of an asset or liability is determined by the deductions that are available on its recovery or settlement. The expected manner

[2] The guidance was developed after discussions of various examples with the FASB staff. But the FASB staff has not yet considered the guidance itself (see paragraph 34).

> of recovery of an asset or liability does not affect its tax base. Deductions available only on a specified use of an asset are not anticipated in the tax base and are recognised when the asset is used in the specified manner. Deductions available only on the sale or scrapping of an asset are anticipated in the tax base.

22. In the case of the allowance, the staff understands that once expenditure on an asset qualifies for the allowance, the asset does not have to be used in a specific manner. But it is the case that, if the asset is disposed of within two years of its acquisition, the allowance to the extent claimed must be repaid. So the question is whether that potential clawback should preclude the allowance forming part of the tax base.

23. [Paragraph omitted from observer notes.]

24. If the allowance is treated as part of the tax base, it would give rise to an initial basis difference. If that difference is a temporary difference (ie if recovery of the carrying amount of the asset has taxable consequences), under the Board's proposals it would be treated as follows. The asset would be recognised at the fair value it would have if its tax base equalled fair value, a deferred tax asset would be recognised for the resulting temporary difference and a purchase discount allowance would be recognised for any difference between the purchase consideration and the total of the asset carrying amount and deferred tax balance. An example illustrating this is given in Appendix A.

Deduction not part of the tax base

25. If the Board does not agree with the staff analysis above that the allowance forms part of the tax base of the asset, the allowance will covered by default by the requirement to measure tax assets and liabilities at the rate expected to apply[3]. In considering how to determine that rate, the Board made the following decision:

> The rate used to measure tax assets and liabilities should include adjustments that depend on levels of taxable income or type of taxable income. No other tax rate reductions or tax deductions should be anticipated. The rate used should be a weighted average of the

[3] Based on rates substantively enacted at the balance sheet date.

possible rates applicable, based on rates enacted or substantively enacted at the balance sheet date.[4]

26. The amount of the allowance that can be used in any period is limited to 70% of taxable income but the amount of the allowance itself does not depend on levels of taxable income. Nor does it depend on the type of taxable income. Under the Board's proposals, therefore, it would not be anticipated in the rate used to measure tax assets and liabilities.

27. Consider the following example. An entity incurs expenditure of 100 on a qualifying fixed asset. The rate of investment allowance is 60%. So the entity can claim a total allowance of 160, 100 capital allowances and 60 investment allowance. The tax rate is 30%.

28. The asset would be recognised at 100 and its tax base would be regarded as 100. No deferred tax asset would be recognised for any unused investment allowance.

Treatment as a tax credit or investment tax credit

29. As noted above, the form of the allowance is a deduction against taxable income rather than a deduction against tax payable. As such, it might be thought clearly not to be a tax *credit* or investment tax *credit*. However, the staff notes that the same benefit that is given by the allowance could also have been structured as a tax credit. The staff argues that similar economic benefits should be treated in a similar way, regardless of their legal form.

30. However, if the allowance were treated as a tax credit, the asset in the above example would be recognised at 100 with a tax base of 100, leading to no temporary difference on initial recognition. The allowance would be recognised as a deferred tax asset of 18, assuming that it was probable that sufficient taxable profit would exist in the future against which it could be utilised.

31. If the allowance were treated as an investment tax credit, it would be scoped out of IAS 12. The possibility of removing that scope exception is discussed

[4] The FASB is yet to discuss this proposal.

in paragraph 35 below. If the scope exception were removed, investment tax credits would be treated as any other tax credit under IAS 12.

32. So, in summary, as under existing IAS 12, there are 4 possible treatments under the proposed amendment:

    a. As part of the tax base

    b. As a special deduction

    c. As a tax credit and

    d. As an investment tax credit.

33. Under the proposed guidance for a and b, no benefit is recognised in profit or loss at the time the allowance arises. Instead the benefit of the allowance is recognised when the allowance is used. Under c, the benefit is recognised in profit or loss at the time the allowance arises, assuming that it is probable that there will be sufficient taxable profit in the future for it to be used. Under d, if the scope exception remained, the IFRS GAAP hierarchy would apply.

34. The IASB staff has discussed the issue with the FASB staff. The FASB has not yet considered the proposed guidance on tax bases in paragraph 21 or the proposals on deductions that do not form part of the tax base (special deductions) in paragraph 25. The FASB staff indicated a desire to consider as one broad issue how different types of deduction should be treated, including:

    a. what the tax base is when different deductions are available depending on how the carrying amount of an asset or liability is recovered or settled,

    b. what deductions should be treated as special deductions

    c. whether any deductions should be treated as in substance tax credits or investment tax credits.

35. The IASB staff agrees that these issues should be considered together, as well as the possibility of removing the scope exception for investment tax credits. In particular, the guidance on the tax base in paragraph 21 was developed as

an attempt to converge with existing US GAAP and practice, rather than as part of a new look at the broader issue described above. The staff of both Boards is aware of the danger of scope creep in the project and does not wish to delay the project further. In developing the broad issue we will be mindful of the limits of a short-term convergence project. Nonetheless we think it is worth trying to establish a coherent approach to these issues.

36. The staff asks the IASB whether the allowance discussed in this paper causes them to reconsider any aspect of the guidance previously developed or whether they think any further guidance would be useful.

Appendix A: illustrative example of treatment of the allowance as part of the tax base

Facts

37. An entity incurs expenditure of 100 on a qualifying fixed asset. The rate of investment allowance is 60%. So the entity can claim a total allowance of 160, 100 capital allowances and 60 investment allowance. The tax rate is 30%.

Proposed treatment as part of the tax base

38. The staff has developed two scenarios. The first assumes that 100 is the fair value of the asset including an expectation of the investment allowance (ie including an expectation of total allowances of 160). Under the Board's proposals, the asset would be recognised at the fair value it would have if its tax base equalled fair value. Assuming for the sake of the example that there is no purchase discount allowance on the tax, that fair value would be 74 (arrived at using simultaneous equations[5]). A deferred tax asset of 26 would be recognised for 30% of the difference between the carrying amount of 74 and the tax base of 160.

39. The deferred tax asset would change over time as:

    a. the carrying amount of 74 is depreciated/amortised

    b. the capital allowances of 100 are received and

    c. the investment allowance of 60 is received.

40. The second scenario assumes that 100 is the fair value of the asset excluding an expectation of the investment allowance (ie assuming an expectation of total allowances of 100. The asset would be recognised at its fair value of 100. The deferred tax asset of 18 would be recognised for the deductible temporary difference of 60. A purchase discount allowance of 18 would be recognised

[5] x is the carrying amount of the asset, y is the deferred tax asset. $x+y=100$ and $y=30\%(160-x)$

(being the difference between the purchase price and the total of the asset and deferred tax asset).

	Dr	Cr
Dr asset	100	
Dr DTA	18	
Cr Purchase discount allowance (DTA)		18
Cr cash		100

41. The deferred tax asset would change over time as:

    a. the carrying amount of 100 is depreciated/amortised

    b. the capital allowances of 100 are received and

    c. the investment allowance of 60 is utilised.

42. The purchase discount allowance would be released as the investment allowance of 60 is utilised.