Project	**Annual Improvements – 2010 Cycle**
Topic	**IAS 12 *Income Taxes* - Tax effect of distributions to equity holders**

Purpose of this paper

1. This paper discusses a conflict between IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* in respect of the accounting for income tax consequences of distributions to holders of equity instruments.

2. This paper asks the IFRIC to consider as part of the *Annual Improvements Project* (AIP) a clarification that tax consequences of distributions to holders of equity instruments should be allocated to profit or loss with specific exceptions, in accordance with IAS 12.

3. This paper:

   (a) provides background information;

   (b) explains the issue;

   (c) analyses the issue raised in the context of IFRSs;

   (d) makes a staff recommendation for a proposed amendment to IFRS; and

   (e) asks the IFRIC whether they agree with the staff recommendation.

Background information

4. During the short-term convergence project on income tax, the staff received a request to resolve a conflict between paragraphs 52A and 52B of IAS 12 and

paragraph 35 of IAS 32 in respect of the accounting for the income tax consequences of distributions to holders of an equity instrument.

5. The Board proposed a change to IAS 32 to resolve the issue in the Exposure Draft *Income Tax* (“ED”) issued in March 2009. However, in October 2009, the Board indicated that it would conduct a limited scope project to amend IAS 12 rather than finalising the ED. The proposal included in the ED to resolve this issue will not be carried forward in that limited scope project.

The issue

6. Paragraphs 52A and 52B of IAS 12 states:

> 52A. In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.
>
> 52B. In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, *the income tax consequences of dividends are recognised in profit or loss for the period* as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b) (emphasis added)

7. On the other hand, Paragraph 35 of IAS 32 states:

> Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. *Distributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit.* Transaction costs of an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit. (emphasis added)

8. While IAS 12 generally requires recognition of income tax consequence of dividends in profit or loss, IAS 32 requires debiting the distribution directly to equity, net of any related income tax benefits. This creates a conflict between the standards.

Staff Analysis

Paragraph 52A and 52B of IAS 12

9. Paragraphs 52A and 52B of IAS 12 were introduced in 2000 in response to a question raised regarding when, and how, income tax consequences of dividends to shareholders of the enterprise should be accounted for. In the requesters' jurisdiction, undistributed profits were subject to a corporate tax rate of 45%, but distributed income was taxed at 30%.

10. Entities that paid dividends from previously undistributed income could receive a tax credit (or tax refund) equal to the difference between the tax computed at the undistributed rate and the tax computed at the distributed rate. Before the revision in 2000, IAS 12 was silent on the accounting for tax consequences of dividends.

11. At that time, the IASC concluded that it would not be appropriate to account for the tax consequences of the dividend as a deferred tax asset until the transaction that triggers the income tax refund (ie the payment of dividend) is recognised as a liability. Consequently, IAS 12 was amended to require an entity to measure tax assets and liabilities using the undistributed tax rate.

12. The revised standard also requires an entity to allocate the tax effect of dividends generally to profit or loss in accordance with the requirements in paragraph 58 of IAS 12.58, because the income tax consequences of dividends are more directly linked to the past transactions or events that generated them than the act of distribution to owners. Paragraph 58 states:

> Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:
>
> (a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A to 65); or
>
> (b) a business combination (see paragraphs 66 to 68).

Paragraph 35 of IAS 32

13. Paragraph AG 37 of IAS 32 provides guidance on paragraph 35 using an example of a compound financial instrument. In the guidance, entities are required to bifurcate a compound financial instrument into a liability component and an equity component. They would then recognise the unwinding of the discount relating to the liability component to profit or loss, and recognise any dividends paid relating to the equity component as an equity transaction.

14. The requirements in paragraph 35 were originally provided in SIC-17 *Equity - Costs of an Equity Transaction*, which was incorporated into IAS 32 in 2003. SIC-17 referred to paragraph 61 of IAS 12, which stated that current and deferred tax should be charged or credited directly to equity if the tax related to items that were credited or charged, in the same or different period, directly to equity.

15. The staff understand that the intention of paragraph 35 of IAS 32 was to follow the requirements under IAS 12 in accounting for tax consequence of costs of an equity transaction. It adopted the same view as paragraph 61, on the grounds that a separate tax asset or liability arose when dividends were paid.

16. However, IAS 12 treats this issue in paragraphs 51A and 52B similarly to a subsequent change in a tax rate, rather than as an intra-period allocation of a separate tax asset or liability. Paragraphs 51A and 52B are more specific requirements relating to tax on distributions. Consequently, the staff believe that paragraph 35 of IAS 32 should be amended to follow the requirements in paragraph 52A and 52 B of IAS 12 instead of paragraph 61A.

Staff recommendation

Annual Improvements criteria assessment

17. The staff believe that the most efficient way to resolve this issue is to amend IAS 32 through the annual improvements project. We believe that the issue

meets the annual improvements criteria because it is a necessary amendment to IFRSs, and the annual improvements process is the fastest way to address the issue.

18. The staff also believe that the best way to amend IAS 32 is for IAS 32 simply to require accounting for income tax in accordance with IAS 12, instead of addressing the specific accounting treatment for income tax on equity transactions in the standard. From this standpoint, the staff also recommend that sentences in paragraphs 35, 37 and 39 of IAS 32 that address tax accounting for transaction costs should also be amended. The proposed amendment wording is included Appendix A.

Effective date and transition

19. The staff propose that an entity shall apply the amendment retrospectively for annual periods beginning on or after 1 January 2012. Earlier application shall be permitted. If an entity applies the amendment for an earlier period it shall disclose that fact. The staff do not think that any transitional relief is necessary, because the proposed amendment is a clarification to confirm the current practice according to IAS 12.

Consequential amendments

20. Paragraph 11 of IFRIC 2 should also be amended because it refers to paragraph 35 of IAS 32 and contains the similar phrase (‘*distributions to holders of an equity instrument are recognised directly in equity, net of any related income tax benefit’*).

Question 1 for the IFRIC
Does the IFRIC agree with the staff’s analysis above?

Question 2 for the IFRIC
Does the IFRIC agree with the staff recommendation to the Board to add the issue to the Annual Improvements project?

Question 3 for the IFRIC
Does the IFRIC agree with the staff recommendation to the Board on the proposed amendment to IAS 32 in Appendix A?

Question 4 for the IFRIC
Does the IFRIC agree with the staff recommendation to the Board on the proposed effective date and transition?

Appendix A – Proposed amendment to IAS 32 *Financial Instruments: Presentation*

Paragraphs 35, 37 and 39 are amended (the amended paragraph is shown with the new text underlined and deleted text struck through).

35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be debited by the entity directly to equity~~, net of any related income tax benefit~~. Transaction costs of an equity transaction shall be accounted for as a deduction from equity~~, net of any related income tax benefit~~.

37 An entity typically incurs various costs in issuing or acquiring its own equity instruments. These costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity ~~(net of any related income tax benefit)~~ to the extent that they are incremental costs directly attributable to the equity transaction that would otherwise have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

39 The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately ~~under~~ in accordance with IAS 1. ~~The related amount of income taxes recognised directly in equity is included in the aggregate amount of current and deferred income tax credited or charged to equity that is disclosed under IAS 12 *Income Taxes*.~~

Paragraph 35A is added.

35A Income tax relating to distributions to holders of equity instruments and transaction costs of an equity transaction shall be accounted for in accordance with IAS 12.

Appendix B – Consequential amendment to IFRIC 2 *Member's Shares in Co-operative Entities and Similar Instruments*

Paragraph 11 of IFRIC 2 is amended (the amended paragraph is shown with the new text underlined and deleted text struck through).

11 As required by paragraph 35 of IAS 32, distributions to holders of equity instruments are recognised directly in equity, ~~net of any income tax benefits~~. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

Appendix C –Basis for conclusions on proposed amendment to IAS 32 *Financial Instruments; Presentation*

The basis for conclusions accompanies, but is not part of, the proposed amendment.

Income tax consequences of distributions to holders of equity instruments and of transaction costs of equity transactions

BC1 The Board was asked to rectify an inconsistency between IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* regarding the recognition of income tax relating to distributions to holders of equity instruments. Whereas paragraph 51B of IAS 12 requires the recognition of income tax relating to distributions to holders of equity instruments in profit or loss (with specific exceptions as required by paragraph 58 of IAS 12), IAS 32 requires the recognition of income tax relating to distributions to holders of equity instruments in equity.

BC2 The Board noted that the intention of paragraph 35 of IAS 32 was to follow the requirements in IAS 12 for recognising income tax relating to distributions to holders of equity instruments. Paragraph 35 of IAS 32 reflects the viewpoint of paragraph 61A of IAS 12 on the grounds that a separate tax asset or liability arose when dividends were paid. However, IAS 12 treats this issue in paragraphs 52A and 52B similarly to a subsequent change in an income tax rate, rather than as an intra-period allocation of a separate income tax asset or liability. Paragraphs 51A and 52B are more specific requirements relating to income tax relating to distributions to holders of equity instruments. Consequently, the Board concluded that paragraph 35 of IAS 32 should be amended to clarify that income tax relating to distributions to holders of equity instruments should be recognised in profit or loss, with specific exceptions in accordance with paragraph 51B of IAS 12

BC3 In making the amendment to paragraph 35 of IAS 32, the Board determined that the best way to amend IAS 32 is for IAS 32 to require accounting for income tax in accordance with IAS 12, instead of specifying the accounting treatment for income tax on equity transactions within IAS 32 itself. From this standpoint, the Board concluded that paragraphs 35, 37 and 39 of IAS 32 and paragraph 11 of IFRIC 2, which address specific accounting for income tax on transaction costs of equity transactions, should also be amended.