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Project **New item for consideration**

Topic **IAS12 Income Tax—Recognition of deferred tax for a single asset in a corporate entity**

Purpose of this paper

1. This paper discusses a question raised in a submission (see Appendix A) regarding the deferred tax relating to corporate wrappers.

2. This paper:

   (a) explains the issue;

   (b) provides background information;

   (c) analyses the issue raised within the context of IFRSs; and

   (d) makes a staff recommendation for the Committee's agenda decision.

Explanation of the issue

3. In some jurisdictions, it is common for investors to trade investment properties through exchange of shares of an entity holding a property (corporate wrapper) rather than direct sale of the property itself.

4. The reasons for trading the shares of the corporate wrappers vary but they are generally for legal, regulatory and tax reasons. For example, some entities use the corporate wrapper in order to protect them from potential lawsuits arising from the property. Some entities use the corporate wrapper because in some tax

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Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

jurisdictions, foreign corporations are prohibited or restricted from trading domestic real estate. Furthermore, in some jurisdictions, there is a tax benefit in trading shares of an entity rather than trading a property itself, because gains on sale of shares are tax-exempt or are taxed at a lower rate than a tax rate applied to sale of properties. For those reasons, entities in those jurisdictions generally trade shares of corporate wrappers rather than properties themselves.

5. IAS 12.51 provides a principle that the measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the entity expects, at the end of reporting period, to recover or settle the carrying amount of its assets and liabilities. When applying this principle to the case of the corporate wrappers, the question arises of whether or not the expected manner of recovering the asset in IAS12.51 should, under any circumstances, reflect disposal of the shares of the wrapper rather than disposal of the property itself. This is because, in many cases, entities do not expect to sell the property but, instead, they expect to sell the shares of the corporate wrapper.

6. A similar question also arises within the context of IAS12.11. In accordance with IAS12.11, the tax base is determined by reference to a consolidated tax return in those jurisdictions in which such a tax return is filed. It also states that in other jurisdictions, the tax base is determined by reference to the tax return of each entity in the group. Some constituents asked whether the tax base of the asset is the tax base attributed to the asset within the entity, or the tax base of the shares of the corporate wrapper because the asset will be realised by selling the shares.

7. This issue was originally raised by constituents in Europe. However, we were recently told that the issue is also emerging in other jurisdictions, particularly in China.

Background

8. This issue was first brought to the Interpretation Committee in 2005. The Committee decided not to take this issue onto its agenda, because the issue fell

directly within the scope of the IASB's short-term convergence project with the FASB on income tax. The Committee expected the IASB to issue an exposure draft some time in 2006.[1]

9. The IASB published the exposure draft on income tax in February 2009. However, proposals in the exposure draft were not well supported by constituents and, in November 2009, the IASB decided not to finalise the exposure draft. Instead, the IASB and the FASB indicated that they would conduct a fundamental review of the accounting for income tax in the future. The IASB, in the meantime, decided to conduct limited scope amendments to IAS 12 Income Tax. In March 2010, the IASB decided not to include the issue of the corporate wrappers within the scope of limited amendments to IAS 12.

10. In December 2010, before the issue of the amendments Deferred Tax: Recovery of Underlying Assets to IAS 12, the IASB acknowledged that the proposed amendments would not solve the practice issue relating to property revaluation in some jurisdictions, particularly in New Zealand. The IASB staff suggested a possible solution that might also solve the issue of the corporate wrappers. The IASB Chairman suggested, and the IASB supported the Chairman, that affected jurisdictions should be invited to develop solutions that would address the concerns they have, which the IASB could look at in the future[2].

Staff analysis

11. We have identified the following example as a case in which the issue typically arises.

The entity acquires a property in Year 1 for CU100 through acquiring all shares of a corporation whose sole asset is that property. The form of a corporation is used to trade the property in order to get tax or legal benefits. This structure is called a corporate wrapper in this example.

[1] IFRIC Update November 2005

[2] IASB Update 3 December 2010

> Assume that the acquisition of the corporate wrapper is not a business combination to be accounted for in accordance with IFRS 3 Business Combinations. The entity records the property for CU100 and no goodwill on its balance sheet. While the entity is able to claim a deduction for CU100 when it sells the shares of the corporate wrapper in the future, the corporate wrapper is also able to claim a deduction of CU60 through depreciation or upon sale of the property. As a result, the tax base of the property is CU60 and the tax base of the investment in the corporate wrapper is CU100. Although there is an initial temporary difference of CU40 (CU100-CU60) relating to the property, the entity recognises no deferred tax liability or asset because of the initial recognition exception in IAS12.15.
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> The entity classifies the acquired property as investment property and chooses the fair value model in accordance with IAS 40 Investment Property. Hence, any gains and losses arising from measuring the investment property at fair value are recognised in profit or loss. At the end of Year 2, the entity evaluates the shares of the corporate wrapper at CU120 and recognises a gain on measuring the investment property at fair value for CU20.
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> As a result of measuring the investment property at fair value, the entity recognises a taxable temporary difference of CU20. Because the initial recognition exception in IAS12.15 does not apply, the entity must recognise a deferred tax liability for a taxable temporary difference of CU20.

12. In the example above, the question arises as to whether or not the measurement of the deferred tax liability should be based on its expectation that the entity will sell the shares of the wrapper rather than selling the property. If the entity is able to measure the deferred tax liability based on its expectation to sell the shares of the wrapper rather than on an expected future sale of the property, it will be able to measure a deferred tax liability for a taxable temporary difference of CU20 at a tax rate applicable to the sale of the shares, rather than for a taxable temporary difference of CU20 (the total taxable temporary difference of CU60 less the initial temporary difference of CU40) at a tax rate applicable to sale (or use) of the property. A tax rate applicable to sale of shares is generally lower than a tax rate applicable to sale (or use) of properties. Some argue that calculating the deferred tax liability based on the expectation of selling the shares of the corporate wrapper than selling (or using) the property is a more faithful representation of the circumstances.

Are the requirements in IAS 12 clear?

13. IAS12.15 sets a principle that a deferred tax liability shall be recognised for all taxable temporary differences except for those that arise from;

    (a) the initial recognition of goodwill; or

    (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 not taxable profit (tax loss).

14. This paragraph also states that a deferred tax liability for certain differences associated with investment in subsidiaries, branches and associates and interests in joint arrangements shall be recognised in accordance with IAS12.39.

15. Paragraphs 24 and 44 provide similar requirements for a deferred tax asset.

16. Those paragraphs require that a deferred tax liability and a deferred tax asset must be recognised for both temporary differences relating to individual assets and liabilities (so called 'inside basis differences') and those relating to investment in subsidiaries, branches and associate and interests in joint arrangements (so called 'outside basis differences'). In the example above, therefore, it is clear that the entity is required to recognise a deferred tax liability for two different types of temporary differences. They are;

    (a) a temporary difference of CU20 (CU60-CU40) relating to the investment property (an inside basis difference). This is the difference between the carrying amount of CU 120 and the tax base of the investment property of CU60. However, the initial temporary difference of CU40 is excluded from recognition of deferred tax liability; and

    (b) a temporary difference of CU20 relating to the investment in corporate wrapper (an outside basis difference). This is the difference between the carrying amount of CU120 and the tax base of the investment in the corporate wrapper of CU100.

17. IAS12.51 provides a principle that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow the

entity's expected manner of recovery. In applying this principle to the example above, we think that it is clear that the expected manner of recovery of the asset should reflect the recovery of:

(a) investment property when measuring a deferred tax liability for the inside basis difference; and

(b) investment in the corporate wrapper when measuring a deferred tax liability for the outside basis difference.

18. Some argue that they do not have to recognise a deferred tax liability for (a) above because it does not expect to sell the investment property itself. However, an inherent assumption used in IAS 12 is that the entity will recover the carrying amount of an asset. Even though the entity does not expect to sell the investment property itself, it should be able to recover the carrying amount of the investment property through using it. We, think therefore, that IAS 12 is clear that the entity must recognise a deferred tax liability for both (a) and (b).

Is the result from applying the requirements in IAS 12 appropriate?

19. We think that some argue that they do not have to recognise a deferred tax liability for (a) above because of their concern on a fundamental principle in IAS 12 rather than on an ambiguity of applying the requirements in IAS 12. We think that, in their view, not recognising a deferred tax liability for (a) above would provide more relevant information and represent their circumstances more faithfully than recognising it.

20. Although we have not conducted thorough analysis of their concerns, we have identified the following views to support their argument;

(a) A deferred tax liability is an incremental tax liability resulted from creation of temporary differences. IAS 12 requires recognition of deferred tax liabilities as a result of fair valuing investment properties. However, in their circumstances, whether or not they measure the investment property at fair value does not change the amount of future tax that they will have to recognise on income or gains relating to the investment property, and

(b) Some people think that some tax effects are already included in fair value of the property. From their view, it would be double counting of the tax effects if a deferred tax liability is separately recognised as a result of fair valuing the investment property. We have included in Appendix C an example of a situation in which some think that tax effects are double counted.

21. In the 3 December 2010 extra Board meeting, we indicated a possibility that a potential solution to the practice issue in New Zealand might also respond to the concerns raised by constituents on the issue of the corporate wrapper. In that meeting, the Board did not discuss a way to resolve the issue in New Zealand, but instead it invited the affected jurisdictions to develop a solution with us in the future. Although it is not certain whether the Board will ultimately employ a solution that will also solve the issue of the corporate wrapper, we think that those issues are related. Therefore, we think that there is a possibility that this issue can be resolved through the Board project on Income tax.

Agenda criteria assessment for the Committee

22. The staff's preliminary assessment of the agenda criteria is as follows:

(a) *The issue is widespread and has practical relevance.*

Yes. This issue is pervasive in Europe and is also emerging in China.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

Yes. We understand that some accounting firms permit measuring a deferred tax liability on the basis of the entity's expectation of selling the shares of the corporate wrapper, in order to achieve a desirable result.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

No. We think that a cause of this issue lies in a fundamental principle in IAS 12. Therefore, we think that elimination of the diverse reporting

methods through a mere interpretation of the existing requirements in IAS 12 does not necessarily improve the financial reporting.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

No. We think that a cause of this issue lies in a fundamental principle in IAS 12. Therefore, we think that the issue cannot effectively be resolved within the confines of existing IAS 12.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

No. We think that a cause of this issue lies in a fundamental principle in IAS 12. Therefore, we think that the Board rather than the Committee should deal with this issue in the Board's project on income tax.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

No. This is a long-standing issue and is emerging in China too. However, we think that a cause of this issue lies in a fundamental principle in IAS 12. Therefore, we think that the Board rather than the Committee should deal with this issue in the Board's project on income tax,

23. As a result, we do not think that the issue meets the agenda criteria. Furthermore, we do not think that the issue would meet the enhanced annual improvement criteria, because resolving this issue would require a more fundamental change to the requirements in IAS 12 (eg creating another exception in IAS 12) than merely clarifying unclear wording or correcting obvious mistake in the standard.

Staff recommendation

24. We recommend that the Committee should not take this issue onto its agenda. This is because:

    (a) The requirements in IAS 12 are clear that the expected manner of recovery should reflect recovery of both:

        (i) investment property, when measuring a deferred tax liability for the investment property itself (ie an inside basis difference); and

        (ii) investment in a corporate wrapper when measuring a deferred tax liability for investment in the corporate wrapper (ie an outside basis difference); and

    (b) A more fundamental change to the requirement in IAS 12 than merely clarifying unclear words or correcting an obvious mistake is necessary in order to improve the financial reporting.

Questions to the Committee

25. The staff would like to put the following questions to the Committee:

Question 1—staff recommendation
Does the Committee agree with the staff recommendation not to add this issue to the agenda? If not, how does the Committee recommend the staff to proceed?

Question2—proposed wording for agenda decision
Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix B?

Appendix A—the submission

IAS12 –deferred tax and corporate wrappers

This is a long standing issue that has come back into focus following the amendment to IAS 12.

It is common for groups in some jurisdictions to hold some assets within a single asset entity ('corporate wrapper'). Such assets are usually bought and sold by buying and selling the shares of the entity. The tax consequences of selling the asset separately or selling the shares are different. There are different views about whether IAS 12.11 requires that the tax base of the asset is the tax base attributed to the asset within the entity or whether the tax base should reflect the tax base of the shares because the asset will be realised by selling the shares.

We wondered whether this might be clarified.

[Submitter]

Appendix B—proposed wording for agenda decision

IAS 12 *Income Tax*—Corporate wrapper

The Committee received a request for clarification relating to whether the expected manner of recovery in IAS12.51 should in any circumstances reflect disposal of the shares of the entity holding the asset (a corporate wrapper) rather than disposal of the asset itself. Specifically, the issue considered involved the measurement of deferred tax resulting from the subsequent measurement of an investment property at fair value.

The Committee observed that the question was asked because of an underlying concern relating to IAS 12 as to how deferred tax should be calculated for assets accounted for at fair value.

The Committee noted that the issue cannot be resolved efficiently within the confines of the existing IAS 12. The Committee also noted that a Board project on Income tax could possibly solve this issue effectively through either limited amendments to IAS 12 or a broader reconsideration of its principles.

Consequently, the Committee [decided] not to add this issue to its agenda,

Appendix C—example of a situation in which some think that some tax effects are double counted

1. Assume that Entity A owns the corporate wrapper through the following scenario:

> Entity A acquires a property in Year 1 for CU100 through acquiring all shares of a corporation whose sole asset is that property. The form of a corporation is used to trade the property in order to get tax or legal benefits. While a tax rate in the jurisdiction is 20%, gains on sale of shares are exempt from taxation. This structure is called a corporate wrapper in this example.
>
> Assume that the acquisition of the corporate wrapper is not a business combination to be accounted for in accordance with IFRS 3 Business Combinations. Entity A records the property for CU100 and no goodwill on its balance sheet. While Entity A does not have to pay a tax when it sells the shares of the corporate wrapper in the future, the corporate wrapper is able to claim a deduction of CU60 through depreciation or upon sale of the property. As a result, the tax base of the property is CU60 and the tax base of the investment in the corporate wrapper is same as its carrying amount (ie CU100). Although there is an initial temporary difference of CU40 (CU100-CU60) relating to the property, Entity A recognises no deferred tax liability or asset because of the initial recognition exception in IAS12.15.
>
> Entity A classifies the acquired property as investment property and chooses the fair value model in accordance with IAS 40 Investment Property. Hence, any gains and losses arising from measuring the investment property at fair value are recognised in profit or loss. At the end of Year 2, Entity A evaluates the shares of the corporate wrapper at CU120 and recognises a gain on measuring the investment property at fair value for CU20. Entity A also recognises a deferred tax liability of CU4 (CU20*20%) for the inside basis difference of CU 20 (CU120-CU60[3]-CU40). No deferred tax liability is recognised for the outside basis difference because sale of the share is tax exempt.

2. Also assume that Entity B owns an identical corporate wrapper in the following scenario:

> Entity B acquires a property in Year 2 for CU120 through acquiring all shares of a corporation whose sole asset is that property. The form of a

[3] Just to simplify, assume no depreciation is claimed in Year 1 for tax and financial reporting purtposes.

> corporation is used to trade the property in order to get tax or legal benefits. While a tax rate in the jurisdiction is 20%, gains on sale of shares are exempt from taxation. This structure is called a corporate wrapper in this example.
>
> Assume that the acquisition of the corporate wrapper is not a business combination to be accounted for in accordance with IFRS 3 Business Combinations. Entity B records the property for CU120 and no goodwill on its balance sheet. While Entity B does not have to pay a tax when it sells the shares of the corporate wrapper in the future, the corporate wrapper is able to claim a deduction of CU60 through depreciation or upon sale of the property. As a result, the tax base of the property is CU60 and the tax base of the investment in the corporate wrapper is same as its carrying amount (ie CU120). Although there is an initial temporary difference of CU60 (CU120-CU60) relating to the property, Entity B recognises no deferred tax liability or asset because of the initial recognition exception in IAS12.15.

3. Compare Entity A and Entity B at the end of Year 2. Both entities are in the same tax situation because both;

   (a) have the same carrying amount of property at fair value of CU120,

   (b) do not have to pay a tax when they will sell the shares of the corporate wrapper, and

   (c) are able to claim a deduction of CU60 against future rental income (or proceeds from sale of the property) when the corporate wrapper will receive rental income (or sell the property) in the future.

4. However, their accounting results are different because;

   (a) Entity A recognises a deferred tax liability of CU4, but

   (b) Entity B does not recognise any deferred tax liability because of the initial recognition exception.

5. This difference is not caused by the initial recognition exception in IAS12.15. This is because, if the initial recognition exception were not applied, IAS12.22 indicates that Entity B would recognise a deferred tax liability using a simultaneous equation method. That would have resulted in Entity B adjusting the carrying amount of the investment property to CU125 (not CU120) and recognising a deferred tax liability of CU5 (not CU4).

6. Some think that, in the example above, some tax effects are already included in the fair value of the property. They think that the tax effect from the temporary difference of CU60 (CU120-CU60) is already included in the fair value. This is because all the market participants who acquire the corporate wrapper at its fair value of CU120 will get a tax deduction of no more than CU60. Therefore, they think that all market participants should have taken it into account the tax effect of the temporary difference when they estimated the fair value. From their view, Entity A is double counting a part of the tax effect of the temporary difference by recognising a deferred tax liability of CU4.