Project **Income Tax**

Topic **Property revaluation**

Purpose of this paper

1. This paper discusses deferred tax on property revaluations.

Summary of staff recommendation

2. The staff recommends that an exception be added to IAS 12 so that an entity does not recognise deferred tax on temporary differences on assets and liabilities if:

   (a) the assets and liabilities are measured at fair value and

   (b) a market participant acquiring the asset or assuming the liability for its fair value would have the same temporary differences.

   This means that an entity would continue to recognise deferred tax on temporary differences arising from remeasurement of assets and liabilities to the extent of any entity-specific temporary differences.

3. This paper contains:

   (a) an explanation of the issue

   (b) various arguments made by commentators

   (c) the staff analysis of the alternatives.

Explanation of the issue

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

4. When an entity measures an investment property at fair value under the fair value model in IAS 40, this creates a temporary difference, unless the remeasurement at fair value also results in an equal adjustment to the tax base of the asset at the same time (a similar temporary difference arises from revaluation of an asset under other IFRSs). Under IAS 12, the entity must first determine how it expects to recover the carrying amount of the property. That expectation determines the tax base of the asset and the applicable tax rate[1]. For example, if the entity expects to recover the carrying amount of the property by use (ie by receipt of future rental income):

   (a) the tax base is the amount of tax deductions available against future rental income and

   (b) the applicable tax rate is the tax rate applicable to the future rental income.

5. Consider how this principle would apply to temporary differences arising from remeasurement of a property at fair value in a jurisdiction where there is no capital gain tax on sale of the property. If an entity has measured a property at fair value and expects to recover its carrying amount through future rental receipts, it would have to determine the tax base and the applicable tax rate that apply to the rental receipts; the fact that there is no capital gain tax on the sale of the property does not change this conclusion.

6. However, constituents in jurisdictions where there is no capital gain tax on sale of properties argue that no deferred tax liabilities should be recognised regardless of the entity's expectation of the manner of recovery. Similarly, where gains on sale of the property are tax free but there is a tax on the claw back of previously claimed tax depreciation for the property, those constituents argue that deferred tax liabilities should be recognised only for the claw-back portion. Their arguments are set out in paragraph 8.

[1] This is different from US GAAP. Under US GAAP, the tax basis is firstly determined as a matter of fact according to a tax law. Then, a tax rate, based on the entity's expected manner of recovery, is applied to the difference between the carrying amount and the tax basis.

7. This issue does not arise under US GAAP because US GAAP does not allow remeasurement of investment property at fair value. US GAAP however measures assets and liabilities at fair value upon business combinations. The tax basis of those assets often is lower than their fair value. We have heard conflicting views on whether US GAAP practice results in the recognition of deferred tax in those circumstances.

Various arguments made by commentators

8. In jurisdictions where there is no capital gains tax, commentators typically make the following arguments to support their view:

   (a) In some jurisdictions, it is common that land is held under a very long term lease contract (50 to 999 years lease). Many commentators see such holdings as in substance equivalent to freehold land. Under SIC 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*, deferred tax for a temporary difference on non-depreciable assets (eg freehold land) is determined based on sale (hence, if gains on sale are tax free, deferred tax is not recognised). However, leasehold land is a depreciable asset so SIC 21 does not apply, and IAS 12 requires recognition of deferred tax to be based on management's expectation of the manner of recovery (often use). Some constituents argue that leasehold land should be treated in the same manner as freehold land.

   (b) Users of financial statements ignore the deferred tax liability on remeasurement of investment properties at fair value in jurisdictions where there is no capital gain tax. This is true even if the property is held for use and the entity is taxed on rental income from the use of the property.

   (c) The valuation technique used to determine the carrying amount of the property generally includes the tax effect arising from the use of

property. There is no need to recognise a deferred tax liability for the same tax effect.

Staff analysis

9. Regarding the argument in paragraph 8(a) (the analogy to the treatment of freehold land using SIC 21), SIC 21 was written based on an understanding that depreciation implies that the entity expects to recover the depreciable amount of a depreciable asset through use. Conversely, if the asset is not depreciated, no part of its carrying amount is expected to be recovered through use. The staff thinks that the SIC 21 deals with freehold land in a way that is consistent with IAS 12, because it considers the manner in which the carrying amount of the asset will be recovered. However, leasehold land is always depreciable because the term of the lease is always finite, albeit sometime very long. This means that some part of the carrying amount is recovered (consumed) in each period in which the property generates rental income. Hence, amending IAS 12 so that no deferred tax liability is recognised for temporary differences on leasehold land in the circumstances highlighted by some commentators (ie no income tax is payable on sale, but the entity expects to recover the carrying amount of the asset through use) would require a new exemption from the basic approach in IAS 12.

10. Similarly, the argument in paragraph 8(b) (arguably users ignore deferred tax in these circumstances) essentially challenges the existing 'expected' model under IAS 12 paragraph 52. Throughout IAS 12, deferred tax assets and liabilities are recognised and measured based on the manner in which the entity expects to recover (or settle) the carrying amount of an asset (or a liability). However, commentators argue that this does not provide useful information if gain on sale of the property is not taxed. Paragraphs 11-17 discuss whether any of the following approaches would, in the circumstances discussed in this paper, provide users with more useful information than they obtain from the existing approach:

(a) A sale approach whereby the deferred tax liability reflects the tax consequences of sale, regardless of whether an entity expects to recovery the carrying amount of the asset by sale or by use (paragraphs 11 to 14)

(b) A least cost approach, whereby a deferred tax liability is recognised at the least amount the entity could be required to pay in the future (ie the lower of the amount payable on recovery by sale and the amount payable on recovery through use). (paragraphs 15 and 17)

Sale approach

11. Under the sale approach, deferred tax liabilities are calculated at the amount that an entity would have to pay if it sold all of its assets and liabilities at the reporting date. This method would determine the tax base in a manner independent of management's expectations and would determine a tax rate consistent with that tax base. The ED proposed to determine the tax basis assuming sale of an asset. However, many respondents to the ED disagreed with the proposal. They thought the proposal would provide less useful information because the assumption under this approach was inconsistent with the going concern basis and the resulting amounts may not reflect the amount of tax that the entity will pay in the future. Many of them preferred to retain the 'expectation' approach under the current IAS 12. In the staff's view, changing to a 'sale' basis for all assets and liabilities would be a significant change to IAS 12, and beyond the reasonable scope of this project.

12. A more limited change would be to apply the sale approach only to assets and liabilities remeasured at fair value. The rationale behind this approach might be a view that fair value remeasurement of assets in IFRSs is, in substance, similar to a sale and immediate repurchase (ie a wash sale) of the assets. If there is no tax on capital gains, the sale would give rise to no tax liability. Furthermore, if a temporary difference arises on initial re-recognition of the asset following its repurchase, the entity would not recognise that temporary difference because of

the initial recognition exception in paragraph 15(b) of IAS 12. Thus, if no current tax or deferred tax liability would be recognised as a result of a wash sale, some would argue that no deferred tax liability should be recognised as a result of a remeasurement at fair value in similar circumstances. However, some could argue that other IFRSs do not state that a remeasurement at fair value should be viewed as equivalent to a wash sale.

13. Others argue that fair value is an amount assuming an exchange transaction and, therefore the tax effect arising from fair value measurement should be based on an exchange, which they regard as being a sale.

14. However, the objective of deferred tax accounting is not to recognise deferred tax based on how the carrying amount arose but to recognise a tax liability based on how the carrying amount of an asset will be recovered in the future. Providing an exception to the basic objective of the standard for remeasurement of assets and liabilities at fair value could be considered a fundamental change in IAS 12.

Least cost approach

15. Under the least cost approach, an entity would determine the tax consequences recovering an asset or settling liability assuming that the entity will recover or settle the asset or liability in the manner that will minimise the entity's tax liability.

16. The rationale behind this is the view that an entity only has a liability for tax that it cannot avoid paying. If the entity in fact does recover an asset or settle a liability in a manner that incurs more tax, it should recognise that cost in the period in which it recovers the asset or settles the liability in that less tax advantageous way.

17. The staff thinks that the least cost approach has some conceptual basis. However, there is no reason to limit this change just to remeasurement of assets and liabilities at fair value. If we change the measurement objective of IAS 12 to

an objective based on the least tax approach, it should apply to all assets and liabilities. That would be a fundamental change outside the scope of a limited project.

Approach based on the view that the tax effect is included in the carrying amount

18. As noted in paragraph 8(c), some respondents argue that the fair value of a property already includes some tax effects in some circumstances and hence it is not necessary to recognise a deferred tax liability in those cases. In addition, the staff notes that there may be a connection between this issue and the treatment of a temporary difference arising on the initial recognition of an asset.

19. Consider the following example of the initial recognition exception.

    An entity purchases an investment property for CU120. Tax deductions are available only to the extent of the original development cost of CU100, so there is an initial temporary difference of CU20 under IAS 12. Without the initial recognition exception, the entity would have to recognise a deferred tax liability of CU9 and the adjusted carrying amount of the investment property at CU129 using a simultaneous equation method (assuming the tax rate is 30%)[2]. However, IAS 12 requires an entity to recognise the investment property at CU120 without any deferred tax liability. IAS 12 states that it is more transparent to show the carrying amount of the asset as CU120 without any tax liability than as CU129 with a deferred tax liability of CU9.

20. We could apply similar thinking in a subsequent revaluation. Suppose an entity had acquired an investment property at a cost of CU105 (equal to its fair value at the date of acquisition). Suppose also that the tax base at initial recognition is only CU100, as in the previous paragraph.

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[2] This assumes that the entity uses the grossing up method required by EITF 98-11. CA-DTL=100, DTL=(CA-100)*30%, CA(carrying amount)=129, DTL(deferred tax liability)=9

21. Some years later, suppose the entity has claimed tax depreciation of CU40 (resulting in a tax base of CU60) and has remeasured the investment property to its current fair value of CU120. Currently, IAS 12 requires an entity:

    (a) not to recognise the deferred tax liability arising at initial recognition from the taxable temporary difference of CU5 at that date.

    (b) to recognise a deferred tax liability of:

        (i) CU4.5 ((20-5)*30%=4.5) [3] for the difference of CU15 that arises after initial recognition.

        (ii) CU12 (40*30%=12) for a temporary difference of CU40 resulting from past depreciation claimed for tax purposes.

22. Market participants acquiring the asset at CU120 would receive tax deductions of the original cost of CU100 and would measure the asset at CU120 with no deferred tax liability. The following table summarises this example.

	Initial recognition	Subsequent revaluation
Carrying amount	105	120
Tax base of market participants	100	100
Tax base of the entity	100	60
Temporary difference:		
- Entity specific	0	40
- Arising for other market participants	5	20

[3] The temporary difference of 5 that arose on initial recognition is covered by the initial recognition exception.

23. The staff thinks that this is the situation that causes some constituents to argue that the tax effect is double counted. The carrying amount of CU120 includes the effect of the temporary difference that would exist for market participants, just as the initial carrying amount of CU105 did. The staff thinks that the entity should be required to recognise a deferred tax liability only for the entity specific temporary difference (CU40 in the above table).

24. The staff is currently investigating the implications of similar cases for financial assets. The staff thinks that the same principles should apply, but will report back to the Board any problems that arise.

25. The staff thinks that this approach would provide consistency between accounting for income tax and fair value measurement. Further, it would not be a major change from the existing general approach in IAS 12 of looking at the expected manner of recovery. In addition, in the tax environments where this exception would be relevant, the same circumstances result in a temporary difference that is not recognised at initial recognition because of the exception in paragraph 15(b) of IAS 12. Thus, this approach would treat these circumstances consistently across initial recognition and subsequent measurement.

26. For the reasons given above, in the staff's view an approach based on the view that the tax effect is included in the carrying amount would:

    (a) provide an exception that would result in more transparent information than the existing treatment.

    (b) provide an exception only to cases which would also be exempt under the other approaches discussed in paragraphs 11 to 17 (sale approach and least cost approach). The staff noted that those other approaches would also provide an exception for temporary differences that a market participant would get. However, those exceptions would be broader and in the staff's view, are something that the Board should consider in the future. It is premature to adopt either of those

approaches now. But doing so in the future would not reverse any effect of the approach being considered here.

(c) be less likely to be seen as pre-empting a possible future fundamental review of IAS 12 because it derives from an exception already in the standard.

27. In adopting this approach, the Board should be aware that, unlike other approaches which might exempt entities from recognising a deferred tax liability for gains from property remeasurement in any tax jurisdictions, this exemption would be more limited. It would apply only to the extent that market participants would have the same tax base as the entity if they acquired the asset at fair value.

28. For example, in some jurisdictions, the amount of tax base available to market participants is the amount of the original development cost. This is the same as the entity's tax base, except to the extent the entity has received deductions which will be subject to claw-back in future. Therefore, the entity would recognise a deferred tax liability for previously claimed tax deductions that would be subject to claw-back, because to that extent the tax base differs from the tax base available to market participants.

29. Compare this with the situation in tax jurisdictions that provide tax deductions based on acquisition cost (the most common situation). In that case, if recovery of the asset is expected to generate taxable income, an entity would recognise deferred tax on revaluations for the temporary difference between the carrying amount (fair value) and its tax base, just as under existing IAS 12. This is because the temporary difference is entirely entity-specific: there is no temporary difference for a market participant acquiring the asset at fair value.

30. The staff considered whether an exception should be provided for all temporary differences arising on remeasurements of an asset or liability at fair value, ie for entity-specific temporary differences as well as those that a market participant acquiring the asset at fair value would have. But, as discussed above, the staff

could not find an approach that achieved that without making fundamental changes to IAS 12 that would not be appropriate in a limited scope project.

31. The staff therefore recommends that the Board proposes an additional exception to IAS 12 for temporary differences that arise on the remeasurement of an asset or liability to fair value, but only if a market participant acquiring the asset or assuming the liability for fair value would get the same temporary difference.

Question 1 – An additional exception for assets and liabilities measured at fair value
Does the Board agree that an exception should be added to IAS 12 for temporary differences arising from remeasurement of assets and liabilities at fair value to the extent that a market participant acquiring the asset or assuming the liability for its fair value would have the same temporary differences?